UK Asset Resolution Limited
Annual Report & Accounts 2012

Registered in England and Wales under company number 07301961

UK Asset Resolution

Our Mission is:

‘maximising value for the taxpayer’

Contents

Chairman's statement

This is the second year of consolidated results for UK Asset Resolution Limited ('UKAR') which comprises the two Government owned mortgage firms of Bradford & Bingley plc ('B&B') and Northern Rock (Asset Management) plc ('NRAM') both of which are closed to new business and are in run-off. In 2012 we continued to make good progress in integrating the two businesses in order to maximise value for the taxpayer. We agreed medium term targets for value creation and loan repayments with our shareholder in 2011 and in the first two years of the scheme, covering 2011 and 2012, the target was exceeded.

In 2012 total remittances to the taxpayer including repayments of loans, interest, fees and corporation tax increased from £2.8bn to £4.0bn. This included the effect of increases in the interest rates paid on the Government loans which delivered an increased interest payment of £260m to the taxpayer. The increase to underlying profit was 25%, excluding these interest rate increases.

The lending standards of the two businesses that became UKAR in the period leading up to the financial crisis in 2008 were more relaxed than those applying to new loans in the market today, which is reflected in the general poor quality of the loan books taken on by UKAR. As a result, arrears levels have been higher as the economy deteriorated and redemptions on the books are lower as lending conditions make re-mortgaging with a third party difficult for many customers. However, the number of residential customers in arrears by more than 3 months continued to improve in 2012 and reduced from 33,200 to 25,600 contributing to the cost of loan impairment falling from £390m to £241m. Encouragingly, over 90% of our customers continue to be fully up to date with their loan payments. We are increasing our proactive early contact with customers who we identify as at risk of facing financial difficulty in order to help them manage their financial affairs.

In 2012 we completed the migration of our mortgage, financial, telephony and treasury systems onto single platforms, giving us an integrated business. This will be followed in 2013 with the replacement of our costly and unreliable legacy IT infrastructure and the completion of our withdrawal from our operations in Gosforth, Newcastle. Colleagues will then be working from two main sites at Doxford in Sunderland and Crossflatts in West Yorkshire.

Since the creation of UKAR we have been remediating a series of regulatory defects, the biggest of which was the mis-selling of Payment Protection Insurance ('PPI') by Northern Rock which, to date, has cumulatively cost around £360m. The announcement in December 2012 of remediation required in respect of a segment of our Northern Rock-sourced Consumer Credit Act ('CCA') regulated loans was hugely disappointing but we are obliged to refund interest charged during the period when NRAM was in breach of the CCA. This has incurred an exceptional cost of £271m which has been included in the 2012 accounts of NRAM. It is pleasing to note that even after charging this cost UKAR still achieved the profit target set at the start of the year.

We have spent the past two years remediating many, albeit smaller, operational defects that occurred within the former Northern Rock and we have commissioned an independent, external review by Deloitte to fully understand what went wrong in implementing the updated CCA regulations applicable from 2008. The Board has received a report from Deloitte, as part of their ongoing review, which concludes that the defects in CCA regulated loan letters and statements were created in 2008, before UKAR was established. These shortcomings were not identified or escalated to UKAR senior management before or at the time of handover. In July 2012, following the transfer of NRAM loans from Northern Rock to UKAR systems, the defects were identified and escalated to senior management who immediately initiated a full review of all CCA documentation. I would like to commend the diligent colleagues who alerted UKAR management to the omissions of information from the letters and statements. The former Northern Rock offered a huge and intricate product range and the complexity of managing this portfolio in a run-off cannot be underestimated. Many of the product features were not properly 'embedded' into the original computer systems requiring complex manual 'work-arounds'.

It is important to acknowledge colleagues across UKAR for their efforts and resilience in coping with so much change and complexity in 2012. It is very pleasing that over 150 colleagues working in Gosforth have moved or are moving to one of our two other main sites and we are working closely with those who are unable to move to give them the best start for their future career. I want to thank all colleagues, those who are in daily contact with our customers and those in the support areas, for their commitment and loyalty during such a difficult year. The efforts made in improving the arrears performance of the book are particularly notable. Three month arrears in B&B at 2.1% have now fallen well below the Council of Mortgage Lenders' national average and although NRAM three month arrears are still high at 6.4% they have fallen from 7.2% the previous year. These improvements are only possible through our teams working closely with customers to remedy poor payment performance.

Our end of year internal review of the performance of the Board was positive and concluded that its performance was satisfactory, demonstrating good collaborative team working. The job of being a Director of such a unique business is demanding, but the UKAR Board team have been very supportive, contributing broadly, challenging robustly when necessary and giving generously with their time and flexibility. We had to hold a lot of additional meetings when the CCA remediation issue arose and Directors made themselves readily available at short notice and contributed very wisely to what was a very difficult issue, where the failure to comply with the CCA had put the taxpayer at a disadvantage when there was no apparent customer detriment.

It was our intention to reduce the number of independent Non-Executive Directors in 2013, however, our shareholder representative, UK Financial Investments (‘UKFI’), has determined to increase their representation to two Non-Executive positions on the Board for a period, which is consistent with UKAR’s governance arrangements. In order to maintain a balance we have, therefore, decided to continue with five independent Directors during this period and I am grateful to Louise Patten for extending her contract to enable us to do this. The UKAR Board, therefore, comprises the Chairman, five independent Directors, two UKFI nominated Directors and two Executive Directors.

Richard Banks and his management team have once again done a superb job. We have seen many complex issues arising over the twelve months and the team have applied themselves with great determination and professionalism to finding solutions to them. I thank everyone involved with UKAR for their efforts in 2012 and look forward to continuing our progress in 2013.

When we launched UKAR in October 2010 we owed HM Treasury £48.7bn and by the end of 2012 that had reduced to £43.5bn. We still have a long way to go, but it remains our expectation and determination to repay that debt in full.

Richard Pym

Chairman

22 March 2013

Chief Executive Officer's review

Financial Performance

I am pleased to report that under the management of UKAR, both B&B and NRAM have again made excellent progress against their business objectives, surpassing all of the financial targets agreed with UKFI, for 2012. This year we paid HM Treasury £4.0bn (2011: £2.8bn) including £3.10bn (2011: £2.15bn) of principal on our loans from the Government, reduced arrears by 23%, reduced our costs by a further 6% and achieved £1,096.9m (2011: £1,089.1m) in underlying profits. Payments of interest to our shareholder increased as the interest rate on the NRAM Government loan was raised, adding to the increase in 2011 to the rate charged on the B&B working capital facility ('WCF'). These higher interest charges amount to around £260m year on year and demonstrate how we have strengthened and stabilised the business as we have brought together B&B and NRAM under UKAR ownership.

Business Model and Objectives

UKAR is responsible for managing NRAM and B&B, the two major Government wholly owned mortgage businesses now in run-off. In doing this we aim to maximise value for the taxpayer and have set ourselves a number of key goals:

- To reduce, optimise and protect the Balance Sheet;
- To maximise cost effectiveness though continuous improvement;
- To be excellent in customer and debt management; and
- To be a great place to work.

I am pleased to report notable achievement against these objectives during 2012.

Balance Sheet

Since UKAR was formed, in October 2010, the UKAR companies have repaid £5.2bn of Government funding, including £3.1bn in 2012. In addition, £0.5bn of liabilities were bought back in 2012 and £4.7bn of other funding repaid on maturity. These repayments have been funded largely from an 8.7% reduction in lending balances (£6.6bn) reflecting £4.6bn of secured residential redemptions, £0.2bn of unsecured redemptions, £0.1bn of commercial redemptions and £1.1bn of ongoing repayments. We also sold £465m of mortgages at full value to Virgin Money. As at 31 December 2012, lending balances stand at £68.7bn (2011: £75.3bn). In total, the Balance Sheet has reduced from £110.9bn at the end of 2010 to £86.9bn in 2012.

Costs

Operational integration of the two businesses has been completed leading to reduced costs and increased operational flexibility. Ongoing administrative expenses decreased to £207.3m (2011: £220.6m).

The process of transferring our IT infrastructure to a new provider continues and combined with our integration programme, will deliver very substantial annual cost savings of over £50m.

The withdrawal from our Gosforth site in Newcastle is on schedule for completion by mid-2013. We will then focus on our remaining two sites in the North East and West Yorkshire, allowing us to further integrate the two businesses, improve efficiency and control and reduce costs. The premises in Gosforth and two other non-core properties were sold in June 2012 at a price over book value to Virgin Money.

Debt Management

We have seen another year of substantial progress in our efforts to minimise impairment. The total number of mortgage cases three or more months in arrears, including those in possession, reduced by 23% year on year to 25,581 cases as at 31 December 2012 (2011: 33,216). The total value of arrears owed by customers has reduced year on year by £48.1m to £185.8m at 31 December 2012.

UKAR is not permitted to write any new mortgages or to allow customers to extend their mortgages beyond their written term. Consequently we work very hard to identify potential future issues within the loan books and aim to be proactive in approaching customers to offer to help them. In total, UKAR has almost 615,000 customers (2011: 702,000), with 587,000 mortgage accounts (2011: 638,000) and 228,000 unsecured personal loan accounts (2011: 278,000). In the main, these loans continue to perform well and over 90% are repaying on time. However, we do have a significant number of customers who are finding it difficult to meet their monthly payments and we work closely with them to offer a range of solutions to help them manage their circumstances.

During the year 48,000 arrangements successfully completed and approximately 4,000 account modifications were made in the year (2011: 7,350) to assist customers with their repayments and continue their existing mortgage. It is inevitable, over time, as we implement our strategy that the nature of the book will change. Those customers with stronger credit characteristics will be more able to find alternative mortgage providers and will leave, whilst those who are stretched financially or, for example, those with a higher loan to value will find this more difficult resulting in a decline in average credit quality in the remaining business.

UKAR aims for excellence in customer and debt management and during 2012, we continued to invest in proactive arrears management. We are concentrating our efforts on spending more time talking to customers about their financial situation, with a particular focus on customers with 'interest only' mortgages. This involves contacting customers to discuss their plans to repay their mortgage at the end of their term. For most this is not an immediate issue but the mortgage market and house price inflation have changed dramatically. Currently 56% of accounts are 'interest only' although 76% of these have over ten years until they are due to be repaid. However, there are now few 'interest only' products in the market and customers need to adapt to the new environment to ensure they meet their commitments and protect their homes. For those who do not have a repayment vehicle we discuss their options, for example, switching their mortgage to a part repayment basis enabling an element of capital reduction.

We also work with a range of debt advice agencies which provide free help to customers to reorganise their finances and ensure, wherever possible, that they can continue as homeowners. We are pleased to have received positive feedback on the newsletter we provide to the debt advice community, ARena, which is helping to raise awareness and understanding of who we are and our proactive engagement strategy. Research conducted by YouGov, commissioned by the Money Advice Service, shows that individuals who seek advice are twice as likely to have their debt become manageable within 12 months compared to those who do not. We are encouraged that as a result of our various initiatives, the number of UKAR customers referred to debt advice agencies has increased by almost 75% this year.

In some circumstances, however, the most appropriate course of action is for customers to sell their homes and we support this process wherever possible through assisted voluntary sales. In some situations repossession is the unfortunate outcome for some customers although this is viewed as a last resort. The number of properties taken into possession decreased from 8,848 in 2011 to 7,326 in 2012.

Where a buy-to-let ('BTL') landlord is in arrears we endeavour to protect tenants by honouring the terms of all valid Assured Shorthold Tenancy agreements and instructing a Law of Property Act ('LPA') receiver to collect rent directly from the tenant, thereby enabling the tenant to stay in the property for the duration of any agreement.

Treating Customers Fairly and Remediation

Our focus is very much on doing what is right for our customers as well as for the taxpayer. As a consequence, over the last two years we have spent considerable effort in remediating the past errors of Northern Rock and B&B. Notably, we conducted a past business review of Northern Rock's PPI sales post the implementation of ICOB, the Insurance Conduct of Business code published by the FSA. As part of this process we have now completed a contact programme with nearly 150,000 customers offering to review their PPI. To date we have repaid £269m to PPI customers and have provided a further £91m for future claims.

We have also conducted a series of remediation exercises on the mortgage book to correct a number of systems and process failures inherited by UKAR from the legacy NRAM and B&B businesses.

Most recently, following UKAR taking full systems control of the NRAM mortgage book, a number of shortcomings in the documentation and statements NRAM sends to its CCA regulated loan customers (ie those where the original loan amount was under £25,000) were identified. The CCA is prescriptive and the consequence of not complying precisely is that interest charged on the loans for the period of non-compliance must be remediated. Although no customer has suffered any financial detriment, we have commenced an exercise to correct the documents and statements and adjusting customers' outstanding balances in respect of the interest amount. This exercise will cost NRAM approximately £271m. Whilst this is unwelcome from a taxpayer viewpoint, we have had to do the right thing in terms of the regulation and our customers.

We are not remediating certain customers with loans that fall outside the limit of the CCA but who have been issued with CCA documentation in the past. We have obtained legal advice and have concluded that this is the correct course of action, but it is possible that this could, in the future, be tested in the courts and we have noted this contingent liability in the accounts.

Colleagues

Pleasingly, over 150 colleagues from our Gosforth site in Newcastle have agreed to transfer to one of our other sites at Doxford in Sunderland or Crossflatts in West Yorkshire. This is positive for both UKAR and our customers who will continue to benefit from our colleagues' detailed knowledge, experience and expertise. Colleagues who will be leaving the business as a result of the Gosforth closure are receiving outplacement support.

A comprehensive training and development programme throughout UKAR provides colleagues with the skills and specialist development opportunities to achieve their potential in order to help them do their job today and for any future roles. Since UKAR was formed over 100 colleagues have achieved an external qualification through the support of the UKAR training academy.

Training also extends to our Apprenticeship Scheme, introduced in 2010. We currently have 17 apprentices within the business and we are looking to recruit a further 20 apprentices during 2013. In 2012 we launched our first Undergraduate Placement Scheme.

Colleague engagement is important to us and we use a variety of channels for communicating including an intranet site, monthly team meetings and a quarterly magazine which is developed with the support of an editorial panel drawn from colleagues throughout the business.

UKAR has established a set of values for colleagues that underpin the way we do business, which are the behaviours and standards we adopt. Colleagues across the business were consulted for their views, through a series of manager events, colleague focus groups, surveys and interviews. This has ensured that everyone had an opportunity to have their say in the creation of our values. Each of our values has defined exemplar behaviours which help everyone to understand what the values mean and how they apply to what we do on a daily basis.

Community

UKAR allows colleagues time to attend charitable events or undertake volunteering work to promote knowledge and experience of working within a diverse community. During the year colleagues raised more than £15,000 for our corporate charity, NSPCC and over £41,000 for various other charities, including £22,500 for three charities voted for by our staff: Sue Ryder Manorlands Hospice in West Yorkshire, The Sir Bobby Robson Foundation and Tiny Lives Special Care Babies in the North of England.

Outlook

A year ago, with the sovereign debt crisis in the Eurozone threatening to derail the global economy, we were more cautious than most about the outlook for the UK. Although the official statistics show that the UK economy ended the year back where it started, the outlook is somewhat more positive than a year ago. Nevertheless, the recovery remains weak by historic standards and pressure on many households' finances remains acute.

At a national level, house prices have remained broadly stable for more than two years. There are significant regional variations but with market activity remaining subdued we expect house prices will be largely unchanged this year. Many of our borrowers find it difficult to access alternative finance. This is the case whether refinancing or moving home, although the Funding for Lending Scheme and the publication of the final Mortgage Market Review rules in H2 2012 led to some improvement in availability and pricing of mortgages, providing some relief. Steadily rising rents have also improved the outlook for many of our buy-to-let landlords.

The Consumer Price Index ('CPI') measure of inflation remains above its target level, with prices for many key goods and services elevated or continuing to rise. The labour market has proved more resilient than most commentators expected, however, with the number of part-time roles growing, wage growth remains subdued. We do not anticipate any change in interest rates this year – continuing welcome breathing space for home-owners seeking to 'rebalance' their budgets, but we remain focused on understanding our customers and helping those who experience difficulties to move their finances back to a sustainable footing.

Conclusion

UKAR has had a successful year completing the integration of the two businesses and delivering all our objectives. Colleagues have worked hard to help our customers and repay the taxpayer and I would like to thank them all for their efforts over the past 12 months and for their continued commitment to UKAR. I also wish to thank the Board and Executive management team for their ongoing support.

Richard Banks

Chief Executive Officer

22 March 2013

Case Study

> **"StepChange Debt Charity have been brilliant, providing regular budget plans and always on hand if I need them"**

Supporting customers in financial difficulty

Although the vast majority of UKAR customers are fully up-to-date with their mortgage payments, there are a significant number who experience financial difficulty. UKAR aims to support customers from the first sign of difficulty, offering a range of solutions to help them get back on track.

As part of our approach, we work in collaboration with a range of free, independent and impartial debt advice providers to give customers dedicated help and support. In 2012, we engaged a record numbers of customers with debt advisers, and in turn delivered better outcomes for customers and the taxpayer.

In 2012 we asked 3,500 customers for feedback following their engagement with a Debt Advice provider. 90 per cent of customers who responded said their debt levels had reduced as a result of their engagement with Debt Advice and 96 per cent of customers said they would recommend their Debt Advice provider to a friend or family member.

PayPlan Customer Testimony – UKAR customer:

'I have been really struggling with my mortgage payments due to lack of work in the building trade. With my wife out of work looking after our three young children the family budget has been stretched to breaking point and we have had to resort to pay day loans to make ends meet, I couldn't even afford to heat my home. When I fell into mortgage arrears I was frightened about losing our home and didn't know what to do.

Fortunately the mortgage company were very sympathetic about our situation and referred us to PayPlan to help us with all of our debts. PayPlan were fantastic – from the first call they reassured me there was still hope, they didn't judge me at all and focussed on solving the problem. They took me through all my income and expenditure and told me what I needed to pay as priorities to take care of my family. We now have a Debt Management Plan in place and peace of mind that in a few years we will be debt free, I cannot thank PayPlan enough.'

UKAR events since incorporation

2010: Oct Nov Dec

2011: Jan ... Dec

Formation of UKAR UK Asset Resolution (Oct 2010)

Balance sheet optimisation exercises

Buyback of Capital Instruments
Value added: £244m

Buyback of Capital Instruments
Value added: £382m

Infrastructure initiatives

Decommissioned B&B mainframe
Saving: £12m pa

Gosforth Site closure announced
Saving: £3m pa

Customer Redress Provision

Unsecured Loan PPI mis-selling
Amount: £155m

Published Annual Results

2010 Annual Results
Government loan repayments: £1.1bn
Underlying Profit: £444.1m
3 month+ arrears: 38,515
Mortgage book: £79.4bn

2011 Annual Results
Government loan repayments: £2.15bn
Underlying Profit: £1,089.1m
3 month+ arrears: 33,216
Mortgage book: £71.9bn

2012 | 2013

Jan Feb Jun Jul Dec | Jan March

Buybackof own debt
Value added: £144m

NRAM loan migration to UKAR platform
Saving: £20m pa

Termination of service arrangements with Virgin Money
Saving: £10m pa

Additional PPI provision
Amount: £130m

CCA Loans non-compliance
Amount: £271m

2012 Annual Results
Government loan repayments: £3.1bn
Underlying Profit: £1,096.9m
3 month+ arrears: 25,581
Mortgage book: £66.1bn

Key performance indicators ('KPIs') – UKAR

In addition to the primary Financial Statements, we have adopted the following KPIs in managing business performance in the context of the Group's strategic priorities:

Strategic priorities	Financial measures	2012	2011	Commentary
Optimise the Balance Sheet	Total lending balances £bn Secured £bn Unsecured £bn	**68.7** **66.8** **1.9**	75.3 72.8 2.5	Lending balances reduced by 8.7% during the year due to £4.6bn of secured residential redemptions, £0.2bn of unsecured loan redemptions, £0.1bn of commercial loan redemptions and £1.1bn of other capital repayments. In addition, £0.5bn of mortgages were sold to Virgin Money
	Residential mortgage redemption rate % Residential redemptions £bn	**6.3** **4.6**	8.1 6.5	Redemptions have fallen relative to 2011 reflecting the characteristics of the book and the low levels of remortgage activity across the market.
	Government loan repayments £bn Government loan balance £bn	**3.10** **43.5**	2.15 46.6	£1.4bn repaid against the B&B Working Capital Facility ('WCF') and £1.7bn on the NRAM Government Loan.
	Total cash payments to HM Treasury £bn	**3.97**	2.84	Total cash paid to HM Treasury during the year. This includes principal and interest repayments, guarantee fees and corporation tax paid. The main driver of the increase year on year is the higher repayments of loan principal.
Minimise impairment and losses	Residential arrears balance: total residential mortgage balance % Residential payments overdue £m	**0.28** **185.8**	0.33 233.9	This represents the value of customers' missed payments as a proportion of the total balance of all residential mortgages and reflects that the level of debt owed on mortgages is falling at a quicker rate than the reduction in the book.
	Residential arrears 3 months and over and possessions as % of the book: - by value - by number of accounts Number of residential arrears 3 months and over and possessions cases	 **5.54** **4.36** **25,581**	 6.61 5.21 33,216	The reduction in arrears reflects both the improvement in collections performance and the continuing support provided to mortgage customers of low interest rates.
	Impairment provisions: Residential secured £m Cover % Unsecured £m Cover % Commercial/other £m Cover %	 **1,411.1** **2.09** **403.8** **17.56** **100.0** **11.34**	 1,644.5 2.24 501.6 16.58 102.2 10.65	The level of residential impairment Balance Sheet provision reduced by £233.4m due to improved arrears performance. Cover on the residential secured book has fallen primarily reflecting the reduction in arrears levels. Coverage on the unsecured book has increased to 17.56% (2011: 16.58%) and on commercial loans this increased to 11.34% (2011: 10.65%).
Reduce costs	Total costs £m Ongoing costs £m* Ratio of costs to average interest-earning assets: - statutory % - ongoing %*	**267.0** **207.3** **0.32** **0.25**	285.8 220.6 0.30 0.23	The reduction primarily reflects the benefits of implementing common systems across UKAR.

* Ongoing costs exclude certain items that are not expected to recur on an ongoing basis; an analysis of items excluded from ongoing costs is provided on page 16.

Financial review

Performance

In 2012, UKAR increased underlying profits by £7.8m to £1,096.9m (2011: £1,089.1m) having also absorbed increases on the interest rates charged on Government loans which had a combined year on year impact of c.£260m. The increase in profits was primarily due to lower loan impairment and investment impairment charges, which outweighed the impact of a full year of interest charged on the B&B WCF at the higher rate introduced in August 2011 (c.£165m) and the increase on the NRAM Government loan with effect from 4 May 2012 (c.£95m).

Compared to 2011, underlying net operating income was £243.5m lower at £1,515.4m (2011: £1,758.9m) due to the increased rates on Government funding and a reducing Balance Sheet, partly offset by increasing yields on assets. Ongoing administrative expenses reduced by £13.3m (6.0%) to £207.3m (2011: £220.6m). Impairment on loans to customers reduced by £149.0m to £241.4m (2011: £390.4m) and net impairment on investment securities was £89.0m better, being a £30.2m credit (2011: a cost of £58.8m). The number of mortgage accounts 3 or more months in arrears including possessions reduced by 23% compared to 2011.

The Board continue to believe it is appropriate to assess performance based on the underlying profits of the business, which excludes non-recurring costs, particularly those associated with the integration of B&B and NRAM and the remediation of inherited regulatory defects and certain gains such as the repurchase of our own liabilities at a discount. Also excluded are movements in fair value and hedge ineffectiveness relating to financial instruments which are expected to be held to maturity as opposed to being traded. The commentary on the results in this statement uses underlying profits and its components as the measure of performance. An analysis of the difference between the statutory profit and the underlying profit of UKAR is provided below.

The Board has decided to change the Group's accounting reference date from 31 December to 31 March. This is in order to align to the reporting year end of our parent, HM Treasury. Therefore, the Group's next Annual Report and Accounts will cover the 15 months to 31 March 2014. Prior to that, the Board intends to publish Interim Financial Reports for the periods to 30 June 2013 and 30 September 2013.

Income Statement

	UKAR		B&B		NRAM	
For the year ended 31 December	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Net interest income	**1,484.9**	1,722.4	**323.1**	458.4	**1,161.7**	1,264.0
Underlying net non-interest income*	**30.5**	36.5	**19.4**	17.6	**11.2**	18.9
Underlying net operating income	**1,515.4**	1,758.9	**342.5**	476.0	**1,172.9**	1,282.9
Ongoing administrative expenses	**(207.3)**	(220.6)	**(93.4)**	(103.9)	**(113.9)**	(116.7)
Impairment on loans to customers	**(241.4)**	(390.4)	**(62.1)**	(79.4)	**(179.3)**	(311.0)
Net impairment on investment securities**	**30.2**	(58.8)	**51.1**	6.5	**(3.7)**	(65.3)
Underlying profit before taxation	**1,096.9**	1,089.1	**238.1**	299.2	**876.0**	789.9
Unrealised fair value movements on financial instruments	**(42.8)**	79.2	**(6.6)**	68.3	**(36.2)**	10.9
Hedge ineffectiveness	**(28.4)**	(85.2)	**(9.4)**	(59.0)	**(19.0)**	(26.2)
Other net administrative expenses	**(59.7)**	(65.2)	**(24.0)**	(25.0)	**(35.7)**	(40.2)
Provision for customer redress	**(419.0)**	–	**(12.0)**	–	**(407.0)**	–
Gain on repurchase of own liabilities	**143.5**	338.1	**27.6**	151.0	**115.9**	187.1
Profit on disposal of credit linked notes	**–**	15.6	**–**	–	**–**	15.6
Defined benefit pension scheme gains	**–**	3.5	**–**	–	**–**	3.5
Statutory profit before taxation	**690.5**	1,375.1	**213.7**	434.5	**494.0**	940.6

* Underlying net non-interest income includes net fee and commission income, net gains on financial instruments designated at fair value, net realised gains less losses on investment securities and other operating income.
** UKAR numbers include consolidation adjustments.

Financial review (continued)

Net interest income

For the year ended 31 December	UKAR 2012 £m	UKAR 2011 £m	B&B 2012 £m	B&B 2011 £m	NRAM 2012 £m	NRAM 2011 £m
Interest receivable and similar income						
On secured loans	**2,426.2**	2,472.5	**884.8**	922.1	**1,541.4**	1,550.4
On other lending	**111.2**	143.7	**–**	–	**111.2**	143.7
On investment securities and deposits	**86.6**	116.8	**31.5**	38.9	**56.9**	80.0
Interest receivable and similar income	**2,624.0**	2,733.0	**916.3**	961.0	**1,709.5**	1,774.1
Interest expense and similar charges						
On amounts due to banks and HM Treasury	**(676.2)**	(475.6)	**(426.1)**	(295.3)	**(250.1)**	(180.3)
State guarantee fee**	**(47.4)**	(74.9)	**(47.4)**	(74.9)	**–**	–
Other	**(415.5)**	(460.1)	**(119.7)**	(132.4)	**(297.7)**	(329.8)
Interest expense and similar charges	**(1,139.1)**	(1,010.6)	**(593.2)**	(502.6)	**(547.8)**	(510.1)
Net interest income	**1,484.9**	1,722.4	**323.1**	458.4	**1,161.7**	1,264.0
Average balances						
Interest-earning assets ('IEA')	**84,117**	94,929	**36,968**	39,570	**47,280**	55,501
Financed by:						
- Interest-bearing funding	**59,769**	71,610	**15,643**	18,528	**44,262**	53,239
- Interest-free funding *	**24,348**	23,319	**21,325**	21,042	**3,018**	2,262
Average rates %	**%**	%	**%**	%	**%**	%
Gross yield on IEA	**3.12**	2.88	**2.48**	2.43	**3.62**	3.20
Cost of interest-bearing funding	**(1.83)**	(1.31)	**(3.49)**	(2.31)	**(1.24)**	(0.96)
Interest spread	**1.29**	1.57	**(1.01)**	0.12	**2.38**	2.24
State guarantee fee**	**(0.06)**	(0.08)	**(0.13)**	(0.19)	**–**	–
Contribution of interest-free funding*	**0.54**	0.32	**2.01**	1.23	**0.08**	0.04
Net interest margin on average IEA	**1.77**	1.81	**0.87**	1.16	**2.46**	2.28
Annual average Bank Base Rate	**0.50**	0.50	**0.50**	0.50	**0.50**	0.50
Annual average 1-month LIBOR	**0.62**	0.65	**0.62**	0.65	**0.62**	0.65
Annual average 3-month LIBOR	**0.83**	0.88	**0.83**	0.88	**0.83**	0.88

* Interest-free funding is calculated as an average over the financial period, and includes the Statutory Debt and share capital and reserves.
** At the time of the nationalisation of B&B, HM Treasury provided a guarantee with regard to certain wholesale borrowings and derivative transactions existing at that time. The amount of this fee is dependent on balances outstanding, and hence it is included within 'interest expense and similar charges.'

Financial review (continued)

Net interest income for the year was 13.8% lower at £1,484.9m (2011: £1,722.4m). The biggest factors driving this movement were the changes in the interest rates paid on the B&B WCF and the NRAM Government loan, with a combined impact of c.£260m. In addition, the lower Balance Sheet size reduced interest income as average interest-earning assets fell by £10.8bn to £84.1bn broadly offset by higher yields on assets, primarily as mortgage accounts revert to standard variable rates.

Net interest margin has reduced to 1.77% (2011: 1.81%) at UKAR level, the impacts of the increases on the pricing of Government loans outweighing the increase in margins due to higher yields.

On the B&B book the main driver of the 0.29% reduction in the net interest margin to 0.87% (2011: 1.16%) was the full year impact of the increase in the interest rate payable on the WCF which increased by 3.50% in August 2011, costing approximately £165m additional interest compared to 2011, partly offset by higher yields on assets.

In NRAM, net interest margin increased to 2.46% (2011: 2.28%), mainly due to the benefit of maturing fixed rate mortgages reverting to a standard variable rate at the end of their deal period. This was partially offset by the higher cost of £95m following the increase in the interest rate payable on its Government loan which was increased from Bank Base Rate ('BBR') + 25bps to BBR + 100bps with effect from 4 May 2012.

Underlying net non-interest income

Underlying net non-interest income fell by £6.0m to £30.5m (2011: £36.5m), primarily due to lower redemption fees, lower fees as transitional servicing arrangements with Virgin Money and JP Morgan ended and lower rental income following the sale of the Gosforth site.

Net non-interest income

	UKAR		B&B		NRAM	
For the year ended 31 December	2012 £m	2011 £m	2012 £m	2011 £m	2012 £m	2011 £m
Total net fee and commission income	**17.0**	28.8	**14.4**	17.3	**2.7**	11.5
Net gains on financial instruments designated at fair value	**17.5**	–	**–**	–	**17.5**	–
Net realised gains less losses on investment securities	**(14.9)**	(1.2)	**1.4**	–	**(16.3)**	(1.2)
Other operating income	**10.9**	8.9	**3.6**	0.3	**7.3**	8.6
Underlying net non-interest income	**30.5**	36.5	**19.4**	17.6	**11.2**	18.9
Unrealised fair value movements on financial instruments	**(42.8)**	79.2	**(6.6)**	68.3	**(36.2)**	10.9
Hedge ineffectiveness	**(28.4)**	(85.2)	**(9.4)**	(59.0)	**(19.0)**	(26.2)
Provision for customer redress	**(419.0)**	–	**(12.0)**	–	**(407.0)**	–
Statutory net non-interest income	**(459.7)**	30.5	**(8.6)**	26.9	**(451.0)**	3.6

Accounting volatility on derivative financial instruments

NRAM and B&B use derivative financial instruments for economic hedging purposes. Most of these are designated and accounted for as IAS 39 'Financial Instruments: Recognition and Measurement' compliant fair value or cash flow hedge relationships. Where effective hedge relationships can be established, the movement in the fair value of the derivative is offset in full or in part either by opposite movements in the fair value of the instrument being hedged or by being taken to reserves. Any ineffectiveness arising from different movements in fair value will offset over time.

Unrealised fair value movements were a net loss of £42.8m in the year (2011: gain of £79.2m) generally relating to derivatives that act as an economic hedge but were not treated as an accounting hedge under IAS 39. The majority of these movements occurred prior to the establishment of new accounting hedges in the first half of 2012.

In NRAM, a cash flow hedge relationship was established on 1 June 2012 with the losses to this date mainly attributable to the movement in the value of the basis swaps, due to the narrowing of LIBOR over BBR.

In B&B, basis swaps were designated into a cash flow hedge at 1 March 2012, therefore, movements after this date have been recognised in reserves, however, prior to this date the narrowing of LIBOR over BBR generated fair value losses.

Financial review (continued)

Provision for customer redress

The proactive customer contact programme for all unsecured loan PPI sales made from 2005 onwards has now completed. Around 150,000 customers who were sold PPI during this period have been contacted and, where appropriate, compensation offered.

On mortgage PPI, there has been an increase in the level of claims which has been largely driven by the activity of claims management companies. A high proportion of the complaints received relate to customers who do not have a PPI policy, however, the number of genuine claims has also significantly increased.

Due to the higher level of activity and persistence of claims, we have increased the overall provision for PPI compensation by £129.8m.

Following changes to the CCA implemented in 2008 before the separation of NRAM and Northern Rock, certain letters and statements have been sent to customers that do not comply with all the requirements prescribed by the CCA. This fact was brought to light following the transfer of the NRAM loans onto the UKAR IT platform. Affected customers are entitled to redress. Redress will be made by correcting customers' account balances to reverse the consequences of them being charged any interest over the period in which their documentation has been non-compliant. Redeemed accounts will be redressed through a cash payment. The total cost to NRAM of remediating the interest charged is estimated at £271.4m, including costs and has, therefore, been provided in the 2012 accounts.

Ongoing administrative expenses

Ongoing administrative expenses were lower at £207.3m (2011: £220.6m) with the ratio of costs to average interest-earning assets increasing to 0.25% (2011: 0.23%). The increase in costs to average interest-earning assets reflects that the cost base has a significant fixed element which does not fall in line with the reduction of balances. Step changes in fixed costs are continually sought as evidenced by the implementation of common systems across UKAR which will deliver considerable benefits.

The UKAR Group has incentive schemes in place which have been agreed with UKFI. These enable staff to earn awards which are aligned to UKAR Group and individual performance. For 2012, the total of all incentives earned by employees of all UKAR Companies, including those of the Executive Directors, was £7.0m (2011: £5.6m) and is included in ongoing administrative expenses. Of these £6.3m (2011: £4.9m) will be paid in 2013, and the remainder will be deferred and paid in future years. All deferred amounts are subject to clawback terms. The increase in incentives paid is due to an increase in the number of staff eligible for a bonus and the first award under the Medium Term Incentive Plan ('MTIP') for senior managers in 2012. The average payment under the Short Term Incentive Plan ('STIP') was flat year on year.

Administrative expenses

For the year ended 31 December	UKAR 2012 £m	UKAR 2011 £m	B&B 2012 £m	B&B 2011 £m	NRAM 2012 £m	NRAM 2011 £m
Wages and salaries	**65.0**	65.6	**28.0**	31.1	**37.0**	34.5
Social security costs	**6.6**	6.8	**3.0**	3.2	**3.6**	3.6
Defined benefit pension costs	**0.6**	(0.9)	**0.9**	(0.4)	**(0.3)**	(0.5)
Defined contribution pension costs	**3.4**	3.5	**1.4**	1.3	**2.0**	2.2
Other retirement benefit costs	**0.5**	0.5	**0.5**	0.5	**–**	–
Total staff costs	**76.1**	75.5	**33.8**	35.7	**42.3**	39.8
IT costs	**56.0**	57.9	**25.9**	27.2	**30.1**	30.7
Outsourced and professional services	**25.5**	29.6	**13.4**	16.2	**12.1**	13.4
Depreciation and amortisation	**12.6**	5.5	**4.7**	1.8	**7.9**	3.7
Other administrative expenses	**37.1**	52.1	**15.6**	23.0	**21.5**	29.1
Ongoing administrative expenses	**207.3**	220.6	**93.4**	103.9	**113.9**	116.7
Other net administrative expenses:						
– Transformation costs	**51.4**	40.0	**24.0**	19.4	**27.4**	26.1
– Accelerated depreciation	**8.3**	25.2	**–**	5.6	**8.3**	14.1
Total other net administrative expenses	**59.7**	65.2	**24.0**	25.0	**35.7**	40.2
Total administrative expenses	**267.0**	285.8	**117.4**	128.9	**149.6**	156.9

Financial review (continued)

Other net administrative expenses

Other net administrative expenses in 2012 of £59.7m (2011: £65.2m) mainly reflect investment in UKAR's IT platform through the transfer to a new outsourced provider HCL Technologies Limited ('HCL'), costs associated with the phased exit of the Gosforth site and the further write-down of the value of buildings. This programme of investment, building on the work in 2011, will realise savings in the ongoing costs of UKAR of c.£56m per annum once completed.

Costs in 2011 reflected the establishment of common systems across UKAR, together with expected redundancy costs and the write-down of the value of buildings following the announcement of the UKAR restructure and the phased exit from the Gosforth site.

Arrears and loan impairment: residential and unsecured loans

Total UKAR loan impairment provisions as at 31 December 2012 were £1,914.9m (2011: £2,248.3m) comprising residential mortgages £1,411.1m (2011: £1,644.5m), unsecured loans £403.8m (2011: £501.6m) and commercial property of £100.0m (2011: £102.2m).

Arrears and possessions

At 31 December		UKAR			
		2012		2011	
		Residential	Unsecured	Residential	Unsecured
Arrears 3 months and over					
Number of cases	No.	**23,376**	31,140	**30,511**	34,282
Proportion of total cases	%	**3.99**	13.67	**4.79**	12.33
Asset value	£m	**3,341.1**	410.1	**4,358.8**	466.1
Proportion of book	%	**5.06**	21.64	**6.06**	18.47
Total value of payments overdue	£m	**132.3**	96.9	**170.4**	78.8
Proportion of total book	%	**0.20**	5.11	**0.23**	3.12
Possessions					
Number of cases	No.	**2,205**	–	**2,705**	–
Proportion of total cases	%	**0.37**	–	**0.42**	–
Asset value	£m	**320.5**	–	**395.9**	–
Proportion of book	%	**0.48**	–	**0.55**	–
Total value of payments overdue	£m	**20.8**	–	**27.1**	–
Proportion of total book	%	**0.03**	–	**0.04**	–
New possessions	No.	**7,326**	–	**8,848**	–
Total arrears 3 months and over and possessions					
Number of cases	No.	**25,581**	31,140	**33,216**	34,282
Proportion of total cases	%	**4.36**	13.67	**5.21**	12.33
Asset value	£m	**3,661.6**	410.1	**4,754.7**	466.1
Proportion of book	%	**5.54**	21.64	**6.61**	18.47
Total value of payments overdue	£m	**153.1**	96.9	**197.5**	78.8
Proportion of total book	%	**0.23**	5.11	**0.27**	3.12
Payments overdue					
Total value of payments overdue	£m	**185.8**	99.0	**233.9**	81.6
Proportion of total book	%	**0.28**	5.22	**0.33**	3.23
Loan impairment provision					
As % of total balances	%	**2.09**	17.56	**2.24**	16.58

Financial review (continued)

Arrears and possessions

At 31 December		B&B 2012 Residential	B&B 2011 Residential	NRAM 2012 Residential	NRAM 2012 Unsecured	NRAM 2011 Residential	NRAM 2011 Unsecured
Arrears 3 months and over							
Number of cases	No.	**5,197**	8,180	**18,179**	**31,140**	22,331	34,282
Proportion of total cases	%	**1.85**	2.74	**5.95**	**13.67**	6.57	12.33
Asset value	£m	**760.7**	1,212.3	**2,580.3**	**410.1**	3,146.5	466.1
Proportion of book	%	**2.38**	3.62	**7.56**	**21.64**	8.19	18.47
Total value of payments overdue	£m	**23.1**	38.6	**109.2**	**96.9**	131.8	78.8
Proportion of total book	%	**0.07**	0.11	**0.32**	**5.11**	0.34	3.12
Possessions							
Number of cases	No.	**717**	587	**1,488**	**–**	2,118	–
Proportion of total cases	%	**0.25**	0.20	**0.49**	**–**	0.62	–
Asset value	£m	**108.2**	96.0	**212.3**	**–**	299.9	–
Proportion of book	%	**0.34**	0.29	**0.62**	**–**	0.78	–
Total value of payments overdue	£m	**4.7**	6.1	**16.1**	**–**	21.0	–
Proportion of total book	%	**0.02**	0.02	**0.05**	**–**	0.06	–
New possessions	No.	**1,760**	1,702	**5,566**	**–**	7,146	–
Total arrears 3 months and over and possessions							
Number of cases	No.	**5,914**	8,767	**19,667**	**31,140**	24,449	34,282
Proportion of total cases	%	**2.10**	2.94	**6.44**	**13.67**	7.19	12.33
Asset value	£m	**868.9**	1,308.3	**2,792.6**	**410.1**	3,446.4	466.1
Proportion of book	%	**2.72**	3.91	**8.18**	**21.64**	8.97	18.47
Total value of payments overdue	£m	**27.8**	44.7	**125.3**	**96.9**	152.8	78.8
Proportion of total book	%	**0.09**	0.13	**0.37**	**5.11**	0.40	3.12
Payments overdue							
Total value of payments overdue	£m	**34.6**	52.6	**151.1**	**99.0**	181.3	81.6
Proportion of total book	%	**0.11**	0.16	**0.44**	**5.22**	0.47	3.23
Loan impairment provision							
As % of total balances	%	**1.96**	2.10	**2.22**	**17.56**	2.35	16.58

Financial review (continued)

Arrears and loan impairment: residential loans

We have continued to invest in improving our debt management operations. As a result of our actions, we have seen arrears in both companies fall notwithstanding the challenging economic conditions. At UKAR level, the number of mortgage accounts 3 or more months in arrears including possessions reduced by 23% since 31 December 2011.

We adhere to the Financial Services Authority's ('FSA') regulatory guidance regarding Treating Customers Fairly and continue to work closely with customers experiencing, or likely to experience, financial difficulty in maintaining their mortgage payments. We offer a range of measures to support these customers depending upon their individual circumstances and ability to pay with the long term aim of sustaining their mortgage commitments and remaining in their homes. Possession continues to be a last resort. Mortgage arrangements are the most prevalent method to recover arrears positions; 48,000 arrangements successfully completed in 2012. In addition, approximately 4,000 account modifications were made in the year (2011: 7,350).

The total number of cases 3 or more months in arrears, including those in possession, reduced by 23.0% from 33,216 at the end of 2011 to 25,581 cases at 31 December 2012. The total value of overdue debt owed by residential customers has reduced from £233.9m at 31 December 2011 to £185.8m at 31 December 2012, equivalent to 0.28% of mortgage balances (2011: 0.33%).

Provisions for residential loan impairment held on the Balance Sheet have reduced by £233.4m since 31 December 2011 to £1,411.1m (2011: £1,644.5m) reflecting the reduction in arrears cases. Write-offs in the year totalled £458.8m. Few new fraud cases have been identified, but the fraud and professional negligence provisions have been increased to fully provide for losses on all cases, even if currently the account is up to date with contractual mortgage payments. The provision for suspected fraud and professional negligence increased by £8.2m to £371.6m, representing 46% of mortgage balances on suspected fraud and professional negligence cases.

Net recoveries in 2012 were £38.4m compared to £8.6m in 2011. 2012 recoveries included the benefit of a £20.3m recovery on a crime insurance claim relating to business written in 2006/7.

In a benign interest rate environment, we continue to review provisioning levels to cater for mortgage affordability and inherent credit risk in the book which may be masked by current low interest rates. We continue to include a provision for the impact of projected house price deflation on future losses. Consistent with the FSA guidance on forbearance and impairment provisions, we are conscious of the risk of loss associated with interest only mortgages that come to the end of the term with no repayment vehicle to clear the outstanding balance. We have provided fully for cases which have reached the end of their term and extended this provision at December 2012 to include a proportion of cases that are within six months of term end. The proportion of UKAR mortgage balances on interest only terms is 56% (NRAM 41%; B&B 78%), the B&B percentage driven by the high proportion of buy-to-let loans on the mortgage book. The total provision on these cases stands at £17.3m across UKAR.

As a proportion of balances, the residential impairment provision was 2.09% (2011: 2.24%), the lower coverage reflecting the improved arrears position. The residential loan impairment charge was £187.0m (2011: £245.3m) as the charge benefited from lower arrears volumes and minimal new fraud cases.

The number of properties in possession for UKAR decreased from 2,705 in 2011 to 2,205. A total of 7,326 properties were taken into possession in the year (2011: 8,848).

In addition to residential property possessions, we also have a number of buy-to-let properties within B&B managed by LPA receivers. Our LPA 'for sale' stock fell from 785 cases at 31 December 2011 to 306 at 31 December 2012. 758 cases were placed for sale by LPA receivers (2011: 940).

During the year, 7,826 cases (2011: 8,749) were sold following possession and a further 1,237 cases (2011: 1,533) were sold which were under LPA management. Realised losses primarily on properties sold following possession or sold by an LPA were £458.8m (2011: £454.5m). Within these losses were fraudulent and professional negligence losses within B&B of £55.8m (2011: £65.1m).

Arrears and loan impairment: unsecured loans

The number of unsecured loans 3 months or more in arrears decreased by 9.2% since the end of 2011 to close the year at 31,140 (2011: 34,282) cases. The charge for unsecured loan impairment was lower at £42.3m (2011: £124.9m). Asset coverage has increased from 16.6% at 31 December 2011 to 17.6% at 31 December 2012.

The provision for unsecured loans reduced to £403.8m from £501.6m at the end of 2011. Realised losses were £155.4m (2011: £179.0m).

Arrears and loan impairment: commercial loan book

The provision for the commercial book has reduced to £100.0m from £102.2m at 31 December 2011 but coverage is higher at 11.34% (2011: 10.65%). The reduction in the provision was mainly due to write-offs of fully provided accounts partly offset by the impact of updated property valuations on the NRAM book. Realised losses were £14.9m compared to £6.6m in 2011. We continually review the level of provisions against each individual loan based on current and future property valuations, future rental income projections, tenant quality and general market conditions.

Financial review (continued)

Net impairment on investment securities

Conditions in wholesale markets have improved somewhat during 2012. Following European Central Bank ('ECB') intervention, relative stability is returning in the Eurozone, leading to improved liquidity and stabilising spreads in bond markets. Ongoing austerity measures, however, are leading to a continued risk of recession in much of Europe and the UK's economic recovery remains faltering.

Against this background, and with evidence of improved performance of underlying collateral, we have sought certain Balance Sheet optimisation opportunities during 2012, including the disposal of a number of investment securities. We have reviewed our investment securities for evidence of impairment, and have identified a small number of assets that we believe to be impaired. We have also identified assets in both B&B and NRAM where events have occurred that mean that impairments previously recognised should be reversed, either partially or in full.

These reversals in 2012 have led to a net credit to impairment on investment securities of £30.2m (2011: £58.8m net charge).

Gain on repurchase of own liabilities

In July 2012, we repurchased some of our securitised notes (Granite £436.9m, Whinstone £16.4m and Aire Valley £83.9m) yielding gains of £143.5m. In 2011, £338.1m of gains resulted from the repurchase of capital instruments and £15.6m from the disposal of credit linked notes.

Taxation

The total charge for tax per the Income Statement for the year ended 31 December 2012 was £126.7m (2011: £213.8m). Given the statutory profit before taxation of £690.5m (2011: £1,375.1m) this equates to an effective tax rate of 18.3% (2011: 15.5%), lower than the average corporation tax rate mainly due to the release of tax provisions for resolved issues.

Balance Sheet

Balance Sheet summary

	UKAR		B&B		NRAM	
At 31 December	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Loans to customers:						
– Residential mortgages	**66,056.3**	71,913.3	**31,911.3**	33,491.3	**34,145.0**	38,422.0
– Commercial and other secured loans	**781.9**	857.2	**556.5**	588.5	**225.4**	268.7
– Unsecured lending	**1,895.4**	2,523.9	**–**	–	**1,895.4**	2,523.9
Wholesale assets	**11,778.9**	11,765.3	**3,717.2**	3,214.4	**8,192.8**	8,685.4
Fair value adjustments on portfolio hedging	**493.8**	597.5	**341.4**	362.6	**152.5**	234.9
Derivative financial instruments	**5,720.2**	7,369.1	**1,800.3**	2,318.0	**3,919.8**	5,051.1
Other assets	**159.7**	203.6	**134.9**	127.4	**79.2**	138.3
Total assets	**86,886.2**	95,229.9	**38,461.6**	40,102.2	**48,610.1**	55,324.3
Statutory Debt and HM Treasury loans	**43,487.3**	46,582.2	**25,424.2**	26,855.8	**18,063.1**	19,726.4
Wholesale funding	**36,415.0**	42,137.4	**9,559.1**	9,899.2	**26,991.3**	32,387.2
Derivative financial instruments	**783.7**	965.4	**502.2**	577.9	**281.5**	387.5
Other liabilities	**575.9**	518.1	**265.4**	197.0	**363.9**	379.6
Other capital instruments	**359.2**	350.4	**146.2**	131.1	**213.0**	219.3
Equity	**5,265.1**	4,676.4	**2,564.5**	2,441.2	**2,697.3**	2,224.3
Total equity and liabilities	**86,886.2**	95,229.9	**38,461.6**	40,102.2	**48,610.1**	55,324.3

The Balance Sheet has decreased by £8.3bn to £86.9bn from £95.2bn since December 2011.

Financial review (continued)

Lending balances are £6.6bn (8.7%) lower, reducing to £68.7bn (2011: £75.3bn) during the year, reflecting £4.6bn of residential redemptions, £0.1bn of commercial redemptions, £0.2bn unsecured loan redemptions and £1.1bn of other capital repayments. In addition, £465m of NRAM mortgages were sold to Virgin Money.

Liabilities

Statutory Debt and HM Treasury loans reduced by £3.1bn to £43.5bn (2011: £46.6bn) due to repayments of principal in the year (NRAM: £1.7bn, B&B: £1.4bn). UKAR did not draw down any facility during the year. In addition, £4.7bn of other external wholesale funding was repaid in the year.

Wholesale funding was also reduced through the purchase of £537m of Granite, Whinstone and Aire Valley notes at a discount to their nominal value.

Cash repayments

At the end of 2011, UKAR had £30.9bn of funding from HM Treasury, plus a further £15.7bn owed to the Financial Services Compensation Scheme ('FSCS'). Repayment of this debt remains a primary objective of UKAR. In the year a further £3.10bn (2011: £2.15bn) of HM Treasury debt was repaid. In addition, other cash flows were generated for Her Majesty's Government in the form of State guarantee fees, interest and taxes. The Board considers the total of all these cash flows paid to HM Treasury to be an important measure. Total cash payments in 2012 to HM Treasury were £4.0bn (2011: £2.8bn).

In addition to the £465m proceeds from the sale of mortgage assets to Virgin Money, £188m of cash was generated from the disposal of Treasury assets in 2012 (NRAM : £141m; B&B: £47m).

Capital

The Group's capital is provided by its shareholders (currently HM Treasury) and the holders of subordinated notes and subordinated liabilities.

The regulated Group companies met their capital requirements in full throughout the year and have received no additional capital from HM Treasury on nationalisation, or subsequently.

Capital Resources – B&B plc

At 31 December	2012 £m	2011 £m
Share capital and reserves	**2,382.6**	2,331.1
Available-for-sale reserve adjustments	**(17.1)**	(19.6)
Cash flow hedge reserve adjustments	**(86.8)**	(46.6)
Net pension deficit adjustment	**(103.3)**	(77.6)
Less: deductions	**(521.3)**	(508.3)
Tier 1 capital	**1,654.1**	1,679.0
Capital instruments	**83.6**	81.5
Total capital	**1,737.7**	1,760.5

Financial review (continued)

Capital Resources – NRAM plc

At 31 December	2012 £m	2011 £m
Share capital and reserves	**2,515.1**	1,933.5
Available-for-sale reserve adjustments	**73.7**	124.6
Cash flow hedge reserve adjustments	**(192.2)**	(68.1)
Pension scheme asset	**(43.0)**	(49.8)
Reserve capital instruments	**101.4**	102.3
Tier one notes	**41.9**	42.9
Less: deductions	**(1.1)**	(1.2)
Tier 1 capital	**2,495.8**	2,084.2
Subordinated notes	**23.4**	23.4
Subordinated liabilities	150.7	150.7
Total capital	2,669.9	2,258.3

B&B plc total capital resources of £1,737.7m are £22.8m lower than 2011, the net reduction being a result of the increase in pension funding costs partly offset by the profits made in the year.

NRAM plc total capital resources of £2,669.9m are £411.6m higher than 2011, due to profits generated in the year.

UKAR operates under a MIPRU regulatory status. Strictly the regulated companies within the Group are required to hold capital in excess of 1% of total Balance Sheet assets plus any undrawn commitments. However, the Board believes it should hold capital above 1% reflecting the increased risk in the business compared to a standard MIPRU firm, and at the year end capital in B&B plc represented 4.6% of B&B Company assets; NRAM plc capital represented 5.7% of NRAM Company assets.

Key performance indicators ('KPIs') – B&B

In addition to the primary Financial Statements, we have adopted the following KPIs in managing business performance in the context of its strategic priorities:

Strategic priorities	Financial measures	2012	2011	Commentary
Optimise the Balance Sheet	Lending balances secured £bn	**32.5**	34.1	Lending balances reduced by 4.7% during the year due to £1.3bn of residential redemptions and £0.3bn of other capital repayments.
	Residential mortgage redemption rate % Residential redemptions £bn	**4.0** **1.3**	4.2 1.5	Redemptions have fallen slightly compared to 2011 reflecting the characteristics of the book and the low levels of remortgage activity across the market.
	Government loan repayments £bn Government loan balance £bn	**1.43** **25.4**	0.15 26.9	No drawdowns were made in the year from the WCF arranged with HM Treasury. The balance of £7.0bn, excluding accrued interest, is within the £11.5bn maximum facility level currently agreed with HM Treasury. Repayments of £1.4bn were made in the year against the WCF. No payments were made against the Statutory Debt and the balance remains at £18.4bn at the year end.
	Total cash payments to HM Treasury £bn	**1.93**	0.65	Total cash paid to HM Treasury during the year. This includes principal and interest repayments, State guarantee fees and corporation tax paid. The main drivers of the increase year on year are £1.4bn principal repayment and an additional £0.2bn increase in interest payments on the WCF following the increase in the rate in August 2011.
Minimise impairment and losses	Residential arrears balance: total residential mortgage balance % Residential payments overdue £m	**0.11** **34.6**	0.16 52.6	This represents the value of customers' missed payments as a proportion of the total balance of all residential mortgages and the reduction to 0.11% reflects that the level of overdue debt owed on mortgages is falling faster than the book.
	Residential arrears 3 months and over and possessions as % of the book: – by value – by number of accounts Number of residential arrears 3 months and over and possessions cases	 **2.72** **2.10** **5,914**	 3.91 2.94 8,767	The reduction in arrears reflects both the improvement in collections performance and the continuing support provided to mortgage customers of low interest rates.
	Impairment provisions: Residential £m Cover % Commercial £m Cover %	 **637.6** **1.96** **50.3** **8.29**	 718.1 2.10 52.3 8.16	The level of the residential impairment Balance Sheet provision reduced by £80.5m and the level of cover decreased from 2.10% to 1.96% due to the improved arrears performance.
Reduce costs	Total costs £m Ongoing costs £m* Ratio of costs to average interest-earning assets: – statutory % – ongoing %*	**117.4** **93.4** **0.32** **0.25**	128.9 103.9 0.33 0.26	The reduction primarily reflects the benefits of implementing common systems across UKAR.

* Ongoing costs exclude certain items that are not expected to recur on an ongoing basis; an analysis of items excluded from ongoing costs is provided on page 16.

Key performance indicators ('KPIs') – NRAM

In addition to the primary Financial Statements, we have adopted the following KPIs in managing business performance in the context of its strategic priorities:

Strategic priorities	Financial measures	2012	2011	Commentary
Optimise the Balance Sheet	Total lending balances £bn Secured £bn Unsecured £bn	**36.3** **34.4** **1.9**	41.2 38.7 2.5	Lending balances reduced by 12.0% during the year due to £3.2bn of residential redemptions, £0.2bn of unsecured loan redemptions and £1.0bn of other capital repayments. In addition, £0.5bn of mortgages were sold to Virgin Money. Unsecured balances include both the Together and standalone unsecured loan books.
	Residential mortgage redemption rate % Residential redemptions £bn	**8.4** **3.2**	11.2 5.0	Redemptions have fallen relative to 2011, reflecting the characteristics of the book and the low levels of remortgage activity across the market.
	Government loan repayments £bn Government loan balance £bn	**1.7** **18.1**	2.0 19.7	During the year, £1.7bn was repaid against the NRAM Government loan.
	Total cash payments to HM Treasury £bn	**2.05**	2.18	Total cash paid to HM Treasury during the year. This includes principal and interest repayments, State guarantee fees and corporation tax paid. The main driver of the decrease year on year is due to lower principal repayments on the Government loan.
Minimise impairment and losses	Residential arrears balance: total residential mortgage balance % Residential payments overdue £m	**0.44** **151.1**	0.47 181.3	This represents the value of customers' missed payments as a proportion of the total balance of all residential mortgages and the reduction to 0.44% reflects that the level of overdue debt owed on mortgages is falling faster than the book.
	Residential arrears 3 months and over and possessions as % of the book: – by value – by number of accounts Number of residential arrears 3 months and over and possessions cases	 **8.18** **6.44** **19,667**	 8.97 7.19 24,449	The reduction in arrears reflects both the improvement in collections performance and the continuing support provided to mortgage customers of low interest rates.
	Impairment provisions: Residential secured £m Cover % Unsecured £m Cover % Commercial £m Cover %	 **773.5** **2.22** **403.8** **17.56** **49.7** **18.07**	 926.4 2.35 501.6 16.58 49.9 15.66	The level of the residential impairment Balance Sheet provision reduced by £152.9m and the level of cover decreased from 2.35% to 2.22% due to the improved arrears performance.
Reduce costs	Total costs £m Ongoing costs £m* Ratio of costs to average interest-earning assets: – statutory % - ongoing %*	**149.6** **113.9** **0.32** **0.24**	156.9 116.7 0.28 0.21	The reduction primarily reflects the benefits of implementing common systems across UKAR.

* Ongoing costs exclude certain items that are not expected to recur on an ongoing basis; an analysis of items excluded from ongoing costs is provided on page 16.

Directors' remuneration report

This section of the Annual Report outlines the role and responsibilities of the UKAR Remuneration Committees (which covers the UKAR, B&B and NRAM businesses), summarises the key areas of focus for the year and provides details of the remuneration for Directors. This remuneration report does not form part of the Financial Statements and is not audited, although the Directors' emoluments figures are audited. It also outlines the overarching reward policy covering all colleagues. The Non-Executive Directors have service contracts with UKAR. All Executive Directors and colleagues were employed by B&B (the legal employer) during 2012.

As outlined in the Relationship Framework Document, the ongoing relationship between UKAR and UKFI ensures UKAR operates in the context of the agreed business plan and the overarching strategic objectives. In addition, UKAR seeks to ensure that remuneration policy and practices are appropriate and are reflective of sound risk management principles.

Opening Statement from Sue Langley, Remuneration Committee Chairman

As Chairman of the Remuneration Committee, I am pleased to present the UKAR Report on Directors' Remuneration for 2012.

UKAR has continued to apply restraint to the remuneration for executives. Base salaries are targeted no higher than market median for financial services companies of UKAR's size, and salary increases for executives are in line with the average for all other UKAR colleagues. It should also be noted that UKAR's variable remuneration components for executives, in the form of annual bonus and medium-term incentive, are substantially smaller than for executives in comparable stock-exchange listed companies.

UKAR's policies place a clear emphasis on sustained performance: 60% of the short-term incentive award is subject to mandatory deferral and in appropriate circumstances, the Remuneration Committee can clawback deferred amounts and incentive awards.

The performance metrics used for incentive awards are aligned to the creation of value for taxpayers, including the generation of profits for the public 'purse' and repaying loans that were provided by Government. Executives are also required to adhere to the Treating Customers Fairly principles laid down by the regulator and to apply prudent management of risk.

UKAR manages and incentivises the performance of all colleagues, including the executive and senior managers, by establishment of a series of annual financial measures and a balanced scorecard of business measures. During 2012, all the financial and the balanced scorecard targets have been surpassed following a very successful performance contributing to the repayment of £5.2bn of Government loans since UKAR was formed. Therefore, the Remuneration Committee and the Board were unanimous in their decisions to award bonuses.

Although the financial and business performance in 2012 has been excellent, the Board has reported an exceptional provision in the accounts of £271m in respect of the impact of remediation required in respect of defects in CCA documentation made by Northern Rock in 2008. The origin of the problem occurred before UKAR was formed, and before the current management team were appointed to their positions. If this cost were included as part of underlying profit, UKAR would still have acheived the target set for financial performance agreed at the start of the year.

Although the scheme rules and performance would suggest incentives to be paid in full, the Remuneration Committee, on the recommendation of the executive management, has made a downward discretionary adjustment amounting to 20% across the whole of the executive and senior management Short Term Incentive Plan ('STIP') earned for 2012 to recognise the impact of the remediation. Incentives for all other colleagues have not been adjusted since we believe it is important that we encourage the appropriate behaviours and pay in line with scheme rules and targets.

The Remuneration Committee appreciated the leadership and professionalism being shown by these bonus sacrifices, particularly as the current management team have performed so well in identifying and resolving complex regulatory issues not of their own making.

In addition, leading by example, Chief Executive, Richard Banks has volunteered that his STIP award should be further reduced by an additional 15% so his payment of £92,430 represents 65% of his earned STIP award and is 26% down on the previous year. Normal deferral rules are applied to this award and 40% is paid immediately. The balance of 60% is paid in three equal tranches in each of the next three years, subject to malus and clawback. Richard has also proposed that his Medium Term Incentive Plan ('MTIP') payment of £69,360, which vested in March 2013 should be deferred until his retirement. This payment is also subject to the provisions of malus and clawback.

The Remuneration Report incorporates many of the forthcoming disclosure requirements that will apply to listed companies and this will be reviewed in future years to ensure best practice is applied wherever possible. I hope you find the report clear and informative.

Sue Langley

Remuneration Committee Chairman

FSA Code of practice on remuneration

UKAR is not required to comply with the FSA's Remuneration Code as non-banks are not in scope, but continues to ensure the principles of the Code underpin its remuneration policies and practices.

Advisors

New Bridge Street are the independent advisors to the Remuneration Committee. New Bridge Street is a trading name of Aon Hewitt Limited.

During the year, advice was received from the advisors on market practice together with updates on legislative and regulatory changes.

Directors' remuneration report (continued)

Remuneration policies

UKAR operates reward and incentivisation policies that aim to support the achievement of our overall business strategy and promote sound risk management. These policies were agreed by the UKAR Remuneration Committee which includes a representative of the UKAR Shareholder, UKFI. No changes have been made to these policies in 2012 and the next review of these policies will be in 2013. Levels of remuneration are set so as to be sufficient to attract, retain and motivate employees of the quality required to run UKAR successfully, but without paying more than is necessary for this purpose. A significant proportion of the remuneration for the senior management team is linked to corporate and individual performance. The Committee takes into account the pay and employment conditions in other companies when setting the remuneration policy for the senior team.

Remuneration Committees

The primary objective of the UKAR Remuneration Committee is to have oversight of the remuneration policy of the UKAR Group Companies. It is responsible for recommending to the Board all aspects of the remuneration arrangements for Executive Directors, Senior Executives, Approved Persons and Code Employees (as defined by the FSA Remuneration Code) across the Group regardless of whether such appointments are on a permanent or an interim basis. The UKAR Remuneration Committee monitors the implementation of all performance-related pay schemes operated by the Companies. The Committee is also responsible for reviewing proposals on the remuneration policies of the Companies for all colleagues and monitors and advises on any major changes in employee benefit structures throughout the Companies. The full Terms of Reference for all Committees are available on the corporate website.

The Remuneration Committees met six times during 2012 to consider, amongst other items, deferred incentive payments for previous years, equal pay, incentive schemes, salary reviews, and latest best practice approaches to remuneration.

During the year the CEO, HR Director, Risk Director and members of the senior management team were invited to attend Remuneration Committee meetings for those items other than their own arrangements to provide information. All other Non-Executive Directors are also welcome to attend the committee if they wish to do so.

The Remuneration Committee was composed entirely of Non-Executive Directors as outlined in Table 1 below.

Table 1 – Remuneration Committee membership for 2012

Sue Langley (Chair)
Louise Patten
Keith Morgan

Executive Directors

Service agreements

Table 2 – Executive Directors' service contracts

	Date of appointment to UKAR	Company's notice period	Director's notice period
Richard Banks	01/10/2010	12 months	6 months
Phillip McLelland	01/07/2011	12 months	6 months

Components of Executive Remuneration

Remuneration frameworks are structured to place appropriate importance on fixed pay and short to medium term incentives. The main elements are outlined in Table 3.

Directors' remuneration report (continued)

Table 3 – Remuneration Policy Overview

Richard Banks		Contractual/ Non-contractual	Clawback	Maximum Payment	Performance Metrics, Weightings, Payment Period
Basic Pay	£355,500	Contractual	N/A	£355,500	Objectives and Position in Pay Range
STIP	Up to 60% of base salary over 1 year	Non-contractual	Clause in place allowing full or part clawback in appropriate circumstances up to 3 years after the year to which the award relates.	Up to 60% of base salary	5 Company targets with equal weighting and individual performance objectives. Paid over 4 years, 40% of award made after the first year, and then 20% of award paid in each of the following 3 years.
MTIP	Up to 60% of base salary over 3 years	Non-contractual	Clause in place allowing full or part clawback in appropriate circumstances up to 3 years after the year to which the award relates.	Up to 60% of base salary over 3 years	Based on a target for money repaid to Government and/or additional value created. A combination of achievement must be met for payments to be made. The scheme runs over 3 years, with up to 20% of base salary awarded after the second year, up to 20% of base salary after the third year, with a further 20% paid after the third year subject to achieving the 3 year target overall.

Phillip McLelland		Contractual/ Non-contractual	Clawback	Maximum Payment	Performance Metrics, Weightings, Payment Period
Basic Pay	£257,500	Contractual	N/A	£257,500	Objectives and Position in Pay Range
STIP	Up to 60% of base salary over 1 year	Non-contractual	Clause in place allowing full or part clawback in appropriate circumstances up to 3 years after the year to which the award relates.	Up to 60% of base salary	5 Company targets with equal weighting and individual performance objectives. Paid over 4 years, 40% of award made after the first year, and then 20% of award paid in each of the following 3 years.
MTIP	Up to 60% of base salary over 3 years	Non-contractual	Clause in place allowing full or part clawback in appropriate circumstances up to 3 years after the year to which the award relates.	Up to 60% of base salary over 3 years	Based on a target for money repaid to Government and/or additional value created. A combination of achievement must be met for payments to be made. The scheme runs over 3 years, with up to 20% of base salary awarded after the second year, up to 20% of base salary after the third year, with a further 20% paid after the third year subject to achieving the 3 year target overall.

- **Basic salary – Policy**

  Base salaries for individual Executive Directors are set on appointment and then reviewed annually by the Committee. Salaries are set by reference to individual performance, experience and contribution, together with developments in the relevant employment market and internal relativities. The Committee gives due consideration to the current economic climate and current market practice regarding Executive salary reviews and the broader employee salary review policy in UKAR.
- **Basic salary – Implementation**

  Richard Banks was appointed as Chief Executive Officer in October 2010. The Committee reviewed his salary during 2012 and awarded him a 2.5% increase to £355,500 pa effective from 1 October.

  Phillip McLelland was appointed as Finance Director in July 2011. The Committee reviewed his salary during 2012 and awarded him a 3% increase to £257,500 pa effective from 1 October.
- **STIP – Policy**

  The annual STIP incentive is linked to achievement of both UKAR targets and personal performance. There are five KPIs:
  - underlying profit;
  - costs;
  - loan repayments;
  - 3+ month arrears; and
  - a balanced scorecard of other measures, aligned to internal controls, customer metrics and people management.

Directors' remuneration report (continued)

The corporate KPIs were chosen to drive both financial and operational performance, aligned to the delivery of value for the taxpayer.

As stated earlier, the FSA Remuneration Code does not apply to UKAR. However, UKAR seeks to follow the principles of the Code wherever possible. Under the FSA Remuneration Code for senior colleagues a minimum of 40% of variable pay is required to be deferred for a period covering not less than three years. The deferral percentage increases to 60% for larger firms and where an individual's variable pay is at least £500,000, which is substantially higher than variable pay at UKAR. However, UKAR has chosen voluntarily to apply deferral to all bonuses for the senior management population, and to apply the highest level of deferral of 60% of the bonus. Therefore, the first 40% of any short-term incentive due is paid in March following the relevant year end, with the remaining 60% deferred and payable in three equal instalments over the subsequent three years.

Where incentive payments have been deferred they will be paid subject to a malus provision which enables the Committee to make downward adjustments in the event of a significant deterioration in financial performance or failure of risk management. Payment of each deferred tranche is subject to achievement of at least 75% of the previous year's profit target.

The range of metrics used to determine performance under the annual STIP and the deferral and malus provisions ensure that the annual STIP is aligned with UKAR's risk strategy. Together, these provisions ensure that incentives can and will be scaled back in the event of poor corporate or individual performance. Both Richard Banks and Phillip McLelland are eligible for this incentive arrangement and received the following awards for 2012.

- **STIP – Implementation**

Table 4 – Executive Director STIP Awards

	Type of Award	Amount	Earliest Vesting Date
Richard Banks	2012 STIP	£36,972	March 2013
		£18,486	March 2014
		£18,486	March 2015
		£18,486	March 2016
	Total	**£92,430**	
Phillip McLelland	2012 STIP	£39,140	March 2013
		£19,570	March 2014
		£19,570	March 2015
		£19,570	March 2016
	Total	**£97,850**	

- **Payment of deferred STIP**

Details of the deferred remuneration of the Executive Directors relating to previous years' annual STIP are shown in Table 5. The Remuneration Committee has determined that there were no issues relevant to previous years impacting the business and individual performances and, therefore, approved the relevant tranches of the deferred awards to vest in full.

Table 5 -Executive Directors' deferred annual STIP and Senior Executives' scheme

	Type of award	Amount granted	Date of payment	Amount	Paid during 2012	Amount outstanding at 31 December 2012
Richard Banks	2009 Annual STIP	£30,000	2012	£10,000	£10,000	–
	2010 Annual STIP	£170,000	2012	£32,300	£32,300	–
			2013	£32,300	–	£32,300
			2014	£32,300	–	£32,300
	2011 Annual STIP	£124,848	2013	£24,970	–	£24,970
			2014	£24,970	–	£24,970
			2015	£24,970	–	£24,970

Directors' remuneration report (continued)

	Type of award	Amount granted	Date of payment	Amount	Paid during 2012	Amount outstanding at 31 December 2012
Phillip McLelland	2009* Scheme		2012	£11,333	£11,333	-
	2010* Scheme		2012	£12,075	£12,075	-
			2013	£12,075	-	£12,075
			2014	£12,075	-	£12,075
	2011 Annual STIP	£115,000	2013	£23,000	-	£23,000
			2014	£23,000	-	£23,000
			2015	£23,000	-	£23,000

* In 2009 and 2010, Phillip McLelland was a member of the Bradford & Bingley Senior Executives' Scheme and the table includes deferred elements of awards granted before his appointment as a Director.

- **MTIP – Policy**

The medium term incentive plan incentivises senior management to accelerate the delivery of shareholder value over and above the STIP targets and the forecasts within the 10 year plan for 2011. The MTIP is based on increasing shareholder value and/or accelerated repayment of the government loans with targets set for a three year period, 2011-2013. The maximum payment for the MTIP over three years is up to 60% of 2011 salary based on the achievement of an overall three-year stretch target set in 2011. Incentive milestones are set over the three year period 2011-2013 and payments may be made in 2013 and 2014. Both Richard Banks and Phillip McLelland are eligible for this incentive arrangement subject to achievement of the targets. The Remuneration Committee have determined that the combined targets for 2011 and 2012 have been exceeded and approved payment.

- **MTIP – Implementation**

Table 6 – Executive Directors' MTIP Awards

	Type of Award	Award	Earliest Vesting Date
Richard Banks	2011 MTIP	£69,360*	March 2013
Phillip McLelland	2011 MTIP	£50,000	March 2013

*** Richard Banks has volunteered to defer his MTIP award of £69,360 due to vest in March 2013 until his retirement, with the release of the payment subject to malus and clawback.**

- **Pensions and other benefits**

Richard Banks receives a cash supplement of 30% of basic salary in lieu of UKAR pension benefit.

Phillip McLelland is a member of the UKAR Pension Plan, a stakeholder plan. He received total employer pension contributions of £37,781 to the Plan during 2012.

In line with typical market practice, other executive benefits are provided in the form of a company car allowance, medical insurance, life assurance, income protection and accident insurance. Richard Banks also receives a housing allowance.

In 2012, NRAM pension payments due to former Directors of the former Northern Rock plc, paid directly by NRAM and not connected to the NR Staff Pension Scheme, amounted to £303,760 (2011: £289,623). There were no payments made directly by B&B (2011: £1,944).

Phillip McLelland is eligible for redundancy payments in line with the UKAR's redundancy policy. Richard Banks is not entitled to such payments.

The emoluments for Richard Banks and Phillip McLelland are detailed in Table 8.

Non-Executive Directorships

Executive Directors who hold Non-Executive Directorships in other companies are permitted to retain their earnings from these posts. Richard Banks is the only Executive Director of UKAR who held external directorships during 2012. One was with Liverpool Compact Education Business Partnership for which he received no fees (2011: £nil) and the second was with ICICI Bank UK plc for which he received fees of £60,000 (2011: £50,000). In both cases, he held these appointments for all of 2012.

Directors' remuneration report (continued)

Non-Executive Chairman and Non-Executive Directors' fees

The Chairman Richard Pym voluntarily reduced his annual fee by 5% on 1 January 2012 to £237,500 pa. He has also offered to reduce his fees by a further 5% with effect from 1 January 2013 and this reduced level will apply throughout 2013. The Non-Executive Directors also volunteered to reduce their fees by 5% effective from 1 October 2012. Following this reduction, the basic fee is set at £47,500 pa plus £14,250 for each Chair held, and £4,750 for each Committee membership. These reductions recognise the increasingly stable position of the two businesses and consequently their time required is reduced.

Non-Executive Directors did not participate in any incentive arrangements and did not receive any other benefits. Table 7 outlines the Non-Executive Directors' terms of appointment and the emoluments of the Non-Executive Chairman and Non-Executive Directors for the year are detailed in Table 8.

Table 7 – Non-Executive Directors' terms of appointment

	Date of appointment	Term end date	Company's notice period	Director's notice period
Richard Pym	1 October 2010	31 December 2013	3 months	3 months
Kent Atkinson	1 October 2010	31 December 2013	3 months	3 months
Michael Buckley	1 October 2010	31 December 2013	3 months	3 months
Sue Langley	1 October 2010	31 December 2013	3 months	3 months
Jim O'Neil	28 June 2012	31 December 2013	3 months	3 months
Keith Morgan	1 October 2010	31 December 2013	3 months	3 months
Louise Patten	1 October 2010	31 December 2013	3 months	3 months
John Tattersall	1 October 2010	31 December 2013	3 months	3 months

Table 8 below sets out the total emoluments paid to those Directors who were Directors of UKAR Group companies at 31 December 2012 in respect of their services in 2012 to companies within the UKAR Group. In accordance with the Companies Act disclosure rules, this includes all remuneration receivable by the Directors in respect of 2012, regardless of when this may be paid and even though payment is conditional on Remuneration Committee discretion.

Table 8 – Directors' Emoluments for the year ended 31 December 2012

Executive Directors	Basic salary/ fees	Non-cash benefits	Allowances	Payment in lieu of pension/ pension contributions	STIP non-deferred	STIP deferred	Total emoluments pre MTIP	MTIP 2011/2013	Total emoluments 2012
Richard Banks[1]	£348,975	£962	£26,400	£104,693	£36,972	£55,458	£573,460	[1]£69,360	£642,820
Phillip McLelland	£251,875	£962	£7,320	£37,781	£39,140	£58,710	£395,788	£50,000	£445,788
Total	**£600,850**	**£1,924**	**£33,720**	**£142,474**	**£76,112**	**£114,168**	**£969,248**	**£119,360**	**£1,088,608**
Non-Executive Directors									
Richard Pym	£237,500	–	–	–	–	–	£237,500	–	£237,500
Kent Atkinson	£69,125	–	–	–	–	–	£69,125	–	£69,125
Michael Buckley	£67,041	–	–	–	–	–	£67,041	–	£67,041
Sue Langley[3]	£69,125	–	–	–	–	–	£69,125	–	£69,125
Keith Morgan[4]	£20,583	–	–	–	–	–	£20,583	–	£20,583
Jim O'Neil[5]	-	–	–	–	–	–	-	–	-
Louise Patten	£59,250	–	–	–	–	–	£59,250	–	£59,250
John Tattersall	£69,125	–	–	–	–	–	£69,125	–	£69,125
Total	**£591,749**	–	–	–	–	–	**£591,749**	–	**£591,749**
Grand Total	**£1,192,599**	**£1,924**	**£33,720**	**£142,474**	**£76,112**	**£114,168**	**£1,560,997**	**£119,360**	**£1,680,357**

Directors' remuneration report (continued)

Table 9 – Directors' Emoluments for the year ended 31 December 2011

Executive Directors	Basic salary/ fees	Non-cash benefits	Allowances	Payment in lieu of pension/ pension contributions	STIP non-deferred	STIP deferred	Total emoluments pre MTIP	MTIP[6] 2011/2013	Total emoluments 2011
Richard Banks	£341,700	£1,239	£26,400	£102,510	£49,938	£74,910	£596,697	–	£596,697
Phillip McLelland [2]	£228,762	£1,388	£7,320	£35,525	£46,000	£69,000	£387,995	–	£387,995
Total	**£570,462**	**£2,627**	**£33,720**	**£138,035**	**£95,938**	**£143,910**	**£984,692**	**–**	**£984,692**
Non-Executive Directors									
Richard Pym	£250,000	–	–	–	–	–	£250,000	–	£250,000
Kent Atkinson	£70,000	–	–	–	–	–	£70,000	–	£70,000
Michael Buckley	£65,000	–	–	–	–	–	£65,000	–	£65,000
Sue Langley [3]	£70,000	–	–	–	–	–	£70,000	–	£70,000
Keith Morgan [4]	–	–	–	–	–	–	-	–	-
Louise Patten	£60,000	–	–	–	–	–	£60,000	–	£60,000
John Tattersall	£70,000	–	–	–	–	–	£70,000	–	£70,000
Total	**£585,000**	–	–	–	–	–	**£585,000**	–	**£585,000**
Grand Total	**£1,155,462**	**£2,627**	**£33,720**	**£138,035**	**£95,938**	**£143,910**	**£1,569,692**	**–**	**£1,569,692**

[1] Richard Banks has elected to defer his MTIP payment of £69,360, due for payment in March 2013, until his retirement from UKAR.
[2] Phillip McLelland's total emoluments for 2011 includes basic pay and other benefits of £124,935 which was for the period from 1 January 2011 to 30 June 2011 prior to Phillip's appointment as a Director.
[3] Sue Langley's fees are not paid directly to her. The fees shown were paid to Lloyd's of London for her services.
[4] Keith Morgan received no fees whilst an employee of UKFI (until August 2012). Fees in respect of September to December 2012 were paid in January 2013.
[5] Jim O'Neil does not receive any fees in respect of his services as a Director.
[6] The first payments under the MTIP scheme were earned in 2012; no award accrued in 2011.

Corporate governance

Introduction

UKAR is the holding company established on 1 October 2010 to bring together the businesses of B&B and NRAM.

UKAR itself is 100% owned by the UK Government which exercises control through UKFI which was set up on 3 November 2008 to manage the Government's investments in Royal Bank of Scotland, Lloyds Banking Group, Northern Rock and B&B.

UKAR governs and controls NRAM and B&B, as their sole shareholder.

Although managed under a common board and management structure, NRAM and B&B (the 'Principal Subsidiaries') remain separate legal entities and continue to operate as individual companies with their own individual brands and balance sheets.

This corporate governance section summarises the governance regime applicable to UKAR Limited including its Principal Subsidiaries (the 'Group') at the date of this report.

Our Board

UKAR, B&B and NRAM share a common Board of Directors. The individual profiles included in this section therefore set out the Directorships of all three companies.

Richard Pym – Non-Executive Chairman

Richard became Chairman of UKAR in July 2010 having been appointed Chairman of B&B in November 2008 and NRAM in January 2010. He also chairs the Nominations Committees of all three companies and the Transactions Approvals Committees of B&B and NRAM.

Richard is a Non-Executive Director of The British Land Company PLC and Non-Executive Chairman of BrightHouse Group Ltd and Nordax Finans AB. He was Group Chief Executive of Alliance & Leicester plc until July 2007. Formerly, he was a Non-Executive Director of Old Mutual plc, Selfridges plc, and Chairman of Halfords Group plc. Richard is a Fellow of the Institute of Chartered Accountants in England and Wales.

Kent Atkinson – Senior Independent Director

Kent joined the Boards of UKAR and B&B in October 2010, and has been a Non-Executive Director of NRAM since January 2010. He is our Senior Independent Director, Chairman of the Audit Committees and a member of the Risk Committees of all three companies.

Kent was previously Group Finance Director of Lloyds TSB plc and subsequently a Non-Executive Director. He is the Senior Independent Director and Chairman of the Audit Committee of Coca-Cola HBC SA. He is a Non-Executive Director, Chairman of the Audit Committee and a member of the Risk Committee of the Bank of Ireland Group as well as being a Non-Executive Director and a member of the Audit Committee and Mergers & Acquisition Committee of Gemalto NV. Previously he was a Non-Executive Director and Chairman of the Group Audit and Compliance Committee and a member of the Risk and Investment Committees of Standard Life plc. He was formerly a Non-Executive Director, Chairman of the Audit Committee and a member of the Risk Committee of Northern Rock plc, the Senior Independent Director and Chairman of the Audit Committees of Cookson Group plc and Telent plc (previously Marconi Corporation plc), and a Non-Executive Director and a member of the Audit Committee of Millicom International Cellular S.A.

Richard Banks – Chief Executive Officer

Richard became Chief Executive Officer of UKAR in July 2010 and was appointed Chief Executive Officer of B&B and NRAM in October 2010. He is also a member of the Transaction Approvals Committee of B&B and NRAM.

Before joining the Board of B&B in May 2009, Richard's career has been in retail and commercial banking. He was previously a Director of Alliance & Leicester plc where he was Group Risk Director and before that Managing Director of Commercial Banking. He is also a Non-Executive Director of ICICI Bank UK PLC and a Non-Executive Director of Liverpool Compact, which provides work experience for 14-19 year olds. Richard is an Associate of the Chartered Institute of Banking.

Michael Buckley – Non-Executive Director

Michael joined the Boards of UKAR and NRAM in October 2010, and has been a Non-Executive Director of B&B since July 2007. He is a member of the Audit, Risk and Nominations Committees of all three companies and the Transactions Approvals Committees of B&B and NRAM.

Michael is Non-Executive Chairman of DCC plc. He is also a senior advisor to a number of privately held Irish and US based companies, and is an Adjunct Professor at the Department of Economics at NUI University College, Cork. He was Group Chief Executive of Allied Irish Banks plc from 2001 to 2005 having earlier served as Managing Director of AIB Capital Markets and AIB Poland. From April 2003 until April 2012 he was a Non-Executive Director of M&T Corporation in the USA. He was Managing Director of the NCB Group, and a senior public servant in Ireland and the EU.

Corporate governance (continued)

Sue Langley – Non-Executive Director

Sue joined the Boards of UKAR and B&B in October 2010, having joined the Board of NRAM in January 2010. She is Chairman of the Remuneration Committee and a member of the Nominations Committee of all three companies.

Previously she was Director of Market Development and a member of the Executive Team for Lloyd's of London, Chairman of Lloyd's Japan and Director of Lloyd's Asia. Prior to this Sue was Chief Operating Officer and a member of the Executive team of the Hiscox Group and Board member for Hiscox Syndicates and Hiscox Insurance. She joined Hiscox from PricewaterhouseCoopers where she was a Principal Consultant working with a range of FTSE 100 companies. Sue is also a member of the Women's Business Council appointed by the Government and a Vice President of the Insurance Institute of London ('IIL').

Phillip McLelland – Finance Director

Phillip joined the Boards of UKAR, NRAM and B&B in July 2011, having been Finance Director of the latter since June 2009. He is responsible for all aspects of reporting and financial control across the business, strategy, planning and communications. He is also a member of the Transaction Approvals Committees of NRAM and B&B.

Prior to joining B&B in 2000, Phillip worked at KPMG Consulting, Coopers & Lybrand and National & Provincial Building Society. He is a member of the Chartered Institute of Management Accountants.

Keith Morgan – Non-Executive Director

Keith joined the Boards of UKAR and B&B in October 2010, having joined the Board of NRAM in January 2010. He is a member of the Risk and Remuneration Committees of all three companies and the Transaction Approvals Committee of B&B and NRAM.

In December 2012 Keith accepted an appointment to lead the establishment of the Government's new business bank. He was formerly a Director and its Head of Wholly-Owned Investments, responsible for managing the Government's shareholdings of UKFI, B&B and NRAM until August 2012. He was also a Non-Executive Director of Northern Rock plc until its sale to Virgin Money in January 2012. Keith joined UKFI from Banco Santander where he was a Director of Sovereign Bancorp in the U.S.A. focusing on the integration of Sovereign into Santander. He was previously Director of Strategy & Planning at Abbey National, where he was a member of the Executive Committee and was also Chairman of Santander's Asset Management and Credit Card businesses in the UK. Before joining Abbey in 2004, Keith spent 18 years at L.E.K. Consulting, where he was a partner specialising in financial services.

Jim O'Neil – Non-Executive Director

Jim joined the Boards of UKAR, B&B and NRAM in June 2012. He is the Chief Executive of UKFI, responsible for managing the Government's shareholding in UKAR, B&B and NRAM.

Jim moved to UKFI in October 2010 from Bank of America Merrill Lynch where he spent 17 years. He has extensive experience of both the capital markets and the banking industry. He joined Merrill Lynch in 1993 in New York and relocated to London in 1999. Most recently he was Head of International Corporate Finance. He holds a BSc from the University of Virginia and an MBA from the University of Chicago, Graduate School of Business.

Louise Patten – Non-Executive Director

Louise joined the Boards of UKAR and NRAM in October 2010, and has been a Non-Executive Director of B&B since December 2003. She is a member of the Remuneration and the Nominations Committees of all three companies.

Louise is a Non-Executive Director of Capital Shopping Centres Group plc and Control Risks Group Holdings Limited as well as the senior advisor to management consultants Bain & Co. She began her career at Citibank and remained in financial services until 1993, when she joined Bain & Co, as a partner. Her previous experience as a Non-Executive Director includes the Hilton Group, Brixton plc, Great Universal Stores, Marks and Spencer Group plc and Somerfield.

John Tattersall – Non-Executive Director

John joined the Boards of UKAR and NRAM in October 2010, having joined the Board of B&B in April 2010. He is Chairman of the Risk Committees and a member of the Audit Committees of all three companies.

John retired as a partner in PricewaterhouseCoopers LLP in 2009, where he had worked since 1975, latterly as leader of the firm's Financial Services Regulatory Practice and a senior client relationship partner. He started his career in the financial services sector with Kleinwort Benson Limited in 1973. Until 2009 he was Chairman of the Risk and Regulation Committee of the Financial Services Faculty of the Institute of Chartered Accountants in England and Wales, and a member of the faculty board. He is currently a Non-Executive Director of UBS Limited, R Raphael & Sons PLC (Raphael's Bank), CCLA Investment Management Limited and the South East Institute for Theological Education. He is also a board member of the Gibraltar Financial Services Commission, Chairman of the court of the Royal Foundation of St Katharine, and a non-stipendiary priest in the Church of England. He acted as Consultant Editor and joint author of two books 'A Practitioner's Guide to the Basel Accord' and 'A Practitioner's Guide to FSA Regulation of Banking' and served as a member of the Independent Commission on Equitable Life payments. John is a Fellow of the Institute of Chartered Accountants in England and Wales.

Corporate governance (continued)

Details of Board appointments and retirements during 2012 are as follows:

Richard Pym	Chairman for the whole of 2012
Kent Atkinson	Director for the whole of 2012
Richard Banks	Director for the whole of 2012
Michael Buckley	Director for the whole of 2012
Sue Langley	Director for the whole of 2012
Phillip McLelland	Director for the whole of 2012
Keith Morgan	Director for the whole of 2012
Jim O'Neil	Appointed 28 June 2012
Louise Patten	Director for the whole of 2012
John Tattersall	Director for the whole of 2012

Board and Committee meetings

During 2012, the number of meetings attended by each Director was as follows:

	Board	Audit	Nominations	Remuneration	Risk	Transaction Approvals
Number of meetings held	**15**	**5**	**3**	**6**	**5**	**2**
Richard Pym	15		3			2
Kent Atkinson	14	5			5	
Richard Banks	15					2
Michael Buckley	15	5	3		5	2
Sue Langley	15		3	6		
Phillip McLelland	15					2
Keith Morgan	15			6	4	2
Jim O' Neil	8					
Louise Patten	15		2	5		
John Tattersall	15	5			5	

The Transaction Approvals Committee only relates to the Principal Subsidiaries.

During 2012, the Chairman of each Committee was as follows:

Audit Committee	Kent Atkinson
Risk Committee	John Tattersall
Nominations Committee	Richard Pym
Remuneration Committee	Sue Langley
Transaction Approvals Committee	Richard Pym

The current membership of the Committees is set out on pages 36 to 38.

Governance structure

Since the transfer to public ownership, the governance structure has been determined by a framework document ('the Framework Document') agreed between UKAR Limited and its Shareholder, HM Treasury. The Framework Document has been updated periodically to reflect changing circumstances and the Group operates in accordance with the terms of the latest revision to the Framework Document, 'UK Asset Resolution Limited and UK Financial Investments Limited: Relationship Framework Document', which sets out how the relationship between the Group and UKFI, acting on behalf of HM Treasury, will work in practice. The terms of this agreement are reflected below and throughout this report.

The Framework Document is intended to ensure that the relationship between the companies in the Group, UKFI, HM Treasury (as Shareholder and the provider of financial support), and the FSA (as regulator), operates in the context of the over-arching objective of maximising value for the taxpayer, whilst paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. The Framework Document requires the Group to deliver a strategic and funding business plan to achieve these objectives.

Corporate governance (continued)

The principles of the Framework Document

The relationship between the Group and UKFI operates according to the following principles under which UKFI:

- Appoints the Chairman of the Board and is entitled to appoint one or more Non-Executive Directors;
- Is required to consent to the appointment of other members of the Board proposed for appointment by the Nominations Committee and agrees the terms on which the Directors are appointed and incentivised;
- Agrees with the Board the high level objectives of the business plan ('the Plan') and any revisions to it;
- Reviews with the Board from time to time the Group's strategic options;
- Requires that the Board is accountable to it for delivering the agreed Plan;
- Gives the Board the freedom to take the action necessary to deliver the Plan;
- Monitors the Group's performance to satisfy itself that the Plan is on track; and
- Is required to give its consent for certain significant actions.

Board structure and governance

The Board operates the following committees:

- Audit Committee;
- Risk Committee;
- Remuneration Committee;
- Nominations Committee, and

in addition, the Principal Subsidiaries operate a Transaction Approvals Committee which is included in these accounts for a full understanding of the Group Committee Structure.

Further details about the Board Committees, and their roles, are provided on pages 36 to 38.

Board appointments and composition

UKFI considers that the composition of the Board is a critical factor and seeks to secure an environment in which it shares a common view about Board composition and succession with the Chairman, including size, balance of experience and diversity. To achieve this and ensure that a common governance approach is applied, the Group operates under the following principles:

- The Chairman and either the Chairman of UKFI or a senior employee nominated by the Chairman of UKFI (the 'Nominated Officer'), will discuss and confirm Board composition and succession regularly in the light of performance and the requirements of the Plan;
- UKFI will be entitled to appoint to the Board, one or more Non-Executive Directors nominated by UKFI (the 'Shareholder Directors'): Mr O'Neil and Mr Morgan are currently appointed as such Directors. The Group acknowledges that the Shareholder Directors intend to liaise with and report to representatives of UKFI from time to time in relation to the business of the Group and decisions made, or to be made, by the Board in order to assist with the exercise of their powers and duties as Directors;
- One or more senior representatives of UKFI will, if so requested by UKFI, attend meetings of the Board in an observer capacity;
- The Chairman will discuss with the Nominated Officer any impending changes to Board membership;
- The Chairman of the Nominations Committee will meet with the Nominated Officer as necessary to obtain UKFI's approval to any proposed Board changes before they become subject to the formal appointment/consent procedure. The Articles of Association require that at every Annual General Meeting each Director, other than the Shareholder Directors who are expressly exempt from this provision, shall retire from office and may offer themselves for re-appointment; the Shareholder Directors are exempt from this provision in respect of their appointments at the Principal Subsidiaries.
- Non-Executive Directors are appointed for a specified term, subject to re-appointment in accordance with the above procedures; and
- The Board will ensure that suitably rigorous appraisals are made of the effectiveness of the Chairman and the Board.

Corporate governance (continued)

Board responsibilities

During 2012, the Board was responsible for developing and delivering the Plan to restructure the Group in order to meet the State Aid requirements of the European Commission.

The Board is responsible for:

- Setting the Group's strategic aims and developing and recommending revisions to the Plan to deliver the over-arching objective of protecting and creating value for the taxpayer, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. Any proposed revisions to the Plan will be subject to review and approval by UKFI;
- Delivering the Plan in accordance with the requirements of the Framework Document. In this respect, decisions on the day-to-day running of the Group, rest with the Board in accordance with the Directors' statutory, common law and fiduciary responsibilities. UKFI is committed to giving the Board the freedom necessary to deliver the agreed Plan and will not interfere in day-to-day operational and commercial matters; and
- Ensuring that the necessary financial and human resources are in place for the Group to deliver the agreed Plan, set the Group's values and standards and ensure that its obligations to HM Treasury as Shareholder are understood and met.

The Board has a written schedule of those matters reserved for its determination and those matters reserved for UKFI, in accordance with the Framework Document.

Balance of Executive and Non-Executive Directors

The Board comprises a Non-Executive chairman, five independent Non-executive Directors, two Executive Directors and two Shareholder Directors. The Non-Executive Directors have experience in a range of commercial or banking activities. The Board has determined that the Non-Executive Directors are independent because of the commonality of purpose between UKAR and the Principal Subsidiaries and a rigorous focus on the identifcation of any specific conflicts of interest.

Monitoring performance

UKFI monitors the Group's performance against the Plan by means of the following main mechanisms:

- Meetings between the Group and UKFI to review performance to date against the Plan; and
- Monthly (or, at UKFI's request, more frequent) financial and business performance monitoring to track the progress of the Plan and the Group's performance against agreed objectives on a timely, regular and appropriate basis.

In addition, UKFI has certain monitoring and information access rights and its approval must be obtained for certain material actions and transactions.

Board Committees

The Board operates a number of Committees, each of which has detailed terms of reference setting out its remit and authority. Details of the membership and role of each Committee are set out below.

Audit Committee

The Audit Committee currently comprises Kent Atkinson (Chairman), Michael Buckley and John Tattersall, all of whom are Non-Executive Directors.

The Audit Committee met five times in 2012.

The Committee monitors, reviews and advises the Board on:

- All regulatory, prudential and accounting requirements that may affect the Group;
- The integrity of the Financial Statements and external reporting responsibilities;
- The Whistleblowing policy; and
- The results of the external audit and any significant matters identified.

The Committee approves the terms of reference for Internal Audit and reviews the adequacy and effectiveness of the activities carried out by the function. In addition, the Committee reviews the effectiveness of the system of internal control annually in accordance with the UK Corporate Governance Code.

The Committee receives reports at each meeting (other than meetings held specifically to consider the Group's results) from the managers responsible for Audit. These reports highlight existing and emerging matters of significance, areas of concern, planned actions, monitoring procedures and any other matters which are likely to impact on internal controls and financial reports.

The Committee reviews the content of the interim and annual financial statements and advises the Board on whether, in the opinion of the Committee, taken as a whole, these are fair, balanced and understandable and provide the information necessary for shareholders to assess the performance, business model and strategy.

The Committee is responsible for recommending the appointment, re-appointment and removal of the external auditors. It reviews the scope and results of the annual external audit and its cost effectiveness. The Committee also develops and recommends to the Board a policy on the supply of non-audit services by the external auditor and reviews this annually, taking into account any relevant ethical guidance on the matter.

Corporate governance (continued)

The external auditors may attend all meetings of the Committee and they have direct access to the Committee and its Chairman at all times. The Head of Internal Audit provides further assurance that the significant risks identified by the business are properly managed. The Head of Internal Audit also has direct access to the Audit Committee and its Chairman. The Committee regularly receives reports of reviews conducted throughout the Group by the Internal Audit function. In 2012, the provision of Internal Audit services were put out to tender and Deloitte LLP was appointed to undertake this function replacing Ernst & Young LLP.

In reviewing the 2012 Financial Statements, the Committee reviewed areas of judgement and key items for the year. In particular, the Committee considered whether the provisions for the loan impairment, impairment on investment securities, customer redress and other sundry amounts were appropriate. A prudent view was taken on all these areas. Coverage on the residential loan books has fallen, but this was due to improved arrears performance rather than any relaxation in provisioning. It was decided to classify the customer redress provision in the Income Statement as a provision, rather than net it off interest income. This provides greater visibility to this material item and is consistent with the treatment of other customer redress. It was also decided that future costs to enable the switch to our new outsourced provider of IT support should be provided this year, as we are committed to the change and no asset will be created, so capitalisation is not appropriate. Final decisions on accounting judgements are made in a "close out" meeting with the external auditors present.

The external audit contract was last put out to tender in 2010 with PricewaterhouseCoopers LLP ('PwC') being appointed as external auditors from 28 April 2011 for a three year term. It is intended to review PwC's appointment in 2013. As 2012 is the first full year that PwC have been in post, a full evaluation of their performance will be undertaken for the first time post the completion of all year-end work.

UKAR have used PwC for non-audit related work, but engagement is subject to the non-audit services policy which recognises the importance of protecting both the internal and external auditors' independence. Specifically, the policy requires the Finance Director to be aware of the hiring of auditors for non-audit work. The Chairman of the Audit Committee must sign-off work which will cost more than £50,000 and the auditors are asked to confirm that they are able to provide the services without compromising objectivity or independence. The Audit Committee reviews the audit and non-audit fees paid to the internal and external auditors every six months.

Risk Committee

The Risk Committee currently comprises John Tattersall (Chairman), Kent Atkinson, Michael Buckley and Keith Morgan, all of whom are Non-Executive Directors.

The Risk Committee met five times in 2012.

The main role of the Risk Committee is to advise the Board on key risks inherent in the business, risk governance and the effectiveness of the systems of control necessary to manage such risks, and to present its findings to the Board. The Head of Internal Audit and external auditors regularly attend the meetings.

This responsibility requires the Risk Committee to keep under review the adequacy of the Group's risk management frameworks and systems of internal control, which include financial, operational and compliance risk management controls and to foster a culture that emphasises and demonstrates the benefits of a risk-based approach to internal control and management of the Group. The Risk Committee fulfils this remit through its oversight of the embedding of a supportive culture in relation to the management of risk and by making appropriate recommendations to the Board on all significant matters relating to the Group's risk appetite, strategy and policies.

The Risk Committee also monitors the overall risk appetite within the Group and risk management performance, taking into account the current and prospective macroeconomic and financial environment, drawing on financial stability assessments such as those published by the Bank of England, the Financial Services Authority and other authoritative sources that may be relevant.

To assist the Board in discharging its responsibilities for the setting of risk policies, the Risk Committee periodically reviews the Group's material risk exposures in relation to the Group's risk appetite and capital adequacy.

The Risk Committee ensures that the public disclosure of information regarding the Group's risk management policies and key risk exposures is in accordance with statutory requirements and financial reporting standards.

Remuneration Committee

The Remuneration Committee currently comprises Sue Langley (Chairman), Louise Patten and Keith Morgan, all of whom are Non-Executive Directors.

The Remuneration Committee met six times in 2012.

The Committee is responsible for advising the Board on the remuneration arrangements for FSA Code employees including Executive Directors. The Committee also reviews and recommends to the Board the remuneration arrangements and policies for those Executives directly below Board level and the remuneration policies for all other staff.

The Committee takes internal and external professional advice where necessary to discharge its obligations and during 2012 has utilised the services of Hewitt New Bridge Street.

Corporate governance (continued)

Nominations Committee

The Nominations Committee currently comprises Richard Pym (Chairman), Michael Buckley, Sue Langley and Louise Patten all of whom are Non-Executive Directors.

The Nominations Committee met three times in 2012.

The Committee is responsible for reviewing the composition of the Board and preparing succession plans. The Committee is also responsible for identifying potential Executive and Non-Executive Directors and making recommendations to the Board concerning the appointment or re-appointment of Directors, having regard to the requirement for the Board to have the appropriate range of skills and experience.

The Committee also reviews the leadership needs of the Group, the succession plans for key executive roles and approves the Board and Employee Diversity Policies.

In accordance with the Framework Document UKFI is entitled to appoint one or more Non-Executive Directors and appointed Jim O'Neil, UKFI's Chief Executive, as a Non-Executive Director on 28 June 2012. In such circumstances the use of open advertising or an external search consultancy is inappropriate.

The Board Diversity policy endorses the principles of best practice and recognises the benefits of having a diverse board. The policy requires that in reviewing board composition, the Committee will consider the benefits of all aspects of diversity including skills, background, race, experience, gender and other qualities of directors. Due to the unique nature of the appointment process and the anticipated reduction in the size of the Board, a gender target is considered to be inappropriate

Transaction Approvals Committee

The Principal Subsidiaries operate a Transaction Approvals Committee, which currently comprises Richard Pym (Chairman), Michael Buckley, Keith Morgan, Richard Banks and Phillip McLelland.

The Transaction Approval Committee met twice in 2012

The Committee is authorised to approve the implementation, including inter alia, terms, timing, pricing, documentation and appointment of advisors of Strategic Transactions, in accordance with any directions and limits set by the Board and with reference to the requirements of the Framework Document.

Management Committees

The Group operates a number of Management Committees, including an Executive Committee ('EXCO'), details of which are set out on pages 40 to 41.

Relationship between the Chairman and the Chief Executive Officer

A clear division of responsibility exists between the Chairman, who is responsible for running the Board and the CEO, who has responsibility for running the business. This division is set out in writing and has been approved by the Board.

Induction and training

The Group requires all newly appointed Directors to undergo a formal induction training programme appropriate to their skills and experience, to ensure that they:

- Are fully aware of their role, duties and responsibilities as a Director; and
- Have a good understanding of the operation of the business, so as to contribute effectively.

The Group also requires Non-Executive Directors to undertake relevant ongoing training and development to improve their capabilities and thereby contribute more effectively to Board decision making.

A comprehensive thematic training programme is in existence.

Board evaluation

During 2012, a Board evaluation exercise was conducted by the Chairman with assistance from the Company Secretary.

All Executive Directors, Non-Executive Directors and the Chairman participated in the appraisal of the Board and its Committees to ensure that their operation continued to be of the highest standard. The appraisal process consisted of a questionnaire and meetings with Directors that canvassed their views on a wide range of matters including the effectiveness of the Board and how it works together as a unit, its Committees and the Chairman. In addition, the evaluation also considered the Board meeting process, the composition of the Board including the balance of skills, experience, independence, knowledge and diversity and the interaction between the Board and its Committees.

The Company Secretary reported to the Chairman on the outcome of the evaluation exercise, which showed that the Board and its Committees are discharging their responsibilities effectively. The appraisal produced a number of recommendations to further improve effectiveness of the Board which are to be implemented during the course of 2013 and the Chairman makes comment on the conclusions in his Chairman's Statement at the front of these accounts.

Corporate governance (continued)

Board procedures

To ensure that the Group functions effectively, Directors have full and timely access to all information which may be relevant to the discharge of their duties and obligations. All Directors have access to the advice and services of the Company Secretary, who is responsible for ensuring that Board procedures and applicable rules are followed. Where necessary, Directors are able to take independent professional advice at the Group's expense.

Internal control and risk management

The Board is responsible for the Group's system of internal control and seeks regular assurance to satisfy itself that the system is functioning effectively in managing risks in the manner which it has approved. Such a system can only provide reasonable, and not absolute, assurance against material misstatement or loss, as it is designed to manage, rather than eliminate the risk of failure to achieve business objectives. Throughout the year ended 31 December 2012, the Group has operated a system of internal control, which includes an ongoing risk management process for identifying, evaluating and managing the significant risks faced by the Group. During the year, the Board has continued to review the effectiveness of the Group's system of financial and non-financial controls including operational and compliance controls, risk management and the Group's most significant risks and mitigating actions.

In addition, as part of the process of preparing this statement, the Board has also performed its annual assessment of the effectiveness of risk management and internal controls. The Board of Directors is not aware of any significant risk events or internal control failures that arose across the Group during 2012 that are not being addressed in accordance with the internal control procedures of the Group.

The Group is committed to developing and maintaining an appropriate risk management framework and culture with the aim of continuing to ensure that Management understand the key risks that the business faces. This is achieved through an organisational structure with clear reporting lines and governed by appropriate business monitoring mechanisms, codes of conduct and policy statements.

Under the risk management framework, the Group operates a risk management process, producing an enterprise-wide risk profile. This identifies the Group's significant risks, the probability of those risks occurring and their impact should they occur. Management regularly takes action to improve the design and operation of suitable controls, either as a result of its own initiative, or in response to reports from Internal Audit and other oversight review functions.

The risk management process is complemented by a formalised reporting and escalation process for control issues. Internal Audit has a key role in maintaining the control environment by providing independent assurance on the effectiveness of the Group's internal control systems. The Risk Committee and the Audit Committee oversee the risk management process, regularly consider the enterprise-wide risk profile, and receive monitoring reports to update them on progress.

The system of risk management and internal control has been in place throughout 2012 and up to the date of approval of the Annual Report and Accounts.

In reviewing the effectiveness of this system, the Board takes into account the work of the Risk Committee which reviews the Group's significant risks and how these are being managed. The Risk Committee also considers reports from Compliance and from Management on the system of internal control, adherence to regulatory requirements and material control weaknesses, where these exist, together with actions taken to address them. The Audit Committee considers reports from Internal Audit and External Audit on the system of internal control and material control weaknesses, where these exist, together with actions taken to address them. The Chairmen of the Risk Committee and the Audit Committee report on the outcome of each meeting to the Board, where appropriate, and the Board also receives minutes of these Committee meetings.

Going concern

The Directors have assessed, in the light of current and anticipated economic conditions, the Company's and the Group's ability to continue as a going concern. As set out in the Annual Reports and Accounts of B&B and NRAM, HM Treasury has provided various on-demand facilities to each of those companies, and has provided confirmation to the Directors of those two companies that it is HM Treasury's intention to fund those companies so as to maintain them as a going concern, and to enable those companies to meet their debts as and when they fall due, for a period up to at least 1 November 2014. Accordingly, the Directors of B&B and NRAM are satisfied at the time of approval of these Financial Statements that the B&B and NRAM companies and groups have adequate resources to continue in business for the foreseeable future. The Directors of the Company confirm that, therefore, they are satisfied that the Company and the Group have adequate resources to continue in business for the foreseeable future, and for this reason they continue to adopt the going concern basis in preparing the Financial Statements.

Risk management and control

Pages 40 to 43 form an integral part of the audited Financial Statements.

Introduction

In accordance with the requirements of the Framework Document which is referred to on page 35, the Group's approach to risk management is built on formal governance processes and relies on individual responsibility and collective oversight, informed by comprehensive reporting.

The following sections describe the Group's approach to risk management, including the risk governance structure and major risk categories under management. Other than the risks described here, there are other factors which could also affect the Group's results, including economic factors. Therefore, the categories of risk described below should not be considered to represent all of the potential risks and uncertainties which could impact the Group's performance.

Risk governance

The responsibility for the strategy and approach to risk governance and management lies with the Board. The Board is responsible for determining risk strategy, setting risk appetite and reviewing the effectiveness of risk and control processes in support of the Group's strategy. The Board is also responsible for establishing a clearly defined risk management structure with distinct roles and responsibilities. Under that structure, Internal Audit provides 'third line of defence' challenge and review of the management of risks, and the adequacy and effectiveness of controls within the business. Management committees and the Risk Function provide 'second line of defence' oversight, challenge and review, and line managers have 'first line of defence' responsibility for the identification, measurement and management of the risks within their business areas.

The management of the risk framework, including oversight and challenge to the business on the effectiveness of their risk management activity, and reporting of Strategic, Operational and Financial Risk, is performed by specialist teams in the Risk Function. Second line of defence monitoring of the risk management framework is also performed by the Risk Function.

Management Committees

The Management Committees, under the authority delegated by the Board are described below:

Executive Committee ('EXCO')

EXCO is an advisory committee which supports the CEO in managing the business to achieve its strategic objectives.

The following are sub-committees of EXCO:

- Executive Transformation Committee ('ETC')
- Investment Advisory Committee ('IAC')
- Remediation Steering Committee ('RSC')
- Executive Risk Committee ('ERC')

Executive Transformation Committee

The primary objectives of the ETC are to ensure that appropriate returns are achieved from investment in change initiatives and to oversee the portfolio of programmes within Transformation. This is achieved by ensuring that the portfolio of programmes aligns with the strategic agenda laid down by EXCO.

Investment Advisory Committee

The IAC supports, advises and makes recommendations to EXCO on the development and subsequent execution of proactive strategies that balance reduction of the UKAR balance sheet with the maximisation of taxpayer value.

Remediation Steering Committee

The RSC supports the EXCO in effectively executing its obligations of ensuring fair and timely remediation to customers in circumstances where customer redress is appropriate. This includes providing oversight and challenge of the delivery of customer remediation or redress activities across the Group.

Executive Risk Committee

The ERC is a management sub-committee of EXCO with a reporting line to the Risk Committee ('RC'). The primary objective of the ERC is to provide technical oversight of key financial and operational risks and governance issues, including the review of the adequacy of risk mitigating actions, costs and capital effectiveness. The Committee supports, advises and makes recommendations to EXCO and the RC.

The following are sub-committees of the ERC:

- Asset & Liabilities Committee ('ALCO')
- Operational Risk Committee ('ORC')
- Credit Risk Committee ('CRC')
- Fraud & Professional Negligence Committee ('FPNC')

Risk management and control (continued)

Pages 40 to 43 form an integral part of the audited Financial Statements.

Asset & Liabilities Committee

The primary objectives of ALCO are to support and advise the ERC on asset and liability management, market risks and risks relating to wholesale credit, capital and liquidity adequacy.

Operational Risk Committee

Principally, ORC supports the ERC in its oversight of the Principal Subsidiaries' adherence to the Operational Risk Framework, Operational Risk Strategy and Policy, and provides challenge to the business on the accuracy, robustness and reliability of operational risk information and reports.

Credit Risk Committee

The CRC's primary purpose is to review credit policies, procedures and credit related proposals that have a financial impact on the business and to ensure the proposals balance the risk and reward ratio in line with the Credit Risk Appetite set by the Board.

Fraud & Professional Negligence Committee

The FPNC determines and oversees the implementation of the strategy to mitigate the impacts of fraud and/or professional negligence and ensures that recoveries are maximised. The FPNC supports risk oversight of key fraud and professional negligence matters through reporting into the ERC.

Risk management oversight

The Risk Function provides oversight and independent challenge to the management of Risk across the Group. The Function comprises a team of risk management specialists with responsibility for the embedding and oversight of operational, financial and strategic risk management, and analysis and reporting of risk matters to the Board, and the Board advisory and management committees. Key functional responsibilities include:

- Development of the Enterprise Wide Risk Management Framework ('EWRMF') and policies for the identification, assessment and mitigation of financial, strategic and operational risks;
- Provision of support to the Group business line management in the implementation of the EWRMF;
- Aggregate analyses and review of risk concentrations and sensitivities across the Principal Subsidiaries;
- Act as a point of reference for risk and control matters, providing advice to management, sharing best practice and carrying out special reviews as directed by the Board, RC, EXCO and sub committees of EXCO; and
- Provision of independent assessment of, and challenge to, the business areas' risk management and profiles to ensure that they are maintained in a robust manner.

Compliance

The role of Compliance is to:

- Provide assurance to the Board and EXCO, through the RC, that control processes are in operation to manage all regulatory risks across the Principal Subsidiaries;
- Contribute to the continuous improvement of regulatory compliance through provision of advice to the Principal Subsidiaries; and
- Oversee and co-ordinate liaison with the FSA on a day to day basis to promote open and co-operative relationships.

Internal Audit

Internal Audit activities are outsourced. During the year, the outsourced provider was changed from Ernst & Young LLP to Deloitte LLP. Deloitte services include the provision of a seconded Head of Internal Audit. This person is approved for the position by the FSA and the Audit Committee. However, the oversight of the Internal Audit function remains with the Group. The Head of Internal Audit reports to the Chairman of the Audit Committee and to the CEO.

The prime objective of the Internal Audit department is to provide reliable, valued and timely assessment to the Board, Audit Committee and Executive management on the effectiveness of the system of internal controls in mitigating current and evolving key risks, and in so doing, assist the organisation in enhancing the effectiveness of its approach to risk management.

Business and support activities of the Group are included in the scope of Internal Audit's responsibility and are subject to regular and appropriate internal audit review in accordance with Internal Audit's risk based Audit Plan.

Risk management and control (continued)

Pages 40 to 43 form an integral part of the audited Financial Statements.

Risk categorisation

The Group categorises Risk under the following headings:

(i) Credit risk

Credit risk is the potential for financial loss caused by a retail or commercial customer, or wholesale counterparty, failing to meet their obligations to the Principal Subsidiaries as they become due. As the Principal Subsidiaries are no longer making any new retail loans, the absolute level of retail credit risk is expected to decline as the current assets mature and wholesale credit risk will decline in line with the maturity profile of financial instruments and investments. Credit risk is the largest risk the Principal Subsidiaries face and the monitoring of the recoverability of loans and amounts due from counterparties is inherent across most of the Principal Subsidiaries' activities.

The Principal Subsidiaries employ credit behaviour scoring and fraud detection techniques to support loss minimising strategies. As no new lending is now being undertaken, the focus of credit risk activities is on:

- A proactive approach to the identification and control of loan impairment in the Residential and Commercial Credit Risk and Credit Control areas;
- Fraud and professional negligence investigation; and
- The use of credit behaviour scoring and other techniques to monitor the risk profile of the existing book.

Adverse changes in the credit quality of borrowers or a general deterioration in UK economic conditions could affect the recoverability and value of the Principal Subsidiaries' assets and therefore the financial performance of each subsidiary.

As credit risk is the main risk to the Principal Subsidiaries, a credit risk framework has been established as part of the overall governance framework to measure, mitigate and manage credit risk within risk appetite. To a lesser degree, the Group is exposed to other forms of credit risk such as those arising from settlement activities where the risk is a consequence of a transaction, rather than a driver of it.

The extent to which credit risk in the Group's Balance Sheet is mitigated is shown by the following table of provisions for mark-downs on impaired assets:

At 31 December	Balance Sheet value	Provision	Balance Sheet value	Provision
	2012	**2012**	2011	2011
	£m	**£m**	£m	£m
Loans secured on residential property	**66,056**	**1,411**	71,913	1,645
Other secured loans	**782**	**100**	857	102
Unsecured personal loans	**1,895**	**404**	2,524	502
Wholesale assets	**11,779**	**667**	11,765	768

The Principal Subsidiaries' ability to influence the structure of their credit risk profiles, in the absence of asset sales, is largely restricted to the degree of control which they have over risk strategy, loan redemptions and credit collections activity. With the composition of the loan portfolio largely fixed in the short to medium term, the Principal Subsidiaries' credit risk profiles are now determined by the credit quality of the existing portfolio. Changes in credit quality will arise from: changes in the underlying economic environment; assumptions about the future trends in the economy; changes in the specific characteristics of individual loans; and the credit risk strategies developed to add value to the book whilst mitigating credit risk.

It is Group policy to monitor the profile of the Principal Subsidiaries' lending exposure on a quarterly basis. Changes in the risk profile are reported as part of the subsidiaries' stress tests. The stress tests forecast losses, impairment and capital requirements at a portfolio and product level over a 10 year horizon given a range of economic scenarios.

The Board receives a monthly update on changes in the key drivers of the lending credit risk profile, with more detailed information on the factors underlying these key drivers being reported monthly to the ERC.

Credit related policies and limits are developed and maintained within Credit Risk and are reviewed and approved annually by the Board, or when significant changes to policies are recommended. The ERC ensures that any exposure to credit risk remains within overall risk exposure levels as agreed by the Board.

Authorised credit risk limits for wholesale money market counterparties reflect their credit rating as well as size, depth and quality of their capital base. Wholesale Credit related policies and limits are developed and maintained by Wholesale Risk and are approved by the Board at least annually, or when material changes to policies are recommended.

The Principal Subsidiaries each hold a structured finance portfolio that primarily consists of investments in asset backed securities ('ABS'). The credit risk is determined by the quality of the underlying securitised assets. No new structured finance investments are permitted apart from the purchase of those issued by the Group's own secured funding vehicles.

Risk management and control (continued)

Pages 40 to 43 form an integral part of the audited Financial Statements.

(ii) Market risk

Market risk is the potential for change in Group income or Group net worth arising from movements in interest rates, exchange rates or other market prices. Effective identification and management of market risk is essential for maintaining stable net interest income. The Principal Subsidiaries do not trade or make markets in any areas and market risk arises only as a consequence of carrying out and supporting core business activities.

Market risk comprises interest rate risk and foreign exchange risk. Interest rate risk is principally managed via interest rate swaps and foreign exchange risk by foreign exchange contracts.

The Board's appetite for Market Risk is expressed in the market risk limits set out in the Board approved Market Risk Policy. Responsibility for staying within limits is delegated to the Investment Director and exposures are reported daily by Finance to senior management and monthly by Wholesale Risk to ALCO. ALCO is responsible for ensuring that the Investment Director implements market risk strategies consistently with the Board's Risk Appetite.

(iii) Liquidity risk

Liquidity risk is the risk of being unable to pay liabilities as they fall due and arises from both the mismatch in asset, liability, derivative, and collateral cash flows and from unforeseen changes to these.

The Board's appetite for Liquidity Risk is expressed as minimum liquidity levels as set out in the Board-approved Liquidity Risk Policy. Responsibility for managing liquidity risk is delegated to the Investment Director. Stress tests are used to assess the adequacy of liquidity both daily and monthly by Finance and Wholesale Risk and the results are reported to ALCO. ALCO is responsible for ensuring that the strategies of the Investment Director maintain liquidity risk within the Board's Risk Appetite.

Sterling liquidity is held as cash balances at the Bank of England. Euro and US dollar cash balances are held at a range of highly rated banks.

(iv) Operational risk

Operational risk is defined as:

'The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events'.

The Operational Risk Framework includes a balance of policies, appropriate procedures and internal controls to enable effective identification, assessment, mitigation and reporting of key Operational Risks. The framework is overseen and reported on by the Operational Risk Function. The key objectives of the framework are as follows:

Risk and Control Self Assessment

Provision of a consistent framework for the identification, assessment, monitoring and reporting of significant risks and key controls across the Group. Where controls are assessed as ineffective in design or operation, a defined Corrective Action Plan process is in place to develop, track and implement control improvements.

Operational Risk Event Reporting

Provision of a consistent framework for the identification, investigation, assessment and reporting of Operational Risk Events (losses, gains and near misses) across the Group. Root cause analysis performed as part of Operational Risk Event Reporting enhances the control environment by directing control improvement effort where there is a risk of event recurrence.

Operational Risk Weighted Financial Impact Analysis and Scenario Analysis

The Group undertakes operational risk weighted financial impact analysis and scenario analysis to calculate the financial impact of both expected and unexpected operational risk events. This analysis facilitates a comparison between operational risk, financial exposure and the operational risk capital allocation derived under the Group's capital adequacy assessment process.

(v) Strategic risk

Strategic Risk is defined as the current or prospective risk to earnings and/or fair value, given the B&B Group and the NRAM Group Balance Sheet structure, arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.

UKAR considers the six primary strategic risks to be macroeconomic environment, market stresses, structural asset/liability mix, political, regulatory and legal risk, infrastructure risk and project risk.

UKAR's focus is on continuous assessment and measurement of movement in strategic risk status in order to ensure continuous monitoring of potential impacts on the 10 Year Plan, annual business and operating plans, and UKAR's overarching strategic objectives. Thus, close oversight of movements in strategic risk (proximity, financial impact, probability) is maintained via monthly reporting to EXCO and the Board. Where appropriate, and taking in to account the mainly external nature of strategic risk, risk management strategies can then be defined to mitigate the impact of a risk event arising.

Corporate social responsibility report

UKAR aims to conduct its business in a socially responsible manner in respect of our customers, the workplace, the communities we operate in and the environment.

Customers

Our subsidiary businesses have some 634,000 customers, making us one of the largest mortgage service providers in the UK.

We are committed to:

- Ensuring that simplicity, integrity and truth applies to everything we do;
- Supporting vulnerable customers; and
- Supporting customers in financial difficulty.

Workplace

UKAR's employment practices reflect international and national standards covering areas such as minimum working age, working hours, health and safety and discrimination.

UKAR aims to recruit high calibre employees from all sections of the community, ensuring that no employee or job applicant receives less favourable treatment on grounds which are not related to the job. We adopt best practice policies and procedures which form a key part of our induction programmes together with the standards of behaviour we should all abide by and expect from each other.

A comprehensive training and development programme for colleagues throughout UKAR provides colleagues with the skills and specialist development opportunities to achieve their potential in order to help them do their job today and for any future roles they may undertake. Since UKAR was formed over 100 colleagues have achieved an external qualification through the support of the UKAR training academy. An Apprenticeship Scheme was introduced in 2010 and in 2012 we have launched our first Undergraduate Scheme.

UKAR believes that promoting both a diverse culture and diverse working practices will help retain and engage talent, maintain motivation and improve the wellbeing of all colleagues in the workplace. We build a working environment based on trust and openness and encourage effective and efficient communication throughout the organisation.

Colleague engagement is important to us and we use a variety of channels for communicating including an intranet site, monthly team meetings and a quarterly magazine which is developed with the support of an editorial panel drawn from colleagues throughout the business. New ideas are encouraged via a suggestion scheme programme and the weekly 'blogs' from Executive Committee members highlight the efforts we are making to encourage teamwork both within and between different sites and departments.

We have a good relationship with the Unite union and colleagues also represent the business on the Health & Safety Committee. We are flexible in the way we approach the personal circumstances of colleagues, preventing discrimination for example on family grounds and ensuring the workplace needs of those with families are addressed. We report our sickness and stress absence data to the Board on a monthly basis and throughout 2012 we remained below the national benchmark for sickness and stress. In particular we monitor stress related absence and investigations to date have shown no particular trends arising from particular business areas or site locations.

Community

We are committed to:

- Using the skills of the business to support education in our communities;
- Building the skills of our colleagues through community engagement; and
- Supporting colleagues with their own community and charity initiatives.

During 2012, UKAR supported the NSPCC as our corporate charity of the year.

At each site we also supported a local charity chosen by our colleagues. These were Sue Ryder – Manorlands in Crossflatts, Tiny Lives Special Care Babies in Sunderland and the Sir Bobby Robson Foundation in Gosforth. The following amounts were raised for these charities in 2012:

- NSPCC £15,663
- Sue Ryder £11,396
- Tiny Lives Special Care Babies £ 6,774
- The Sir Bobby Robson Foundation £ 4,354

£18,641 was also raised for other charities in 2012.

In addition, UKAR supports other charitable fundraising activities by adding up to £250 to funds raised per employee and by matching employee donations to charity through a payroll giving programme. During the year, in total, UKAR matched employee fundraising to the total of £29,568 and payroll giving totalled £19,812.

Corporate social responsibility report (continued)

UKAR works with Young Enterprise to give colleagues the opportunity to have a positive impact on young people in the local communities by volunteering to deliver their programmes in local schools.

Young Enterprise is a charity set up to work with schools to inspire young people with the confidence, ability and ambition to succeed in a challenging and changing economy.

During 2012, 272 employees took part in volunteering events.

Environment

We are committed to:

- Reducing environmental impact wherever possible
- Increasing recycling programmes
- Creating awareness of environmental programmes and engaging colleagues in these activities

We seek to improve our environmental performance through a range of initiatives and in 2012 we achieved the following:

Recycling	98% of waste recycled.
Landfill	2% of waste sent to landfill.
Carbon*	Reduced by 14.7%.

We achieved the Carbon Saver** gold standard award in 2012 for saving 29% of our total energy costs since 2009.

Wherever possible surplus furniture and equipment is donated to charitable organisations or is recycled in other ways.

Corporate Social Responsibility in 2013

In 2013 our Community Investment Approach will focus on using the skills of the business to support youth education in our communities and address health as a social issue which affects our business and the communities we operate in.

UKAR’s corporate charity in 2013 is Heart Research UK. We will also support the following local charities:

Crossflatts	Yorkshire Air Ambulance
Doxford	Grace House Children’s Hospice
Gosforth	St Oswald’s Hospice

* Carbon produced from utilities (Gas/Electric consumption).

** The Carbon Saver awards are part of the CRC Energy Efficiency Scheme, which is the mandatory programme run by the Department of Energy and Climate Change. It’s aimed at improving energy efficiency and cutting emissions in large public and private sector organisations.

Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report, the Directors' Remuneration Report 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 Group and Parent Company Financial Statements in accordance with International Financial Reporting Standards ('IFRS') 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 Group and the Company and of the profit or loss of the Group 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 IFRS as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the Financial Statements; and
- prepare the Financial Statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

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 the Group and enable them to ensure that the Financial Statements and the Directors' Remuneration Report comply with the Companies Act 2006 and, as regards the Group Financial Statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the Company's website, and legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the Directors confirms that, to the best of each person's knowledge and belief:

- the Financial Statements, prepared in accordance with IFRS as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit of the Group and Company; and
- the Directors' Report contained in the Annual Report includes a fair review of the development and performance of the business and the position of the Company and Group, together with a description of the principal risks and uncertainties that they face.
- The Annual Report and Accounts, taken as a whole, is fair, balanced and understandable, providing the information necessary for shareholders to assess the Group's performance, business model and strategy.

Other matters

Principal activities

The principal activities of the UKAR Group are explained in the CEO's review on pages 6 to 8.

Review of business, future developments and uncertainties

A review of the business, future developments and uncertainties is set out in the CEO's review on pages 6 to 8.

Principal risks

Principal risks of the UKAR Group are covered on pages 40 to 43.

Property, plant and equipment

Land and buildings, which are included in the Balance Sheet at cost less accumulated depreciation, amounted to £11.1m at 31 December 2012 (2011: £29.0m). In the Directors' opinion, based on valuations carried out by the Group's external qualified Chartered Surveyors, the total market value of those assets at that date was not significantly different to the Balance Sheet amount.

Dividends

The Directors do not propose the payment of any dividend in respect of the year ended 31 December 2012.

Directors' interests

No Director has any interests in shares in the Group.

No Director had any material interest during the year in any contract of significance to the Group's business.

Major Shareholders

As at the date of this Report, all shares in UKAR are held by HM Treasury and all shares in B&B and NRAM are held by UKAR Limited.

Employee involvement

UKAR is committed to providing employment practices and policies which recognise the diversity of our workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief.

Employees are kept closely involved in major changes affecting them through measures such as: team meetings, briefings, internal communications and engagement surveys. There are well established procedures, including regular meetings with our recognised union, to ensure that the views of employees are taken into account in reaching decisions.

UKAR is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. We have established a full suite of communication channels, including an extensive face-to-face briefing programme which allows us to update our employees on our performance and any financial issues throughout the year.

The Non-Executive Directors have service contracts with UKAR. All Executive Directors and colleagues were employed by B&B (the legal employer) during 2012.

Charitable and political donations

Details of the Company's charitable donations and corporate social responsibility activity can be seen on pages 44 to 45.

No contributions were made for political purposes in 2012 or 2011. The Group does not make any payments that might be deemed to be political in nature.

Creditor payment policy

The Company has no creditors other than other Group Companies. It is the policy of the Group to aim to pay creditor invoices within 30 days of the invoice date. The Group is willing to consider requests by small suppliers for a shorter settlement period. The UKAR Group's average number of creditor days in 2012 was 26 days (2011: 26 days).

Other matters (continued)

Directors' indemnities

The Articles of Association provide the power to indemnify any Director against liabilities incurred as a result of their office.

UKAR has also provided each Director with a Deed of Indemnity indemnifying them to the fullest extent permitted by law against all losses suffered or incurred in respect of acts and omissions arising as a result of holding office. The indemnities also extend to the reimbursement of each Director with the costs of defending all claims, actions and proceedings including regulatory investigation arising out of or connected with the exercise of, or failure to exercise, any of the Director's powers, duties or responsibilities as an officer, director, trustee, agent or employee of the Group and any of its subsidiaries. Reimbursement is subject to the Director's obligation to repay the Company in accordance with the provisions of the Companies Act 2006. The payment obligations of the Company under each Deed of Indemnity are backed by a specific guarantee in favour of the Director entered into between each Director and HM Treasury.

UKAR has also arranged Directors' and Officers' Insurance on behalf of the Directors in accordance with the provisions of the Companies Act 2006.

Annual General Meeting ('AGM')

It is proposed that the AGM of the Company will be held on 27 March 2013.

Independent Auditor

A resolution to re-appoint PricewaterhouseCoopers LLP as the Group's auditor will be put to the Shareholder at the forthcoming AGM.

Disclosure of information to the Auditor

As at the date of this report, each person who is a Director confirms that:

- So far as each Director is aware there is no relevant audit information of which the Company's auditor is unaware; and
- Each Director has taken such steps as he or she ought to have taken as a Director in order to make him or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 (2) of the Companies Act 2006.

Paul Hopkinson

Company Secretary, by order of the Board

22 March 2013

The Accounts

Notes to the Financial Statements

UKAR Limited Company Accounts

Notes to the Financial Statements

Independent Auditors' report to the members of UK Asset Resolution Limited

We have audited the Group Financial Statements of UK Asset Resolution Limited for the year ended 31 December 2012, which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated Balance Sheet, the Consolidated Statement of Changes in Equity, the Consolidated Cash Flow Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ('IFRS') as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 46, 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 of 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 Group'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 Annual Report & Accounts 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 Group Financial Statements:

- give a true and fair view of the state of the Group'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 IFRS as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006, and Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the Group Financial Statements are prepared is consistent with the Group Financial Statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following.

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- 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.

Other matter

We have reported separately on the parent Company Financial Statements of UK Asset Resolution Limited for the year ended 31 December 2012.

Craig Gentle (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP

Chartered Accountants and Statutory Auditors

Bristol

22 March 2013

Consolidated Income Statement

For the year ended 31 December	Note	2012 £m	2011 £m
Interest receivable and similar income	3	**2,624.0**	2,733.0
Interest expense and similar charges	3	**(1,139.1)**	(1,010.6)
Net interest income	3	**1,484.9**	1,722.4
Fee and commission income		**29.3**	43.1
Fee and commission expense		**(12.3)**	(14.3)
Net fee and commission income		**17.0**	28.8
Net gains on financial instruments designated at fair value	4	**17.5**	–
Net realised gains less losses on investment securities	5	**(14.9)**	(1.2)
Unrealised fair value movements on financial instruments	6	**(42.8)**	79.2
Hedge ineffectiveness	6	**(28.4)**	(85.2)
Provision for customer redress	27	**(419.0)**	–
Other operating income		**10.9**	8.9
Non-interest income		**(459.7)**	30.5
Net operating income		**1,025.2**	1,752.9
Administrative expenses:			
– Ongoing	7	**(207.3)**	(220.6)
– Other net expenses	7	**(59.7)**	(65.2)
Impairment on loans to customers	15	**(241.4)**	(390.4)
Net impairment on investment securities	12	**30.2**	(58.8)
Defined benefit pension scheme gains	19 (c)	**–**	3.5
Gain on repurchase of own liabilities	8	**143.5**	338.1
Profit on disposal of credit linked notes	9	**–**	15.6
Profit before taxation		**690.5**	1,375.1
Taxation	10	**(126.7)**	(213.8)
Profit for the financial year		**563.8**	1,161.3

The notes on pages 56 to 114 form an integral part of these Financial Statements.

The Group's business and operations comprise one single activity, principally within the United Kingdom, and the Group has only one operating segment for the purposes of IFRS 8 'Operating Segments'. The results above arise from continuing activities and are attributable to the equity shareholder.

Consolidated Statement Of Comprehensive Income

For the year ended 31 December 2012	**Gross of tax £m**	**Tax £m**	**Net of tax £m**
Profit for the financial year	**690.5**	**(126.7)**	**563.8**
Available-for-sale instruments:			
– net gains recognised in available-for-sale reserve during the year	**73.0**	**(17.8)**	**55.2**
– amounts transferred from available-for-sale reserve and recognised in profit during the year	**(2.2)**	**0.5**	**(1.7)**
Cash flow hedges:			
– net losses recognised in cash flow hedge reserve during the year	**(1,236.9)**	**647.1**	**(589.8)**
– amounts transferred from cash flow hedge reserve and recognised in profit during the year	**1,322.0**	**(692.5)**	**629.5**
Actuarial gains and losses on retirement benefit obligations	**(87.2)**	**19.6**	**(67.6)**
Total other comprehensive income	**68.7**	**(43.1)**	**25.6**
Total comprehensive income for the financial year	**759.2**	**(169.8)**	**589.4**

For the year ended 31 December 2011	**Gross of tax £m**	**Tax £m**	**Net of tax £m**
Profit for the financial year	1,375.1	(213.8)	1,161.3
Available-for-sale instruments:			
– net gains recognised in available-for-sale reserve during the year	128.8	(21.2)	107.6
– amounts transferred from available-for-sale reserve and recognised in profit during the year	(3.5)	0.7	(2.8)
Cash flow hedges:			
– net gains recognised in cash flow hedge reserve during the year	83.6	(22.4)	61.2
– amounts transferred from cash flow hedge reserve and recognised in profit during the year	267.7	(25.5)	242.2
Actuarial gains and losses on retirement benefit obligations	51.3	(15.5)	35.8
Effect of funding plan for retirement benefit obligations	117.6	(30.7)	86.9
Total other comprehensive income	645.5	(114.6)	530.9
Total comprehensive income for the financial year	2,020.6	(328.4)	1,692.2

Consolidated Balance Sheet

	Note	31 December 2012 £m	31 December 2011 £m
Assets			
Balances with the Bank of England	11	**5,599.8**	6,170.7
Cash at bank and in hand	13	**4,129.2**	2,746.5
Investment securities	12	**2,049.9**	2,848.1
Loans to customers	14	**68,733.6**	75,294.4
Fair value adjustments on portfolio hedging	14	**493.8**	597.5
Derivative financial instruments	35 (d)	**5,720.2**	7,369.1
Other assets	18	**40.7**	42.7
Deferred tax assets	17	**–**	0.8
Retirement benefit assets	19 (c)	**43.0**	49.8
Investment property	20	**–**	26.6
Property, plant and equipment	21	**28.7**	49.2
Intangible assets	22	**47.3**	34.5
Total assets		**86,886.2**	95,229.9
Liabilities			
Amounts due to banks	23	**4,794.9**	4,075.9
Statutory Debt and HM Treasury loans	24	**43,487.3**	46,582.2
Derivative financial instruments	35 (d)	**783.7**	965.4
Debt securities in issue	25	**31,620.1**	38,061.5
Other liabilities	26	**169.8**	163.9
Current tax liabilities		**64.1**	114.6
Deferred tax liabilities	17	**43.9**	–
Retirement benefit obligations	19 (b)	**70.5**	24.6
Provisions	27	**227.6**	215.0
Capital instruments	28	**359.2**	350.4
Total liabilities		**81,621.1**	90,553.5
Equity			
Issued capital and reserves attributable to equity holder of the parent:			
– Share capital	29	**1.2**	1.2
– Reserves	30	**1,319.3**	1,226.1
– Retained earnings		**3,819.8**	3,323.4
Share capital and reserves		**5,140.3**	4,550.7
Non-shareholders' funds	31	**124.8**	125.7
Total equity		**5,265.1**	4,676.4
Total equity and liabilities		**86,886.2**	95,229.9

The notes on pages 56 to 114 form an integral part of these Financial Statements.

The Financial Statements were approved by the Board of Directors and authorised for issue on 22 March 2013 and signed on its behalf by:

Richard Banks — Chief Executive Officer

Phillip McLelland — Finance Director

UK Asset Resolution Limited is registered in England and Wales under company number 07301961.

Consolidated Statement Of Changes In Equity

For the year ended 31 December 2012	Share capital £m	Available-for-sale reserve £m	Cash flow hedge reserve £m	Merger reserve £m	Retained earnings £m	Total share capital and reserves £m	Non-shareholders' funds £m	Total equity £m
At 1 January 2012	1.2	(106.9)	210.4	1,122.6	3,323.4	4,550.7	125.7	4,676.4
Other comprehensive income:								
– Net movement in available-for-sale reserve	–	70.8	–	–	–	70.8	–	70.8
– Net movement in cash flow hedge reserve	–	–	85.1	–	–	85.1	–	85.1
– Actuarial gains and losses	–	–	–	–	(87.2)	(87.2)	–	(87.2)
– Tax effects of the above	–	(17.3)	(45.4)	–	19.6	(43.1)	–	(43.1)
Total other comprehensive income	–	53.5	39.7	–	(67.6)	25.6	–	25.6
Profit for the financial year	–	–	–	–	563.8	563.8	–	563.8
Total comprehensive income	–	53.5	39.7	–	496.2	589.4	–	589.4
Gain on repurchase of equity	–	–	–	–	0.2	0.2	(0.9)	(0.7)
At 31 December 2012	1.2	(53.4)	250.1	1,122.6	3,819.8	5,140.3	124.8	5,265.1

For the year ended 31 December 2011	Share capital £m	Available-for-sale reserve £m	Cash flow hedge reserve £m	Merger reserve £m	Retained earnings £m	Total share capital and reserves £m	Non-shareholders' funds £m	Total equity £m
At 1 January 2011	1.2	(211.7)	(93.0)	1,122.6	2,006.9	2,826.0	209.1	3,035.1
Other comprehensive income:								
– Net movement in available-for-sale reserve	–	125.3	–	–	–	125.3	–	125.3
– Net movement in cash flow hedge reserve	–	–	351.3	–	–	351.3	–	351.3
– Actuarial gains and losses	–	–	–	–	51.3	51.3	–	51.3
– Effect of funding plan for retirement benefit obligations	–	–	–	–	117.6	117.6	–	117.6
– Tax effects of the above	–	(20.5)	(47.9)	–	(46.2)	(114.6)	–	(114.6)
Total other comprehensive income	–	104.8	303.4	–	122.7	530.9	–	530.9
Profit for the financial year	–	–	–	–	1,161.3	1,161.3	–	1,161.3
Total comprehensive income	–	104.8	303.4	–	1,284.0	1,692.2	–	1,692.2
Gain on repurchase of equity	–	–	–	–	32.5	32.5	(83.4)	(50.9)
At 31 December 2011	1.2	(106.9)	210.4	1,122.6	3,323.4	4,550.7	125.7	4,676.4

Consolidated Cash Flow Statement

For the year ended 31 December	2012 £m	2011 £m
Cash flows from operating activities		
Profit before taxation for the financial year	**690.5**	1,375.1
Adjustments to reconcile profit to cash flows used in operating activities:		
– Provision for customer redress	**419.0**	–
– Depreciation and amortisation	**20.5**	24.6
– Net loss on sale of property, plant and equipment and intangible assets	**0.4**	–
– Impairment on loans to customers	**241.4**	390.4
– Net impairment on investment securities	**(30.2)**	58.8
– Gain on repurchase of own liabilities	**(143.5)**	(338.1)
– Income taxes paid	**(175.8)**	(207.8)
– Fair value adjustments on financial instruments	**(178.1)**	331.1
– Other non-cash movements	**(809.6)**	(78.1)
Cash flows from operating activities before changes in operating assets and liabilities	34.6	1,556.0
Net (increase)/decrease in operating assets:		
– Loans to customers	**5,622.0**	8,754.6
– Sale of loans to customers	**465.0**	–
– Derivative financial instruments receivable	**1,649.0**	2,102.5
– Other assets	**(36.9)**	(35.0)
Net increase/(decrease) in operating liabilities:		
– Amounts due to banks	**719.9**	(2,979.2)
– Derivative financial instruments payable	**(181.7)**	(392.9)
– Debt securities in issue	**(4,749.2)**	(9,920.5)
– Other liabilities	**89.0**	(177.7)
– Provisions	**(210.9)**	(36.7)
Net cash generated from/(used in) operating activities	**3,400.8**	(1,128.9)
Cash flows from investing activities		
– Purchase of property, plant and equipment and intangible assets	**(24.5)**	(44.8)
– Proceeds from sale of property, plant and equipment, intangible assets and investment property	**40.8**	0.5
– Purchase of investment securities	**(74.3)**	(231.7)
– Proceeds from sale and redemption of investment securities	**959.4**	1,308.8
Net cash from investing activities	**901.4**	1,032.8
Cash flows used in financing activities		
– Repayment of HM Treasury loans	**(3,098.8)**	(2,149.6)
– Repurchase of own liabilities and equity	**(394.7)**	(843.4)
Net cash used in financing activities	**(3,493.5)**	(2,993.0)
Net increase/(decrease) in cash and cash equivalents	**808.7**	(3,089.1)
Cash and cash equivalents at beginning of year	**8,912.4**	12,001.5
Cash and cash equivalents at end of year	**9,721.1**	8,912.4
Represented by cash and assets with original maturity of three months or less within:		
– Balances with the Bank of England	**5,597.4**	6,168.2
– Cash at bank and in hand	**4,122.7**	2,741.2
– Investment securities	**1.0**	3.0
Total	**9,721.1**	8,912.4

Notes to the Financial Statements

1. Principal accounting policies

UK Asset Resolution Limited ('UKAR' or 'the Company') is a private limited company incorporated on 1 July 2010 and domiciled in the United Kingdom. UKAR acquired B&B and NRAM by a share-for-share exchange on 1 October 2010. These consolidated Financial Statements are prepared under the 'predecessor accounting' method, which presents the UKAR consolidated results as if the UKAR Group ('the Group') had always been in existence in its present form. The Financial Statements of the UKAR Company are presented on pages 116 to 118, and form an integral part of these Financial Statements.

These Financial Statements were authorised for issue by the Directors on 22 March 2013 and will be put to the shareholder for approval at UKAR's Annual General Meeting to be held on 27 March 2013.

(a) Statement of compliance

Both the UKAR Company Financial Statements and the Group (comprising UKAR and its subsidiaries) Financial Statements have been prepared and approved by the Directors in accordance with International Financial Reporting Standards ('IFRS') as adopted by the EU. In publishing the UKAR Company Financial Statements here together with the Group Financial Statements, the UKAR Company has taken advantage of the exemption in s408 of the Companies Act 2006 not to present its individual Income Statement and related notes.

For these 2012 Financial Statements, including the 2011 comparative financial information where applicable, the Group and Company have adopted for the first time the following statement:

- The December 2010 amendments to IAS 12 'Income Taxes' relating to 'Deferred Tax: Recovery of Underlying Assets'. This amendment is mandatory for 2012 Financial Statements, with 2011 comparative information. Adoption of this statement has had no impact on the Financial Statements of the Group or Company.

For these 2012 Financial Statements the Group and Company have not adopted the following statements; the Group and Company are assessing the impacts of these statements on their Financial Statements:

- IFRS 9 'Financial Instruments', sections of which have been issued as part of the International Accounting Standard Board's ('IASB's') project to replace IAS 39 'Financial Instruments: Recognition and Measurement', this statement is expected to be mandatory for 2015 financial statements, with 2014 comparative information, but has not yet been adopted for use in the EU. The Group continues to monitor developments.
- IFRS 10 'Consolidated Financial Statements'. In the EU this statement is mandatory for 2014 financial statements, with 2013 comparative information.
- IFRS 11 'Joint Arrangements'. In the EU this statement is mandatory for 2014 financial statements, with 2013 comparative information.
- IFRS 12 'Disclosure of Interests in Other Entities'. In the EU this statement is mandatory for 2014 financial statements, with 2013 comparative information.
- IFRS 13 'Fair Value Measurement'. This statement is mandatory for 2013 financial statements, with 2012 comparative information.
- IAS 27 'Separate Financial Statements' (revised 2011). In the EU this statement is mandatory for 2014 financial statements, with 2013 comparative information.
- IAS 28 'Investments in Associates' (revised 2011). In the EU this statement is mandatory for 2014 financial statements, with 2013 comparative information.
- The June 2011 amendments to IAS 1 'Presentation of Financial Statements' relating to 'Presentation of Items of Other Comprehensive Income'. This statement is mandatory for 2013 financial statements, with 2012 comparative information.
- The June 2011 amendments to IAS 19 'Employee Benefits'. This statement is mandatory for 2013 financial statements, with 2012 comparative information.
- The December 2011 amendments to IFRS 7 'Financial Instruments: Disclosures' and IAS 32 'Financial Instruments: Presentation' relating to the offsetting of financial assets and financial liabilities. These amendments are mandatory for 2014 financial statements, with 2013 comparative information.
- The Annual Improvements to IFRSs 2009-2011 Cycle, issued in May 2012. These changes are expected to be mandatory for 2013 financial statements, with 2012 comparative information, but have not yet been adopted for use in the EU.

All other new standards, amendments to standards and interpretations are not considered relevant to, and have no impact upon, the Financial Statements of the Group or UKAR Company.

(b) Basis of preparation

The Financial Statements have been prepared on a going concern basis and using the historical cost convention except:

(i) the following assets and liabilities are carried at their fair value:

- derivative financial instruments;
- financial instruments categorised under IAS 39 as 'at fair value through profit or loss';
- financial instruments categorised under IAS 39 as 'available-for-sale'; and
- investment property; and

(ii) where fair value hedge accounting has been applied, the carrying value of hedged items has been adjusted to take account of the fair value of the risk which has been hedged.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

The validity of the going concern basis of accounting is dependent upon the funding position of the UKAR Company, B&B and NRAM. At the date of approval of these Financial Statements, the Group is reliant upon the financing facilities and also upon the guarantee arrangements provided to B&B and NRAM by HM Treasury. Withdrawal of the financing facilities or the guarantee arrangements would have a significant impact on the Group's operations and its ability to continue as a going concern, in which case adjustments may have to be made to reduce the carrying value of assets to recoverable amounts and to provide for further liabilities that might arise. At the signing date of these Financial Statements, HM Treasury has confirmed its intentions to continue to provide funding until at least 1 November 2014. It has also committed to convert up to £1.6bn of its loan to NRAM to meet regulatory capital requirements if so required.

The Directors consider that the accounting policies set out in this note are the most appropriate to the Group's and the UKAR Company's circumstances, have been consistently applied to both the Group and the Company in dealing with items which are considered material, and are supported by reasonable and prudent estimates and judgements.

The accounting policies have been applied to all periods presented in these Financial Statements and are consistent with the accounting policies used by the B&B Group and the NRAM Group in preparing their Interim Financial Reports for the six months ended 30 June 2012.

B&B and NRAM are regulated by the Financial Services Authority ('FSA') as mortgage administration companies and the Directors believe that those companies have appropriate and adequate levels of capital to support these activities subject to the continuing support of HM Treasury.

The Financial Statements have been prepared in accordance with EU-adopted IFRS, IFRIC interpretations issued by the IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee) and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. A summary of accounting policies is set out below. The preparation of the Financial Statements in conformity with these accounting policies and generally accepted accounting principles requires the use of estimates and assumptions that affect the reported values of assets and liabilities at the date of the Financial Statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from those estimates (see note 2).

The Directors consider the business to comprise one operating and geographical segment due to the similarity of risks faced within its UK-based residential, commercial and unsecured portfolios.

(c) Basis of consolidation

The UKAR Group's Financial Statements incorporate on a fully consolidated line-by-line basis the Financial Statements of the UKAR Company and those entities (including special purpose structures) which are controlled by UKAR (its subsidiaries); the Group Financial Statements primarily comprise the transactions and balances of the B&B Group and the NRAM Group. The UKAR Company's acquisition of the entire issued share capital of B&B and NRAM in a share-for-share exchange has been accounted for under 'predecessor accounting' and the UKAR Group's Financial Statements cover the year ended 31 December 2012 and the comparative year ended 31 December 2011. The UKAR Company's Financial Statements cover the year ended 31 December 2012 and the comparative 18 month period from incorporation to 31 December 2011. The difference between the UKAR Company's carrying value of investments and merger reserves, and the share capital and non-distributable reserves of the B&B Group and the NRAM Group, has been accounted for in the UKAR Group as a 'merger reserve'.

Control is achieved where UKAR has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities. Where subsidiaries have been acquired during a period, their results are consolidated into the UKAR Group's Financial Statements from the date control is transferred to UKAR. Where subsidiaries have been disposed of, their results are consolidated to the date of disposal. On the acquisition of a business, fair values are attributed to the assets, liabilities and contingent liabilities acquired. Any difference between the consideration given and the fair value of the net assets acquired is capitalised as goodwill, which is subject to impairment testing in accordance with IAS 36 'Impairment of Assets'. All intra-group transactions and balances are eliminated on consolidation.

The UKAR Group has securitised various residential mortgage loans, generally by sale or transfer to Special Purpose Vehicles ('SPVs') which in turn have issued securities to investors. The SPVs are consolidated line-by-line into the UKAR Group Financial Statements if they are, in substance, controlled by UKAR. The UKAR Group presently receives substantially all of the post-tax profits of all the SPVs and hence retains substantially all of the risks and rewards of the securitised loans, and consequently all of the SPVs are fully consolidated.

(d) Interest income and expense

For all interest-bearing financial instruments except derivatives, interest income and expense are recognised in the Income Statement on an Effective Interest Rate ('EIR') basis.

The EIR method calculates the amortised cost of a financial asset or financial liability and spreads the resulting interest income or interest expense on a level yield basis over the expected life of the instrument, or an appropriate shorter period. In respect of loans to customers, the period used is the period to which the product reprices to a Standard or Product Variable Rate. The EIR is the rate which at the inception of the instrument exactly discounts expected future cash flows over the appropriate period to the initial carrying amount. When calculating the EIR, future cash flows are estimated, considering all contractual terms of the instrument (for example prepayment options), but potential future credit losses are not considered. The calculation includes all directly attributable incremental fees and costs, premia on acquisition of mortgage portfolios and all other premia and discounts as well as interest.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

Interest on derivatives is included in interest income where the derivative is hedging interest income, and interest expense where the derivative is hedging interest expense.

When a financial asset or a group of similar financial assets is written down as a result of an impairment loss, interest income continues to be recognised by applying the applicable EIR to the reduced balance.

(e) Fee and commission income

Where Value Added Tax ('VAT') is charged, income is stated net of VAT.

Commission receivable from the renewal of third party regulated financial services products was recognised as income within 'fee and commission income' when the renewal policy went 'on risk', net of any provision for repayment in the event of early termination by the customer. If the commission is receivable on deferred terms, a deemed interest element of the commission is separated and recognised on an EIR basis over the deferred payment period.

Fees charged to existing borrowers, including arrears and redemption fees, are recognised in fee and commission income as they arise.

(f) Bonuses payable

An accrual is made for all bonuses which have been earned by the Balance Sheet date, even though these may not subsequently be payable due to clawback or the employee leaving the Group.

(g) Financial instruments

In accordance with IAS 39 each financial asset is classified at initial recognition into one of four categories:

(i) Financial assets at fair value through profit or loss;

(ii) Held-to-maturity;

(iii) Loans and receivables; or

(iv) Available-for-sale;
and each financial liability into one of two categories:

(v) Financial liabilities at fair value through profit or loss; or

(vi) Other liabilities.

Where the Directors believed it appropriate to do so, financial assets have been reclassified out of the 'available-for-sale' category to 'loans and receivables' in accordance with the revisions to IAS 39 issued by the IASB in October 2008. Such reclassifications are permitted only under certain restricted circumstances, including that there is no active market for the asset. The asset is reclassified using its fair value at the point of transfer, and from that point on is accounted for on an EIR basis. The difference between the carrying value at the point of reclassification and the expected value at the redemption date is recognised in profit or loss on an EIR basis over the expected life of the asset, and the asset's carrying value accretes to the redemption amount over that period, except where the asset has become impaired. The balance in the available-for-sale reserve which related to the asset is amortised to profit or loss over the expected life of the asset; in the Income Statement the amortisation of the difference between value at reclassification and at redemption and the amortisation out of the available-for-sale reserve exactly offset each other.

Measurement of financial instruments is either at amortised cost (categories (ii), (iii) and (vi) above) or at fair value (categories (i), (iv) and (v) above), depending on the category of financial instrument.

Amortised cost is the amount measured at initial recognition, adjusted for subsequent principal and other payments, less cumulative amortisation calculated using the EIR method; the amortisation is taken to interest income or expense depending on whether the instrument is an asset or a liability. For assets, the amortised cost balance is reduced where appropriate by an allowance for amounts which are considered to be impaired or uncollectible.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Where an active market is considered to exist, fair values are based on quoted prices or lead manager prices. For instruments which do not have active markets, fair value is calculated using present value models, which take individual cash flows together with assumptions based on market conditions and credit spreads, and are consistent with accepted economic methodologies for pricing financial instruments. Interest income and interest expense on instruments carried at fair value are included in the Income Statement in 'interest receivable and similar income' or 'interest expense and similar charges'. Movements in fair value are recognised in the 'unrealised fair value movements on financial instruments' line in the Income Statement, except in the case of instruments categorised as 'available-for-sale', in which case the fair value movements are taken to the 'available-for-sale' reserve. On sale or derecognition of an available-for-sale instrument the accumulated fair value movements are transferred from the 'available-for-sale' reserve to the 'net realised gains less losses on investment securities' line of the Income Statement.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

(h) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the Balance Sheet only where there is a legally enforceable right to offset the recognised amounts, and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

(i) Derivative financial instruments and hedge accounting

All of the Group's derivative contracts are used for commercial management of exposures to interest rate risks, foreign currency risks and risks arising from forecast transactions.

For many of the Group's derivative contracts hedge accounting is applied. However, in some cases natural offsets apply.

Each derivative is carried at fair value in the Balance Sheet; as an asset when the fair value is positive and as a liability when the fair value is negative. The fair value of a derivative includes any interest accrued on that derivative. Changes in the fair value of derivatives are charged to the Income Statement; however by applying the hedge accounting rules set out in IAS 39 the changes in fair value of derivatives which are used to hedge particular risks can either be mitigated in the Income Statement (fair value hedge accounting) or recognised in other comprehensive income (cash flow hedge accounting). The Group has adopted cash flow hedge accounting and fair value hedge accounting.

(i) Cash flow hedge accounting

A cash flow hedge is used to hedge exposures to variability in cash flows, such as variable rate financial assets and liabilities. The effective portion of changes in the derivative fair value is recognised in other comprehensive income, and recycled to the Income Statement in the periods when the hedged item will affect profit and loss. The fair value gain or loss relating to the ineffective portion is recognised immediately in the Income Statement.

(ii) Fair value hedge accounting

A fair value hedge is used to hedge exposures to variability in the fair value of financial assets and liabilities, such as fixed rate loans. Changes in fair value of derivatives that are designated and qualify as fair value hedges are recorded in the Income Statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. The Group uses fair value hedge accounting on one-to-one relationship and portfolio hedging bases, as described below.

Where hedge accounting is not applied, changes in fair values are recognised immediately in the Income Statement.

(iii) One-to-one fair value hedges

Where one or more specific derivative financial instruments hedge the changes in fair value of a specific asset or liability, provided that the hedge arrangement meets the requirements of IAS 39 to be classed as 'highly effective', the associated hedged item is carried on the Balance Sheet at fair value in respect of the hedged risk. Fair value gains and losses are recognised in the Income Statement, mitigating the fair value movements on the associated derivative financial instruments. The Income Statement immediately recognises any hedge accounting 'ineffectiveness', that is any difference between the fair value movement on the hedging instrument and that on the hedged item.

(iv) Portfolio fair value hedges

Where a group of derivative financial instruments hedges the interest rate exposure of a group of assets or liabilities, and the hedge meets the requirements of IAS 39 to be classed as 'highly effective', the hedge relationship is accounted for in the same way as a one-to-one fair value hedge except that the Balance Sheet carrying value of the hedged items is not adjusted; instead the difference between the carrying value and the fair value in respect of the hedged risk is carried on the Balance Sheet in 'fair value adjustments on portfolio hedging'.

(v) Hedge effectiveness

At the inception of each hedging arrangement, the relationship between the hedging instruments and the hedged items is documented, as well as the risk management objective and strategy. Also documented is an assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in the hedging arrangement are 'highly effective' in offsetting changes in fair values or cash flows of the hedged items. Under IAS 39 a hedge is deemed to be 'highly effective' if effectiveness is forecast to fall, and is actually found to fall, within the 80% to 125% range. Any hedge relationship falling outside these limits is deemed to be ineffective and hedge accounting is discontinued.

(vi) Termination of hedges

Where a hedge relationship is terminated or deemed not to be highly effective (other than as a result of the hedged item being derecognised from the Balance Sheet due to sale or other reason), the adjustment relating to the terminated hedge relationship is amortised to the Income Statement over the period that the hedged item affects profit and loss.

(vii) Embedded derivatives

Certain financial instruments have derivative features embedded within them. Where the economic characteristics and risks of the embedded derivative are not closely related to those of the host instrument, and where changes in value in the host instrument are not reflected in the Income Statement, the embedded derivative is separated from the host and carried on the Balance Sheet at fair value, with gains and losses on the embedded derivative being recognised in the Income Statement. In accordance with IFRIC 9 'Reassessment of Embedded Derivatives' the decision as to whether to separate and value an embedded derivative is reassessed when and only when the terms of the host contract are significantly modified.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

(j) Sale and repurchase agreements

Securities sold subject to repurchase agreements ('repos') continue to be reported as they were originally classified within the Group's Balance Sheet, as the risks and rewards associated with that asset remain with the Group. The counterparty liability is included in 'amounts due to banks' or 'other deposits'. Securities purchased under agreements to resell ('reverse repos') are recorded as 'cash at bank and in hand'. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the EIR method.

(k) Impairment losses

Financial assets which are not held at fair value through profit or loss are reviewed for indications of possible impairment throughout the year and at each published Balance Sheet date. An impairment loss is recognised if, and only if, there is objective evidence that a loss event (or events) has occurred after initial recognition and before the Balance Sheet date and has a reliably measurable impact on the estimated future cash flows of the financial asset or group of financial assets. Losses that are incurred as a result of events occurring after the Balance Sheet date are not recognised.

(i) Financial assets held at amortised cost

For each asset an assessment is made as to whether an impairment provision should be made on either an individual or a collective basis. Loans where an individual assessment is made include all loans in possession or held for sale with a Law of Property Act ('LPA') receiver and others which management consider to be individually impaired, for example where a fraud has been uncovered. The carrying value of the loan at the Balance Sheet date is reduced, by applying an impairment allowance, to the net present value of the expected future cash flows associated with the loan, calculated at the loan's original EIR. These cash flows include, where appropriate, estimated amounts recoverable by possession and sale of the secured property taking into account a discount on property value to reflect a forced sale.

All loans that have been assessed as having no individual impairment are then assessed collectively, grouped by loans with similar characteristics. Assessment is made of impairment arising due to events which are believed to have occurred by the Balance Sheet date but have not yet been reported, taking into account the economic climate in the market. This collective impairment is reflected by reducing the carrying value of total loans by applying an impairment allowance.

The impairment of loans is charged in the Income Statement in the 'impairment on loans to customers' line.

For impaired loans, interest is accrued for accounting purposes on the loan amount after any impairment adjustments, in accordance with IAS 39, using the original EIR of the loan. However, for the purposes of the amount legally due from the borrower, interest continues to accrue on the full outstanding balance, and it is this full balance plus full interest which is pursued for collection.

A loan is written off and any associated impairment allowance released when and only when the property is sold or the account is redeemed, or in respect of unsecured loans where the collections process indicates a loan is not recoverable. Any subsequent proceeds are recognised on a cash basis and offset against 'impairment on loans to customers' in the Income Statement.

Where a property has been taken into possession, or an LPA receiver has been appointed to collect rental income on the property, the loan continues to be carried within 'loans to customers'.

(ii) Available-for-sale financial assets

Investment securities classified as available-for-sale are carried at fair value, which appropriately reflects any impairment. Impairment is recognised when the investment security exhibits objective evidence of impairment or is uncollectible. Such evidence may include:

- Significant financial difficulty;
- Payment defaults;
- Renegotiation of terms due to borrower difficulty;
- Sustained fall in credit rating or creditworthiness;
- Significant restructuring;
- Disappearance of an active market;
- Significant and sustained fall in market price; or
- Observable data indicating measurable decrease in the estimated future cash flows from a group of financial assets, although the decrease cannot yet be identified within individual assets in the group.

Movements in the fair value which are a reflection of impairment of the long term value of the investment security are charged to 'net impairment on investment securities' in the Income Statement. Investment impairment losses recognised against investment securities are reversed through 'net impairment on investment securities' in the Income Statement if the improvement relates to an event occurring after the initial impairment was recognised.

If there is a sustained increase in the fair value of an investment security where an impairment loss has previously been recognised, but no improvement can be attributed to a subsequent credit event, then the increase in value may be treated as a revaluation and recognised through other comprehensive income in the available-for-sale reserve.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

(l) Recognition and derecognition of financial instruments

Purchases and sales of mortgage portfolios are accounted for on the completion date. All other purchases and sales of financial assets are accounted for on the date of commitment to buy or sell (the 'trade date').

A financial asset is derecognised (ie removed from the Balance Sheet) only when substantially all of the risks and rewards associated with that asset have been transferred to another party.

A financial liability is derecognised only when the contractual obligation is discharged, cancelled or has expired.

(m) Debt and equity securities in issue

Issued securities, including capital instruments, are classified as liabilities where the contractual arrangements result in the issuing company having an obligation to deliver either cash or another financial asset to the security holder, or to exchange financial instruments under conditions that are potentially unfavourable to the company. Issued securities are classified as equity where they meet the definition of equity and confer a residual interest in the company's assets on the holder of the securities. Issued securities include ordinary and preference share capital. Preference shares are classified as equity instruments where dividend payments and redemptions are discretionary.

On initial recognition, debt issued is measured at its fair value net of directly attributable issue and transaction costs. Subsequent measurement is at amortised cost using the EIR method to amortise attributable issue and transaction costs, premia and discounts over the life of the instrument. These costs are charged along with interest on the debt to 'interest expense and similar charges'. Unamortised amounts are added to or deducted from the carrying value of the instrument.

Equity instruments (including share capital) are initially recognised at net proceeds, after deducting transaction costs and any related income tax.

(n) Foreign currencies

The presentational and functional currency of the Company and the presentational currency of the Group is pounds sterling.

Transactions which are not denominated in pounds sterling are translated into sterling at the spot rate of exchange on the date of the transaction. Monetary assets and liabilities which are not denominated in pounds sterling are translated into pounds sterling at the closing rate of exchange at the Balance Sheet date.

Foreign exchange gains and losses resulting from the restatement and settlement of such transactions are recognised in the Income Statement.

(o) Intangible assets

Intangible assets comprise computer software systems. Purchased computer software licences are capitalised as intangible assets where it is probable that future benefits will flow to the Group. Thereafter they are carried at cost less accumulated amortisation. Amortisation is provided on a straight line basis over their useful economic lives, which may be up to five years. Those which have a life expectancy at the outset of less than two years are not capitalised but instead their costs are charged to the Income Statement as they arise.

Costs that are directly associated with developing identifiable computer software systems are capitalised if the criteria in IAS 38 'Intangible Assets' are satisfied; the main criteria are that the successful completion of the development project is reasonably certain and that the software is expected to generate future economic benefits. Each item of capitalised developed computer software is carried at cost less accumulated amortisation; amortisation is provided on a straight line basis over its estimated useful life. Costs that do not qualify for capitalisation or are associated with maintaining software are charged to the Income Statement as they arise.

All items of intangible assets are reviewed annually for impairment. If any item is considered to be impaired, it is written down to the impaired value, being the higher of value in use and estimated net proceeds of sale. In addition, the estimated useful lives are also reassessed annually, and if they are judged to have changed then the rate of amortisation charged in periods after the date of the change reflects the revised estimates.

(p) Cash and cash equivalents

Cash and cash equivalents comprise balances which are highly liquid and have an original maturity of three months or less.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

(q) Taxation

(i) Current tax

The charge for taxation is based on the result for the year and takes into account taxation deferred or accelerated arising from temporary differences between the carrying amounts of certain items for taxation and for accounting purposes. Tax relating to items which are taken directly to reserves is also taken directly to reserves.

(ii) Deferred tax

Deferred tax is calculated using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the Financial Statements. Deferred tax is determined using tax rates and laws that have been enacted or substantively enacted by the Balance Sheet date and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled. The principal temporary differences arise from depreciation of property, plant and equipment; revaluation of certain financial assets and liabilities including derivative contracts; provisions for pensions and other post-retirement benefits; tax losses carried forward; and changes in accounting basis on adoption of IFRS.

Deferred tax assets are recognised when it is probable that future taxable profits will be available against which these temporary differences can be utilised.

Deferred tax is provided on temporary differences arising from investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future.

Deferred tax related to fair value re-measurement of available-for-sale investments and cash flow hedges, which are recognised in other comprehensive income, is also recognised in other comprehensive income, and subsequently in the consolidated Income Statement together with the associated gain or loss.

(r) Retirement benefits

The Group operates a number of retirement benefit plans for its employees, including defined contribution plans, defined benefit plans and post-retirement healthcare benefits. The costs of these plans are charged to the ‘administrative expenses’ line of the Income Statement and other comprehensive income in accordance with IAS 19 ‘Employee Benefits’ and IFRIC 14 ‘IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction’. For 2013, the Group will adopt the revisions to IAS 19 which were issued in June 2011 and adopted for use in the EU in June 2012. The main effect on the Group of the revisions to IAS 19 is that instead of an expected rate of return being applied to defined benefit plan assets, the discount rate previously applied to defined benefit plan obligations will instead be applied to the net surplus or deficit on the plan.

A defined contribution plan is a pension arrangement where the employer pays fixed contributions into a separate fund. The contributions are charged to the Income Statement when employees have rendered the related services, which is generally in the year of contribution.

A defined benefit plan is a pension arrangement that defines an amount of pension benefit that an employee will receive during retirement, usually dependent on one or more factors such as age, years of service and salary.

As at 31 December 2012 and 31 December 2011 the B&B defined benefit scheme was in deficit. The NRAM defined benefit scheme was in surplus on an accounting basis, but in deficit on a trustees funding basis. As these are separate schemes, a surplus on one scheme cannot be used to offset a deficit on the other.

A full actuarial valuation of the Group’s defined benefit sections of the existing schemes is undertaken every three years with interim reviews in the intervening years; these valuations are updated to 30 June and 31 December each year by qualified independent actuaries. For the purpose of these updates, scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. Liabilities are discounted using rates equivalent to the market yields at the Balance Sheet date on high quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. Details of the actuarial assumptions made are provided in note 19. The resulting net surplus or deficit is included in the Group’s Balance Sheet. Actuarial gains and losses are charged to retained earnings in full in the period in which they occur, and pass through other comprehensive income rather than the Income Statement. The Group’s Income Statement includes, for each scheme, the current service cost of providing pension benefits, the expected return on the scheme’s assets, net of administration costs, and the interest cost on the scheme’s liabilities. Following closure of the schemes, the current service cost for 2010 and subsequent years is nil.

At 31 December 2010 the inflation assumption used to determine B&B’s benefit obligations was based on the Retail Prices Index (‘RPI’), pending fulfilment of conditions which would need to be satisfied in order for the proposed change to a Consumer Prices Index (‘CPI’) basis to come into effect in respect of deferred members. These conditions were satisfied during 2011, and consequently CPI has been applied with effect from 1 January 2011. Consequently the net pension liability carried on the Balance Sheet reduced at that time by a credit to other comprehensive income. The inflation assumption used to determine NRAM’s benefit obligations is RPI.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

Surpluses are only recognised on the Balance Sheet to the extent that they are recoverable through reduced contributions in the future or through refunds from the scheme; the surplus on the NRAM scheme is recognised on this basis. The Group is committed to funding plans to address the deficits on the schemes. In accordance with IFRIC 14, the net pension deficit on the B&B scheme which is recognised on the Balance Sheet is the higher of the deficit calculated as above and the net value of the committed funding. However, to the extent that the Group has a clear unconditional right to a refund of future surpluses which may arise in the plans, the carrying value of the deficit should be reduced to take account of the anticipated future available funds. As detailed in note 19, as at 31 December 2010 B&B had no clear unconditional right to the refund of such surpluses, but on 29 March 2011 the Trustees finalised a resolution granting such a right and consequently the net pension liability carried on the Balance Sheet reduced at that time by a credit to other comprehensive income.

For defined contribution plans, the Group has no further payment obligations once the contributions have been paid. The contributions are recognised as an employee benefit expense when they are due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

In B&B, post-retirement healthcare benefits are accounted for in the same way as pension benefits, with the present value of the defined benefit obligation being carried as a liability on the Group's Balance Sheet. In the event of a defined benefit plan surplus exceeding the value of post-retirement medical benefits, these benefits will be offset against the defined benefit asset. NRAM does not provide post-retirement healthcare benefits.

(s) Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation and provision for impairment, as appropriate. Additions and subsequent expenditure are included in the asset's carrying value or are recognised as a separate asset only when they improve the expected future economic benefits to be derived from the asset. All other expenditure is regarded as repairs and maintenance and is charged to the Income Statement in the period in which it is incurred. Depreciation is provided so as to write off the cost less the estimated residual value of each significant component of each item of property, plant and equipment over that component's estimated useful life, as follows:

- Freehold land is not depreciated
- Freehold and leasehold buildings 6.7%pa on a straight line basis
- Motor vehicles 25% pa on a reducing balance basis
- Computer equipment 20% – 33% pa on a straight line basis
- Fixtures and fittings 20% pa on a straight line basis
- Other plant and equipment and major alterations to buildings 10% pa on a straight line basis or over the remaining life of the building if shorter.

All items of property, plant and equipment are reviewed annually for impairment. If any item is considered to be impaired, it is written down to the higher of value in use and estimated net proceeds of sale. In addition, the estimated useful lives and estimated residual values are also reassessed annually, and if they are judged to have changed then the rate of depreciation charged in periods after the date of the change reflects the revised estimates.

Where a property ceases to be occupied by a Group company and it is not intended to re-occupy the property or to sell it in the ordinary course of business, the property is reclassified as an investment property and is carried at fair value. Any shortfall between the carrying amount of the property and its fair value at the date of reclassification is charged to the Income Statement, unless there is a revaluation surplus in respect of that property against which to allocate any shortfall. Any surplus between the carrying amount of the property and its fair value at the date of reclassification is credited directly to other comprehensive income except to the extent that the increase reverses a previous impairment loss for that property, in which case the increase is recognised in the Income Statement.

Assets in the course of construction are not depreciated until they have been completed and transferred to the appropriate category of property, plant and equipment. The costs of financing assets in the course of construction are not included in the costs of the assets. Assets in the course of construction are included within the impairment test referred to above where appropriate.

A previously recognised impairment charge on an asset may be reversed in full or in part where a change in circumstances leads to a change in the estimates used to determine its recoverable amount. The carrying value of the asset will only be increased to the carrying value at which it would have been held had the impairment not been recognised.

(t) Investment property

Investment properties represent properties held as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the Balance Sheet at fair value, with changes recognised in the Income Statement in the period of change. Fair values are determined by independent professional valuers by application of recognised valuation techniques.

Notes to the Financial Statements (continued)

1. Principal accounting policies (continued)

(u) Leases

Rentals under operating leases are charged to 'administrative expenses' on a straight line basis to the date of change in the rental amount. Typically operating leases have rent review dates in their terms, several years apart, and between those dates the annual rent remains constant. Any initial rent-free period and any lease premia paid are amortised over the full lease period on a straight line basis.

If a lease agreement in which the Group is a lessee transfers the risks and rewards of the asset, the lease is recorded as a finance lease and the related asset is capitalised. At inception the asset is recorded at the lower of the present value of the minimum lease payments and fair value, and is depreciated over the estimated useful life. The lease obligations are recorded as borrowings. If the lease does not transfer the risks and rewards of the asset, the lease is recorded as an operating lease.

Where an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor in compensation is charged to the Income Statement in the period in which termination is made.

Where the Group leases assets out under an operating lease agreement, the asset is included in the Balance Sheet based on the nature of the asset. Lease income is recognised over the term of the lease on a straight line basis.

(v) Provisions and contingent liabilities

Provisions are recognised when, and only when, the following criteria are all met:

- there is a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

Provisions are reviewed at each Balance Sheet date and are released if they no longer meet the above criteria

Provisions are discounted to net present value using rates which reflect the risks specific to the provision, if the effect of discounting is material.

Contingent liabilities are possible obligations whose existence depends upon the outcome of uncertain future events or are present obligations where the outflows of resources are uncertain or cannot be reliably measured. Contingent liabilities are not recognised in the Balance Sheet but are disclosed unless they are remote.

(w) Investment securities held

Investment securities intended for use on a continuing basis in the Group's activities are categorised either as 'available-for-sale' or as 'loans and receivables'; for each instrument, the Directors adopt the category which they consider to be the most appropriate.

Investment securities categorised as available-for-sale are carried at fair value, with movements in fair value, excluding impairment provisions, being taken to the available-for-sale reserve. If an investment security which has been categorised as available-for-sale becomes impaired, the impairment is charged to the Income Statement in the 'net impairment on investment securities' line.

Investment securities categorised as loans and receivables are carried at amortised cost, less any impairment, with any impairment being charged to the Income Statement in the 'net impairment on investment securities' line.

Where the Directors believe it appropriate to do so, investment securities which were initially categorised as 'at fair value through profit or loss' or 'available-for-sale' have subsequently been re-categorised to 'loans and receivables' in accordance with the revisions to IAS 39 issued by the IASB in October 2008.

(x) Financial guarantees

The Group applies insurance accounting to financial guarantee contracts, and provides against any claims arising under such contracts.

(y) Loan commitments

Loan commitments are disclosed, but are accounted for only if there is an onerous commitment; there were no onerous loan commitments in the year or previous year. The commitment ceases to be disclosed once it is advanced or expires. Loan commitments comprise commitments to advance cash sums, and to allow drawdown of monies previously overpaid (where the terms of the loan specifically allow). In respect of lifetime mortgages which involved the advance of a lump sum on which interest continues to accrue but is not payable until the loan is redeemed, the commitment reflects an estimate of the interest expected to roll up until redemption. In respect of monthly drawdown products, the commitment reflects an estimate of the future drawdowns to redemption.

Notes to the Financial Statements (continued)

2. Critical judgements and accounting estimates

In preparing the Financial Statements, management are required to make a series of judgements and estimates. Judgements involve an interpretation of requirements to decide how to allocate, value or recognise an item. Estimates arise from using assumptions which result in a range of possible outcomes. The most important judgements and estimates used in preparing these Financial Statements are described below.

(a) Qualifying hedge relationships

In designating a financial instrument as part of a qualifying hedge relationship the Group has determined that the hedge is expected to be highly effective over the life of the hedging instrument. In accounting for a derivative as a cash flow hedge the Group has determined that the hedged cash flow exposure relates to highly probable future cash flows.

(b) Impairment of investment securities

For investment securities carried at fair value, judgement is applied in determining whether any fall in value represents impairment, and whether any increase represents a reversal of impairment. Factors considered in determining whether an asset is impaired, or impairment has reversed, are detailed in note 1(k).

(c) Securitisations

In applying the Group's policies on securitised financial assets, the Group has considered both the degree of transfer of risks and rewards on assets transferred to another entity and the degree of control exercised by the Group over the other entity.

- Where the Group, in substance, controls the entity to which financial assets have been transferred, the entity is included in these consolidated Financial Statements.
- Where a Group entity has transferred financial assets to another entity, but has not transferred substantially all of the risks and rewards relating to the transferred assets, the assets continue to be recognised on the transferring entity's Balance Sheet.

(d) Deferred tax assets

Management judgement is required to determine the extent to which tax losses can be offset against future taxable profits and therefore recognised in the form of deferred tax assets and also the extent to which other temporary differences can be utilised. This judgement is based upon examination and assessment of the business plan, and the expectation that there may be sufficient profitability in future years. A deferred tax asset is recognised accordingly, but only to the extent to which future taxable profits are foreseen. In excess of this value any taxable losses and other temporary differences are not recognised as deferred tax assets. Details of deferred tax assets are contained in note 17.

(e) Impairment losses on loans

The Group reviews its loan impairment on a monthly basis and assesses individual impairment losses by reference to an individual review of the underlying asset and utilises actual loss experience to provide both probabilities of defaults and property forced sale discounts across a portfolio of products. Collective impairment losses on loans are calculated using a statistical model. The key assumptions used in this model are: the probability of any balance entering into default as a result of an event that had occurred prior to the Balance Sheet date; the probability of this default resulting in possession or write-off; and the estimated subsequent loss incurred. These key assumptions are based on observed data trends and are updated on a regular basis within agreed methodology to ensure the impairment allowance is entirely representative of the current portfolio. The accuracy of the impairment calculation would therefore be affected by unanticipated changes to the economic situation and assumptions which differ from actual outcomes. To the extent that house prices were to change by +/- 10%, the residential impairment allowance would be an estimated £174.3m lower (2011: £202.3m) or £184.1m higher (2011: £222.7m) respectively.

(f) Provisions

Provisions are carried in respect of certain known or forecast future expenditure, as described in note 27. Where the future payment amount is unknown, provisions are set at a level which covers the estimated number of future payments and the estimated average payment amount. Provisions are calculated using the best available information, but the actual future outcomes of items provided for may differ from expectations.

(g) Fair value calculations

Fair value is defined as the value at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. For the majority of instruments carried at fair value, this is determined by reference to quoted market prices. Where these are not available, fair value is based upon cash flow models, which use, wherever possible, independently sourced market parameters such as interest rate yield curves, currency rates and option volatilities. Other factors are also considered, such as counterparty credit quality and liquidity. Management must use judgement to arrive at estimates where not all necessary data can be externally sourced or where factors specific to the Group's holdings need to be considered. The accuracy of the fair value calculations may therefore be affected by unexpected market movements, or variations in actual outcomes when compared to estimates and assumptions used for modelling purposes. For example, if management were to use a tightening in the credit spread of 10 basis points, the fair value of derivatives would decrease from the reported fair values by £20.8m (2011: £26.7m).

Notes to the Financial Statements (continued)

3. Net interest income

	2012 £m	2011 £m
Interest receivable and similar income		
On secured loans	**2,426.2**	2,472.5
On other lending	**111.2**	143.7
On investment securities and deposits	**86.6**	116.8
Total interest receivable and similar income	**2,624.0**	2,733.0
Interest expense and similar charges		
On amounts due to banks and HM Treasury	**(676.2)**	(475.6)
State guarantee fee*	**(47.4)**	(74.9)
Other	**(415.5)**	(460.1)
Total interest expense and similar charges	**(1,139.1)**	(1,010.6)
Net interest income	**1,484.9**	1,722.4
Average balances		
Interest-earning assets ('IEA')	**84,117**	94,929
Financed by:		
– Interest-bearing funding	**59,769**	71,610
– Interest-free funding**	**24,348**	23,319
Average rates:	**%**	**%**
– Gross yield on IEA	**3.12**	2.88
– Cost of interest-bearing funding	(1.83)	(1.31)
Interest spread	1.29	1.57
State guarantee fee*	(0.06)	(0.08)
Contribution of interest-free funding**	0.54	0.32
Net interest margin on average IEA	**1.77**	**1.81**
Average Bank Base Rate	**0.50**	0.50
Average 1-month LIBOR	**0.62**	0.65
Average 3-month LIBOR	**0.83**	0.88

* At the time of the nationalisation of B&B, HM Treasury provided guarantees with regard to certain wholesale borrowings and derivative transactions existing at that time. The amount of this fee is dependent on balances outstanding, and hence it is included within 'interest expense and similar charges'.

At the time of the nationalisation of NRAM, HM Treasury provided a guarantee with regard to certain wholesale borrowings and derivative transactions existing at that time.

The amount of this fee is currently £12m pa, and is not dependent on balances outstanding, and hence it is included within 'fee and commission expense'.

** Interest-free funding is calculated as an average over the financial year, and includes the Statutory Debt and share capital and reserves.
Total interest receivable and similar income includes interest accrued on individually impaired assets of £15.4m (2011: £18.1m).

4. Net gains on financial instruments designated at fair value

The gains of £17.5m (2011: £nil) arose on the disposal of assets which had previously been held at a fair value of £nil on the Balance Sheet.

5. Net realised gains less losses on investment securities

Net realised gains less losses on investment securities recognised in the Income Statement comprised the following:

	2012 £m	2011 £m
Net realised gains on available-for-sale instruments	1.4	–
Net realised losses on instruments at amortised cost	(16.3)	(1.2)
Total net realised losses on investment securities	(14.9)	(1.2)

Notes to the Financial Statements (continued)

6. Unrealised fair value movements on financial instruments and hedge ineffectiveness

	2012 £m	2011 £m
Net (loss)/gain in fair value:		
– translation (losses)/gains on underlying instruments	**(291.9)**	160.6
– fair value movements on derivatives which are economic hedges but are not in hedge accounting relationships	**249.1**	(81.4)
Unrealised fair value movements	**(42.8)**	79.2
Net gains on fair value hedging instruments	**110.0**	228.8
Net gains/(losses) on fair value hedged items attributable to hedged risk	**(118.4)**	(289.5)
Ineffectiveness on cash flow hedges	**(20.0)**	(24.5)
Net hedge ineffectiveness losses	**(28.4)**	(85.2)
Total	**(71.2)**	(6.0)

7. Administrative expenses

Certain employees of B&B work for NRAM, and the staff numbers below show B&B's employees split by which company they work for. NRAM had no direct employees during the years presented.

The monthly average number of persons employed by UKAR Group companies during the year was as follows:

For the year ended 31 December	2012 Number	2011 Number
Average headcount:		
Full time	**1,923**	1,855
Part time	**501**	538
Total employed	**2,424**	2,393
Working for NRAM:		
Full time	**1,017**	982
Part time	**342**	382
Total working for NRAM	**1,359**	1,364
Working for B&B:		
Full time	**906**	873
Part time	**159**	156
Total working for B&B	**1,065**	1,029
Total average full time equivalent	**2,249**	2,199
Total average full time equivalent working for NRAM	**1,234**	1,221
Total average full time equivalent working for B&B	**1,015**	978

The full time equivalent is based on the average hours worked by employees in the year.

Notes to the Financial Statements (continued)

7. Administrative expenses (continued)

The number of persons employed by UKAR Group companies at the end of the year was as follows:

	2012 Number	2011 Number
Full time	**1,965**	1,954
Part time	**471**	538
Total employed	**2,436**	2,492
Working for NRAM:		
Full time	**839**	1,089
Part time	**319**	378
Total working for NRAM	**1,158**	1,467
Working for B&B:		
Full time	**1,126**	865
Part time	**152**	160
Total working for B&B	**1,278**	1,025
Total full time equivalent headcount	**2,277**	2,305
Total full time equivalent headcount working for NRAM	**1,046**	1,332
Total full time equivalent headcount working for B&B	**1,231**	973

Staff numbers include Executive but not Non-Executive Directors.

In addition to the permanent staff above, the Group employed a full time equivalent of 346 temporary staff and specialist contractors at 31 December 2012 (2011: 290).

The Group's aggregate costs of permanent staff were as follows:

	2012 £m	2011 £m
Wages and salaries	**65.0**	65.6
Social security costs	**6.6**	6.8
Defined benefit pension costs (see note 19)	**0.6**	(0.9)
Defined contribution pension costs (see note 19)	**3.4**	3.5
Other retirement benefit costs (see note 19)	**0.5**	0.5
Total staff costs	**76.1**	75.5
IT costs	**56.0**	57.9
Outsourced and professional services	**25.5**	29.6
Depreciation and amortisation (see notes 21 and 22)	**12.6**	5.5
Other administrative expenses	**37.1**	52.1
Ongoing administrative expenses	**207.3**	220.6
Other net administrative expenses:		
– Transformation costs	**51.4**	40.0
– Accelerated depreciation (see note 21)	**8.3**	25.2
Total other net expenses	**59.7**	65.2
Total administrative expenses	**267.0**	285.8

Notes to the Financial Statements (continued)

7. Administrative expenses (continued)

Other net expenses of £59.7m (2011: £65.2m) mainly reflect one-off costs associated with establishing common systems across UKAR (including a change in primary IT service provider), and redundancy costs and write-downs of assets following the announcement of the UKAR restructure and the phased exit from the Gosforth site.

Services provided by the Group's auditors and network firms

During the year the Group obtained services from the Group's auditors, as detailed below:

	2012 £m	2011 £m
Fees payable to Company auditors for the audit of parent Company and consolidated accounts	**0.1**	0.1
Fees payable to Company auditors and its associates for other services:		
– The audit of the Company's subsidiaries pursuant to legislation	**0.5**	0.8
– All other services (including regulatory)	**0.1**	0.1
Total	**0.7**	1.0

Amounts shown in the above analysis are exclusive of VAT.

8. Gain on repurchase of own liabilities and equity

2012	Subordinated notes £m	Reserve capital instruments £m	Total gains taken to reserves £m	Tier one notes £m	Subordinated liabilities £m	Other capital instruments £m	Securitised notes £m	Total Income Statement gains £m
Principal amount of instruments repurchased	**–**	**0.9**	**0.9**	**0.2**	**0.2**	**–**	**537.2**	**537.6**
Amount paid to repurchase instruments	**–**	**(0.5)**	**(0.5)**	**(0.1)**	**(0.1)**	**–**	**(391.6)**	**(391.8)**
Other net losses resulting from the repurchase*	**–**	**(0.1)**	**(0.1)**	**(0.1)**	**–**	**–**	**(2.2)**	**(2.3)**
Gain on repurchase of own liabilities and equity	**–**	**0.3**	**0.3**	**–**	**0.1**	**–**	**143.4**	**143.5**

2011	Subordinated notes £m	Reserve capital instruments £m	Total gains taken to reserves £m	Tier one notes £m	Subordinated liabilities £m	Other capital instruments £m	Securitised notes £m	Total Income Statement gains £m
Principal amount of instruments repurchased	29.7	54.1	83.8	79.8	949.5	46.3	–	1,075.6
Amount paid to repurchase instruments	(11.8)	(27.0)	(38.8)	(51.9)	(719.6)	(30.8)	–	(802.3)
Other net (losses)/gains resulting from the repurchase*	(0.3)	(0.5)	(0.8)	31.6	24.3	8.9	–	64.8
Gain on repurchase of own liabilities and equity	17.6	26.6	44.2	59.5	254.2	24.4	–	338.1

* The other net gains and losses were principally release of deferred coupons and hedge adjustments, less accelerated amortisation of the discounting effect of deferral of coupons and fees.

The gain on repurchase of subordinated notes and reserve capital instruments is reported in reserves as these instruments are accounted for as equity; after tax of £0.1m (2011: £11.7m), the net gain taken to reserves was £0.2m (2011: £32.5m). The gain on repurchase of tier one notes, subordinated liabilities, other capital instruments and securitised notes is reported in the Income Statement as these instruments are accounted for as liabilities.

Notes to the Financial Statements (continued)

9. Profit on disposal of credit linked notes

On 24 June 2011 holders of various classes of credit linked notes issued by NRAM's subsidiary Graphite Mortgages plc were invited to tender such notes for purchase by NRAM for cash. The result of this tender was announced on 6 July 2011 and as a consequence NRAM purchased notes with a par value of €216.1m for €197.8m. On 7 July 2011 NRAM announced that it intended to exercise its right to terminate the credit default swap between NRAM and KfW to which these notes related as of the payment date scheduled to fall on 10 August 2011. As a result of this, Graphite Mortgages plc was obliged to redeem all notes in issue on that date at par with NRAM receiving €216.1m for the notes that it had acquired. The profit resulting from the sale of the notes amounted to £15.6m.

10. Taxation

	2012 £m	2011 £m
The tax charge for the year comprises:		
Current tax:		
– on profit for the year	**(121.6)**	(186.7)
– adjustments in respect of prior years	**12.1**	20.9
– foreign tax	**–**	(2.0)
Total current tax	**(109.5)**	(167.8)
Deferred tax (see note 17):		
– origination and reversal of temporary differences	**(28.5)**	(54.6)
– change in rate effective 1 April 2013/1 April 2012 on deferred tax items	**11.3**	8.6
Total deferred tax	**(17.2)**	(46.0)
Total taxation charge per the Income Statement	**(126.7)**	(213.8)

The following tax amounts have been (charged)/credited to equity:

	2012 £m	2011 £m
Current tax:		
– Relating to available-for-sale investments	**(15.6)**	(22.7)
– Relating to repurchase of equity (see note 8)	**(0.1)**	(11.7)
Deferred tax:		
– Relating to cash flow hedge reserve	**(45.4)**	(47.9)
– Relating to actuarial movements on retirement benefit obligations	**19.6**	(46.5)
– Relating to available-for-sale investments	**(1.7)**	2.4
Net charge to equity	**(43.2)**	(126.4)

Notes to the Financial Statements (continued)

10. Taxation (continued)

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

	2012 £m	2011 £m
Profit before taxation	**690.5**	1,375.1
Tax calculated at rate of 24.5% (2011: 26.5%)	**(169.2)**	(364.4)
Effects of:		
Utilisation of deferred tax assets	**–**	141.0
Change in rate effective 1 April 2013 / 1 April 2012 on deferred tax items	**11.3**	8.4
Expenses not deductible for tax purposes	**(7.7)**	(20.4)
Adjustments in respect of prior years	**38.9**	21.6
Total taxation charge for the year	**(126.7)**	(213.8)

Taxation appropriately reflects changes in tax rates which had been substantively enacted by 31 December 2012, as detailed in note 17.

11. Balances with the Bank of England

	2012 £m	2011 £m
Balances for liquidity purposes	**2,995.2**	3,374.3
Collateral balances	**2,604.6**	2,796.4
Total	**5,599.8**	6,170.7

12. Investment securities

	2012 £m	2011 £m
Available-for-sale securities	**635.5**	970.4
Investment securities held as loans and receivables	**1,195.0**	1,536.6
Unsecured investment loans	**219.4**	341.1
Total	**2,049.9**	2,848.1

In the Balance Sheet the carrying values of impaired assets are presented net of the impairment allowances shown in note 13.

Net impairment on investment securities for the year comprised:

	2012 £m	2011 £m
Net impairment reversals on available-for-sale securities	**(45.4)**	(6.3)
Net impairment losses on investment securities held as loans and receivables and unsecured investment loans	**15.2**	65.1
Total net impairment (reversals) / charge	**(30.2)**	58.8

Notes to the Financial Statements (continued)

12. Investment securities (continued)

(a) Available-for-sale securities

	2012 £m	2011 £m
At fair value:		
Listed	**542.6**	881.7
Unlisted	**92.9**	88.7
Total	**635.5**	970.4

	2012 £m	2011 £m
The movement in available-for-sale securities was as follows:		
At 1 January	**970.4**	1,699.9
Additions	**104.3**	234.6
Disposals (sales and redemptions)	**(459.8)**	(981.2)
Exchange differences	**(10.9)**	(16.6)
Net gains on changes in fair value	**31.5**	33.7
At 31 December	**635.5**	970.4

(b) Investment securities held as loans and receivables

	2012 £m	2011 £m
Carrying value	**1,195.0**	1,536.6
Fair value	**1,182.1**	1,340.4
Listed	**1,175.9**	1,512.6
Unlisted	**19.1**	24.0
Total	**1,195.0**	1,536.6

(c) Unsecured investment loans

	2012 £m	2011 £m
Carrying value	219.4	341.1
Fair value	189.7	275.0
Listed	219.4	341.1
Total	219.4	341.1

Notes to the Financial Statements (continued)

13. Wholesale assets

The assets in the following table are of a wholesale nature as opposed to individual customer assets. The credit and concentration risk characteristics of these portfolios should therefore be considered together.

	2012 £m	2011 £m
Balances with the Bank of England (see note 11)	**5,599.8**	6,170.7
Cash at bank and in hand	**4,129.2**	2,746.5
Investment securities (see note 12)	**2,049.9**	2,848.1
Total	**11,778.9**	11,765.3

The Group had no collateral or other credit enhancements in respect of these assets.

(a) Credit risk

The credit quality of wholesale assets is set out in the table below:

At 31 December 2012	Balances with the Bank of England £m	Cash at bank and in hand £m	Available-for-sale securities £m	Investment securities held as loans and receivables £m	Unsecured investment loans £m	Total £m
Neither past due nor impaired	**5,599.8**	**4,129.2**	**467.5**	**1,109.5**	**219.4**	**11,525.4**
Impaired	**–**	**–**	**495.2**	**185.4**	**239.6**	**920.2**
	5,599.8	**4,129.2**	**962.7**	**1,294.9**	**459.0**	**12,445.6**
Provisions	**–**	**–**	**(327.2)**	**(99.9)**	**(239.6)**	**(666.7)**
Total	**5,599.8**	**4,129.2**	**635.5**	**1,195.0**	**219.4**	**11,778.9**

At 31 December 2011	Balances with the Bank of England £m	Cash at bank and in hand £m	Available-for-sale securities £m	Investment securities held as loans and receivables £m	Unsecured investment loans £m	Total £m
Neither past due nor impaired	6,170.7	2,746.5	855.5	1,465.7	341.1	11,579.5
Impaired	–	–	507.6	196.0	250.5	954.1
	6,170.7	2,746.5	1,363.1	1,661.7	591.6	12,533.6
Provisions	–	–	(392.7)	(125.1)	(250.5)	(768.3)
Total	6,170.7	2,746.5	970.4	1,536.6	341.1	11,765.3

Notes to the Financial Statements (continued)

13. Wholesale assets (continued)

The credit quality of wholesale assets by reference to credit ratings is set out in the table below:

At 31 December 2012	£m	AAA %	AA %	A %	BBB to B %	CCC and below %
Balances with the Bank of England	**5,599.8**	**100**	**–**	**–**	**–**	**–**
Cash at bank and in hand	**4,129.2**	**13**	**48**	**34**	**1**	**4**
Investment securities:						
– available-for-sale securities	**635.5**	**49**	**5**	**25**	**2**	**19**
– investment securities held as loans and receivables	**1,195.0**	**1**	**25**	**39**	**30**	**5**
– unsecured investment loans	**219.4**	**–**	**–**	**–**	**100**	**–**
Total investment securities	**2,049.9**	**16**	**16**	**30**	**29**	**9**
Total	**11,778.9**	**55**	**20**	**17**	**5**	**3**

At 31 December 2011	£m	AAA %	AA %	A %	BBB to B %	CCC and below %
Balances with the Bank of England	6,170.7	100	–	–	–	–
Cash at bank and in hand	2,746.5	–	50	50	–	–
Investment securities:						
– available-for-sale securities	970.4	70	10	10	1	9
– investment securities held as loans and receivables	1,536.6	5	29	32	29	5
– unsecured investment loans	341.1	–	–	–	100	–
Total investment securities	2,848.1	29	17	18	30	6
Total	11,765.3	60	16	16	7	1

Additional information in respect of impairment of investment securities is provided in note 12.

(b) Concentration risk

Wholesale assets are analysed by geographical region at their carrying amounts in the table below:

At 31 December 2012	UK £m	Europe £m	US £m	Other countries £m	Total £m
Balances with the Bank of England	**5,599.8**	**–**	**–**	**–**	**5,599.8**
Cash at bank and in hand	**2,844.7**	**1,160.4**	**16.0**	**108.1**	**4,129.2**
Investment securities:					
– available-for-sale securities	**288.6**	**292.3**	**8.2**	**46.4**	**635.5**
– investment securities held as loans and receivables	**586.7**	**82.5**	**58.5**	**467.3**	**1,195.0**
– unsecured investment loans	**–**	**–**	**–**	**219.4**	**219.4**
Total investment securities	**875.3**	**374.8**	**66.7**	**733.1**	**2,049.9**
Total	**9,319.8**	**1,535.2**	**82.7**	**841.2**	**11,778.9**

Notes to the Financial Statements (continued)

13. Wholesale assets (continued)

At 31 December 2011	UK £m	Europe £m	US £m	Other countries £m	Total £m
Balances with the Bank of England	6,170.7	–	–	–	6,170.7
Cash at bank and in hand	2,266.5	449.5	19.8	10.7	2,746.5
Investment securities:					
– available-for-sale securities	624.2	267.7	20.9	57.6	970.4
– investment securities held as loans and receivables	718.0	240.6	90.8	487.2	1,536.6
– unsecured investment loans	–	–	–	341.1	341.1
Total investment securities	1,342.2	508.3	111.7	885.9	2,848.1
Total	9,779.4	957.8	131.5	896.6	11,765.3

At 31 December 2012 and 31 December 2011 the Group held no investment securities issued by the governments of Portugal, the Republic of Ireland, Italy, Greece or Spain.

14. Loans to customers

At 31 December	2012 £m	2011 £m
Residential mortgages	**66,056.3**	71,913.3
Commercial loans	**781.9**	857.2
Total secured loans	**66,838.2**	72,770.5
Unsecured loans	**1,895.4**	2,523.9
Total	**68,733.6**	75,294.4

Residential mortgages include all of the Group's buy-to-let loans. Commercial loans comprise loans secured on commercial properties. The Together product, previously offered by NRAM, combines a secured and unsecured loan all at one interest rate and with flexible payments. Outstanding secured balances in respect of this product are included within total residential mortgages while outstanding unsecured balances are included within unsecured loans.

All of the Group's loans to customers are to UK customers.

Balances include accounting adjustments in respect of provisioning requirements.

Loans to customers include loans amounting to £46,455.1m (31 December 2011: £50,876.2m) which have been sold to bankruptcy-remote SPVs whereby substantially all of the risks and rewards of the portfolio are retained by the Group. Accordingly, all of these loans are retained on the Group's Balance Sheet. Further details are provided in note 25.

Fair value adjustments on portfolio hedging amounting to £493.8m (2011: £597.5m) relate to fair value adjustments to loans to customers in relation to interest rate risk as a result of their inclusion in a fair value portfolio hedge relationship.

Notes to the Financial Statements (continued)

14. Loans to customers (continued)

Loans to customers comprise the following product types:

	Balances 31 December 2012 £m	%	Redemptions 2012 £m	Balances 31 December 2011 £m	%	Redemptions 2011 £m
Residential mortgages						
Buy-to-let	**24,543.5**	**37**	**(843.5)**	25,799.5	36	(894.1)
Self Cert	**6,561.8**	**10**	**(291.0)**	6,902.4	9	(330.6)
Together	**13,185.8**	**20**	**(884.9)**	14,312.0	20	(1,183.5)
Standard and other	**21,765.2**	**33**	**(2,534.3)**	24,899.4	35	(4,042.4)
Total residential mortgages	**66,056.3**	**100**	**(4,553.7)**	71,913.3	100	(6,450.6)
Residential loans	**66,056.3**	**96**	**(4,553.7)**	71,913.3	96	(6,450.6)
Commercial loans	**781.9**	**1**	**(60.6)**	857.2	1	(178.6)
Total secured loans	**66,838.2**	**97**	**(4,614.3)**	72,770.5	97	(6,629.2)
Unsecured loans	**1,895.4**	**3**	**(231.9)**	2,523.9	3	(362.7)
Total	**68,733.6**	**100**	**(4,846.2)**	75,294.4	100	(6,991.9)

Redemptions comprise full redemptions and voluntary partial redemptions, but exclude overpayments and regular monthly payments.

On 23 July 2012 NRAM announced the sale of £465m of loans to customers, at par, secured on residential property, to Virgin Money. These sold loans are excluded from the redemptions disclosed in the above table.

As detailed in note 27, loan balances have been reduced to reflect remediation to certain customers for non-compliance with CCA rules. These adjustments are excluded from the redemptions disclosed in the above table.

15. Impairment on loans to customers

Allowances for credit losses against loans to customers have been made as follows:

2012	On residential mortgages £m	On commercial loans £m	On unsecured loans £m	Total £m
At 1 January	**1,644.5**	**102.2**	**501.6**	**2,248.3**
Movements during the year:				
– Write-offs	**(458.8)**	**(14.9)**	**(155.4)**	**(629.1)**
– Loan impairment charge	**225.4**	**12.7**	**57.6**	**295.7**
Net movements during the year	**(233.4)**	**(2.2)**	**(97.8)**	**(333.4)**
At 31 December	**1,411.1**	**100.0**	**403.8**	**1,914.9**
The Income Statement charge comprises:				
– Loan impairment charge	**225.4**	**12.7**	**57.6**	**295.7**
– Recoveries net of costs	**(38.4)**	**(0.6)**	**(15.3)**	**(54.3)**
Total Income Statement charge	**187.0**	**12.1**	**42.3**	**241.4**

Notes to the Financial Statements (continued)

15. Impairment on loans to customers (continued)

2011	On residential mortgages £m	On commercial loans £m	On unsecured loans £m	Total £m
At 1 January	1,845.1	88.6	542.3	2,476.0
Movements during the year:				
– Write-offs	(454.5)	(6.6)	(179.0)	(640.1)
– Loan impairment charge	253.9	20.2	138.3	412.4
Net movements during the year	(200.6)	13.6	(40.7)	(227.7)
At 31 December	1,644.5	102.2	501.6	2,248.3
The Income Statement charge comprises:				
– Loan impairment charge	253.9	20.2	138.3	412.4
– Recoveries net of costs	(8.6)	–	(13.4)	(22.0)
Total Income Statement charge	245.3	20.2	124.9	390.4

In the Balance Sheet the carrying values of loans to customers are presented net of these impairment allowances.

16. Credit quality of loans to customers

In respect of loans to residential customers, the Group holds collateral in the form of mortgages over residential properties. The fair value of this collateral was as follows:

At 31 December	2012 £m	2011 £m
Neither past due nor impaired	**82,351.1**	93,503.3
Past due but not impaired	**6,547.0**	7,592.4
Impaired	**1,151.6**	1,613.9
Total	**90,049.7**	102,709.6

If the collateral amount on each individual loan were capped at the amount of the balance outstanding, and any surplus of collateral values over balances outstanding ignored, the fair value of collateral held would be as follows:

At 31 December	2012 £m	2011 £m
Neither past due nor impaired	**58,712.3**	63,482.8
Past due but not impaired	**5,605.3**	6,477.5
Impaired	**1,045.2**	1,482.6
Total	**65,362.8**	71,442.9
The impaired balances above include the following carrying amount of assets in possession, capped at the balance outstanding	**260.4**	266.1

The fair value of the collateral is estimated by taking the most recent valuation of the property and adjusting for house price inflation or deflation up to the Balance Sheet date.

Notes to the Financial Statements (continued)

16. Credit quality of loans to customers (continued)

The indexed loan to value ('LTV') of residential loan balances, weighted by loan balance, falls into the following ranges:

At 31 December	2012 %	2011 %
To 50%	**6.7**	7.2
50% to 75%	**14.7**	14.1
75% to 100%	**45.3**	46.3
Over 100%	**33.3**	32.4
Total	**100.0**	100.0

The average indexed loan to value based on a simple average is 74.9% (31 December 2011: 71.6%) on a weighted average is 89.1% (31 December 2011: 89.5%).

	At 31 December 2012				At 31 December 2011			
	Residential mortgages £m	Commercial loans £m	Unsecured loans £m	Total £m	Residential mortgages £m	Commercial loans £m	Unsecured loans £m	Total £m
Neither past due nor impaired	**60,347.7**	**599.0**	**1,724.8**	**62,671.5**	64,998.3	706.4	2,327.3	68,032.0
Past due but not impaired:								
– less than 3 months	**3,358.9**	**0.5**	**160.5**	**3,519.9**	3,668.7	2.7	207.2	3,878.6
– 3 to 6 months	**1,455.8**	**–**	**49.3**	**1,505.1**	1,801.7	1.3	–	1,803.0
– over 6 months	**1,088.1**	**–**	**136.6**	**1,224.7**	1,316.1	–	–	1,316.1
Impaired	**1,216.9**	**282.4**	**228.0**	**1,727.3**	1,773.0	249.0	491.0	2,513.0
	67,467.4	**881.9**	**2,299.2**	**70,648.5**	73,557.8	959.4	3,025.5	77,542.7
Impairment allowances	**(1,411.1)**	**(100.0)**	**(403.8)**	**(1,914.9)**	(1,644.5)	(102.2)	(501.6)	(2,248.3)
Loans to customers net of impairment allowances	**66,056.3**	**781.9**	**1,895.4**	**68,733.6**	71,913.3	857.2	2,523.9	75,294.4
Impairment allowances:								
– individual	**217.3**	**100.0**	**131.9**	**449.2**	316.9	71.5	–	388.4
– collective	**1,193.8**	**–**	**271.9**	**1,465.7**	1,327.6	30.7	501.6	1,859.9
Total impairment allowances	**1,411.1**	**100.0**	**403.8**	**1,914.9**	1,644.5	102.2	501.6	2,248.3

'Impaired' loans are those which are 12 months or more in arrears, in possession or held for sale with an LPA receiver, and others which management consider to be individually impaired.

Improvements in impairment methodology during 2012 have enabled an element of the allowance for unsecured loans to be calculated on an individual loan basis.

The above table includes balances within 'neither past due nor impaired' which would have been shown as past due or impaired other than due to renegotiation; these were loans where arrears were capitalised during the year. These loans amounted to £31.4m (2011: £81.9m). A loan is eligible for capitalisation of arrears only once the borrower has complied with stringent terms for a set period.

The Group also offers other forbearance methods to borrowers, subject to compliance with loan terms and switching to interest-only products, the aim of these being to assist the borrower to reduce the level of arrears. Management have taken into consideration the forbearance options in applying loan default probabilities and in their overall assessment of the total impairment provision.

Notes to the Financial Statements (continued)

16. Credit quality of loans to customers (continued)

Arrears and possessions on residential mortgages and unsecured loans

Arrears and possessions are monitored for the Group as a whole, and also split by type of product.

		At 31 December 2012		At 31 December 2011	
		Residential	Unsecured	Residential	Unsecured
Arrears 3 months and over					
Number of cases	No.	**23,376**	**31,140**	30,511	34,282
Proportion of total cases	%	**3.99**	**13.67**	4.79	12.33
Asset value	£m	**3,341.1**	**410.1**	4,358.8	466.1
Proportion of book	%	**5.06**	**21.64**	6.06	18.47
Total value of payments overdue	£m	**132.3**	**96.9**	170.4	78.8
Proportion of total book	%	**0.20**	**5.11**	0.23	3.12
Possessions					
Number of cases	No.	**2,205**	**–**	2,705	–
Proportion of total cases	%	**0.37**	**–**	0.42	–
Asset value	£m	**320.5**	**–**	395.9	–
Proportion of book	%	**0.48**	**–**	0.55	–
Total value of payments overdue	£m	**20.8**	**–**	27.1	–
Proportion of total book	%	**0.03**	**–**	0.04	–
Total arrears 3 months and over and possessions					
Number of cases	No.	**25,581**	**31,140**	33,216	34,282
Proportion of total cases	%	**4.36**	**13.67**	5.21	12.33
Asset value	£m	**3,661.6**	**410.1**	4,754.7	466.1
Proportion of book	%	**5.54**	**21.64**	6.61	18.47
Total value of payments overdue	£m	**153.1**	**96.9**	197.5	78.8
Proportion of total book	%	**0.23**	**5.11**	0.27	3.12
In respect of all arrears (including those which are less than 3 months in arrears) together with possessions, the total value of payments overdue as at 31 December was:					
Payments overdue					
Total value of payments overdue	£m	**185.8**	**99.0**	233.9	81.6
Proportion of total book	%	**0.28**	**5.22**	0.33	3.23
Loan impairment provision					
As % of total balances	%	**2.09**	**17.56**	2.24	16.58
New possessions	No.	**7,326**	**–**	8,848	–

Notes to the Financial Statements (continued)

16. Credit quality of loans to customers (continued)

Analysis of residential mortgages and unsecured loans 3 months and over in arrears by product.

		At 31 December 2012		At 31 December 2011	
		Residential	Unsecured	Residential	Unsecured
Buy-to-let					
Number of cases	No.	**3,390**	**–**	5,623	–
Proportion of total cases	%	**1.66**	**–**	2.63	–
Asset value	£m	**527.9**	**–**	870.7	–
Proportion of book	%	**2.15**	**–**	3.37	–
Total value of payments overdue	£m	**19.7**	**–**	31.3	–
Proportion of total book	%	**0.08**	**–**	0.12	–
Self Cert					
Number of cases	No.	**1,563**	**–**	2,080	–
Proportion of total cases	%	**3.60**	**–**	4.59	–
Asset value	£m	**273.4**	**–**	362.3	–
Proportion of book	%	**4.17**	**–**	5.25	–
Total value of payments overdue	£m	**7.2**	**–**	10.4	–
Proportion of total book	%	**0.11**	**–**	0.15	–
Together					
Number of cases	No.	**8,422**	**13,541**	10,391	15,149
Proportion of total cases	%	**6.49**	**10.18**	7.43	10.49
Asset value	£m	**958.2**	**228.4**	1,178.9	262.3
Proportion of book	%	**7.27**	**15.21**	8.24	13.95
Total value of payments overdue	£m	**40.0**	**22.9**	50.4	21.9
Proportion of total book	%	**0.30**	**1.52**	0.35	1.16
Standard and other					
Number of cases	No.	**10,001**	**17,599**	12,417	19,133
Proportion of total cases	%	**4.80**	**18.57**	5.20	14.31
Asset value	£m	**1,581.6**	**181.7**	1,946.9	203.8
Proportion of book	%	**7.27**	**46.21**	7.82	31.68
Total value of payments overdue	£m	**65.4**	**74.0**	78.3	56.9
Proportion of total book	%	**0.30**	**18.82**	0.31	8.84

Notes to the Financial Statements (continued)

17. Deferred taxation

The net deferred taxation (liability)/asset is attributable to the following:

At 31 December	Assets 2012 £m	Assets 2011 £m	Liabilities 2012 £m	Liabilities 2011 £m	Net 2012 £m	Net 2011 £m
Changes in accounting basis on adoption of IFRS	**20.5**	11.7	**(4.5)**	(8.5)	**16.0**	3.2
Cash flow hedges	**–**	–	**(83.5)**	(38.1)	**(83.5)**	(38.1)
Accelerated tax depreciation	**1.8**	4.7	**(0.5)**	(0.7)	**1.3**	4.0
Available-for-sale reserve and fair value	**–**	–	**(9.6)**	(10.3)	**(9.6)**	(10.3)
Employee benefits	**24.2**	6.5	**(14.8)**	(11.0)	**9.4**	(4.5)
Taxation value of losses carried forward	**22.5**	46.5	**–**	–	**22.5**	46.5
	69.0	69.4	**(112.9)**	(68.6)	**(43.9)**	0.8
Offset	**(69.0)**	(68.6)	**69.0**	68.6	**–**	–
Total	**–**	0.8	**(43.9)**	–	**(43.9)**	0.8

No deferred tax assets were unrecognised at 31 December 2012. At 31 December 2011, £22.6m of deferred tax assets were unrecognised, relating to unused tax losses of £10.3m and deductible temporary differences of £80.0m. £22.5m (2011: £46.5m) of deferred tax assets have been recognised in respect of tax losses carried forward; based upon detailed business plans, there will be sufficient taxable profits in future years to utilise the losses on which deferred tax has been recognised.

The movements in the Group's temporary differences during the year and previous year were as follows:

	At 1 January 2012 £m	Recognised in income £m	Recognised in equity £m	At 31 December 2012 £m
Change in accounting basis on adoption of IFRS	**3.2**	**12.8**	**–**	**16.0**
Cash flow hedges	**(38.1)**	**–**	**(45.4)**	**(83.5)**
Accelerated tax depreciation	**4.0**	**(2.7)**	**–**	**1.3**
Available-for-sale reserve and fair value	**(10.3)**	**2.4**	**(1.7)**	**(9.6)**
Employee benefits	**(4.5)**	**(5.7)**	**19.6**	**9.4**
Taxation value of losses carried forward	**46.5**	**(24.0)**	**–**	**22.5**
Total	**0.8**	**(17.2)**	**(27.5)**	**(43.9)**

	At 1 January 2011 £m	Recognised in income £m	Recognised in equity £m	At 31 December 2011 £m
Change in accounting basis on adoption of IFRS	(10.9)	14.1	–	3.2
Unremitted earnings from overseas subsidiary	(3.4)	3.4	–	–
Cash flow hedges	9.8	–	(47.9)	(38.1)
Accelerated tax depreciation	5.9	(1.9)	–	4.0
Available-for-sale reserve and fair value	(13.4)	0.7	2.4	(10.3)
Employee benefits	50.8	(8.8)	(46.5)	(4.5)
Taxation value of losses carried forward	100.0	(53.5)	–	46.5
Total	138.8	(46.0)	(92.0)	0.8

Deferred tax appropriately reflects the change to the standard rate of UK corporation tax to 23% with effect from 1 April 2013. The announced further rate reductions to 20% with effect from 1 April 2015 would have the maximum potential impact of reducing the Group's deferred tax assets by approximately £9.0m.

Notes to the Financial Statements (continued)

18. Other assets

	2012 £m	2011 £m
Prepayments and accrued income	**24.0**	26.6
Other	**16.7**	16.1
Total	**40.7**	42.7

19. Retirement benefit assets and obligations

(a) Pension schemes

The UKAR Group operates a number of retirement benefit plans for its employees, including defined benefit plans, defined contribution plans and post-retirement medical benefits. The costs of these plans are charged to the Income Statement and other comprehensive income in accordance with IAS 19 'Employee Benefits' and IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'. Further details in respect of the Group's schemes are given in sections (b) (B&B schemes) and (c) (NRAM schemes) below. For 2013, the UKAR Group will adopt the revisions to IAS 19 which were issued in June 2011 and adopted for use in the EU in June 2012. The main effect on the Group of the revisions to IAS 19 is that instead of an expected rate of return being applied to defined benefit plan assets, the discount rate previously applied to defined benefit plan obligations will instead be applied to the net surplus or deficit on the plan.

(b) Bradford & Bingley schemes

Pension schemes

The B&B Group operated a defined benefit staff pension scheme, the Bradford & Bingley Staff Pension Scheme ('the principal scheme'), which was administered by 'the Trustees'. On 31 December 2009 the scheme was closed to future service accrual and all members became deferred members and were given the option to transfer to the B&B Group defined contribution scheme from 1 January 2010. The assets of the principal scheme are held in a separate trustee-administered fund. The normal pension age of employees in the principal scheme is 65.

The B&B Group also operates a defined contribution scheme, the Bradford & Bingley Group Pension Plan. The assets of this scheme are independent from those of the Group. The UKAR Group and Company had no liabilities or prepayments associated with this scheme at 31 December 2012 (2011:£nil). The cost in the year to the UKAR Group of this scheme was £3.4m (2011: £3.5m).

Other post-retirement benefits

The B&B Group provides healthcare benefits to some of its pensioners. The healthcare benefits are provided through a post-retirement medical scheme into which the UKAR Group contributes 100% towards the cost of providing medical expense benefits for members who retired before 1 January 1996 and 50% for members who retired after this date. The total number of members of the scheme at 31 December 2012 was 323 (2011: 336). Private medical costs are assessed in accordance with the advice of a qualified actuary.

Accounting treatment

The full net deficit is carried on the UKAR Group Balance Sheet, and gains and losses arising due to actuarial revaluations and adjustments to reflect the funding plan commitments are taken to UKAR Group other comprehensive income rather than being credited or charged in the Income Statement.

The Group is committed to a funding plan to address the deficit on the B&B defined benefit plan and in July 2010 B&B committed to make contributions of £16m per annum increasing at 10% pa for 10 years, commencing in 2010. The schedule of contributions has been re-considered, and the Group expects to make a contribution of £32m in June 2013. In accordance with IFRIC 14, the net pension deficit which is recognised on the Balance Sheet is the higher of the deficit calculated under IAS 19 and the net present value of the committed funding. However, to the extent that the B&B Group has a clear unconditional right to a refund of future surpluses which may arise in the plan, the carrying value of the deficit should be reduced to take account of the anticipated future available refunds. In March 2011 the Trustees finalised a resolution under Section 251(3) of the Pensions Act 2004 for the ultimate refund to B&B of any future surpluses on the plan. At 31 December 2010, this resolution not yet being in effect, the funding plan reduced retained earnings by £117.6m.

At 31 December 2010 the inflation assumption used to determine benefit obligations was based on the Retail Prices Index ('RPI'), pending fulfilment of conditions which would need to be satisfied in order for the proposed change to a Consumer Prices Index ('CPI') basis to come into effect in respect of deferred members. The conditions were satisfied during 2011, and consequently CPI has been applied with effect from 1 January 2011. Consequently the net pension liability carried on the UKAR Group Balance Sheet reduced at that time by a credit to other comprehensive income.

The actuarial loss recognised in the UKAR Group's other comprehensive income during the year was £64.3m (2011: gain £34.0m) and retained earnings also increased in 2011 by £117.6m as a result of the passing of the resolution regarding the refund of surpluses. The cumulative actuarial loss recognised in the UKAR Group since transition to IFRS on 1 January 2004 is £99.3m (2011: £35.0m).

Notes to the Financial Statements (continued)

19. Retirement benefit assets and obligations (continued)

Defined benefit obligations

The amounts carried on the UKAR Group Balance Sheet are as follows:

	Defined benefit pension plans		Post-retirement medical benefits		Total	
	2012	2011	**2012**	2011	**2012**	2011
	£m	£m	**£m**	£m	**£m**	£m
Present value of defined benefit obligations	**(730.8)**	(663.7)	**(9.6)**	(9.9)	**(740.4)**	(673.6)
Fair value of defined benefit assets	**669.9**	649.0	**–**	–	**669.9**	649.0
Net defined benefit liability	**(60.9)**	(14.7)	**(9.6)**	(9.9)	**(70.5)**	(24.6)

The amounts recognised in the UKAR Group Income Statement were as follows:

	Defined benefit pension plans		Post-retirement medical benefits		Total	
	2012	2011	**2012**	2011	**2012**	2011
	£m	£m	**£m**	£m	**£m**	£m
Interest on defined benefit obligations	**30.8**	34.0	**0.5**	0.5	**31.3**	34.5
Expected return on defined benefit assets	**(29.9)**	(34.4)	**–**	–	**(29.9)**	(34.4)
Net cost/(credit)	**0.9**	(0.4)	**0.5**	0.5	**1.4**	0.1

The actual return on defined benefit assets for the year was £20.3m (2011: £65.8m).

Movements in the present value of defined benefit obligations were as follows:

	Defined benefit pension plans		Post-retirement medical benefits		Total	
	2012	2011	**2012**	2011	**2012**	2011
	£m	£m	**£m**	£m	**£m**	£m
At 1 January	**663.7**	650.7	**9.9**	9.0	**673.6**	659.7
Interest on defined benefit obligations	**30.8**	34.0	**0.5**	0.5	**31.3**	34.5
Actuarial loss/(gain)	**55.2**	(3.3)	**(0.5)**	0.7	**54.7**	(2.6)
Benefits paid	**(18.9)**	(17.7)	**(0.3)**	(0.3)	**(19.2)**	(18.0)
At 31 December	**730.8**	663.7	**9.6**	9.9	**740.4**	673.6

Movements in the fair value of defined benefit assets were as follows:

	Defined benefit pension plans		Post-retirement medical benefits		Total	
	2012	2011	**2012**	2011	**2012**	2011
	£m	£m	**£m**	£m	**£m**	£m
At 1 January	**649.0**	583.2	**–**	–	**649.0**	583.2
Expected return on defined benefit assets	**29.9**	34.4	**–**	–	**29.9**	34.4
Defined benefit company contributions	**19.4**	17.6	**0.3**	0.5	**19.7**	18.1
Actuarial (loss)/gain	**(9.6)**	31.4	**–**	–	**(9.6)**	31.4
Benefits paid	**(18.8)**	(17.6)	**(0.3)**	(0.5)	**(19.1)**	(18.1)
At 31 December	**669.9**	649.0	**–**	–	**669.9**	649.0

Notes to the Financial Statements (continued)

19. Retirement benefit assets and obligations (continued)

The UKAR Group expects to contribute £32.0m to this defined benefit pension plan in 2013, to address the deficit on the plan.

The major categories of defined benefit assets as a percentage of total defined benefit assets at 31 December were as follows:

	2012	2011
Equities	**25%**	23%
Property	**6%**	8%
Bonds	**45%**	40%
Gilts	**18%**	19%
Cash and other	**6%**	10%
Total	**100%**	100%

Summary actuarial assumptions (expressed as weighted averages) were as follows:

	2012	2011
To determine benefit obligations:		
Discount rate at 31 December	**4.5%**	4.7%
Inflation (RPI)	**3.0%**	3.0%
Inflation (CPI)	**2.4%**	2.3%
Future pension increases	**2.9%**	2.9%
To determine net pension cost:		
Expected return on plan assets	**4.6%**	5.9%
Discount rate	**4.7%**	5.3%
For post-retirement medical plan:		
Discount rate	**4.5%**	4.7%
Medical cost trend for duration of liability	**6.1%**	5.2%

In determining the expected long-term return on defined benefit assets, the B&B Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns on each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long-term return for the portfolio.

The table below shows the life expectancy assumptions from age 60:

		2012		2011
	Pensioner	Non-retired member	Pensioner	Non-retired member
Male	**28.3**	**29.8**	27.3	28.9
Female	**31.0**	**32.6**	30.2	31.8

The basis of estimation of life expectancy was changed during the year to use of data which is believed closer to reflect the characteristics of the membership of the plan.

Notes to the Financial Statements (continued)

19. Retirement benefit assets and obligations (continued)

The table below illustrates the 5 year history of experience gains and losses for the B&B defined benefit pension plan:

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Defined benefit obligations	**(730.8)**	(663.7)	(650.7)	(615.1)	(480.5)
Fair value of assets	**669.9**	649.0	583.2	525.2	485.3
IFRIC 14 restriction	**–**	–	(117.6)	–	(4.8)
Deficit	**(60.9)**	(14.7)	(185.1)	(89.9)	–
Experience (loss)/gain on liabilities	**(55.2)**	3.3	(22.4)	(132.6)	101.5
Experience (loss)/gain on assets	**(9.6)**	31.4	31.2	21.3	(115.7)

Sensitivity

The following table illustrates the sensitivity of the net defined benefit pension scheme obligations to three key assumptions: the discount rate, the rate of inflation and the mortality assumption:

Assumption	Change in assumption	Impact on net obligations
Discount rate	Decrease by 0.5%	Increase by 11%
Inflation	Increase by 0.5%	Increase by 11%
Mortality	Decrease by 1 year	Increase by 2%

If the assumptions were to change by the same amount in the opposite direction to those illustrated, the net defined benefit obligations would decrease by a similar percentage to those shown in the table in each case.

Assumed healthcare cost trend rates have an effect on the amounts recognised in staff costs. A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	2012 £m	2011 £m
Effect on interest cost	**0.1**	0.1
Effect on defined benefit obligations	**1.5**	1.3

(c) NRAM schemes

Pension schemes

The NRAM Group operated a staff pension scheme ('the Scheme'), which had both defined benefit and defined contribution sections. On 1 January 2010 all employees previously employed by the NRAM Group transferred to Northern Rock plc under the terms of the Northern Rock Transfer Order 2009. As a consequence of this, members of the Scheme became members of the Northern Rock (2010) Pension Scheme, which had both defined benefit and defined contribution sections, and the existing Scheme was closed. The assets of the closed Scheme are held in a separate trustee-administered fund. The normal pension age of employees in this Scheme is 60.

Of the employees who transferred to the Northern Rock (2010) Pension Scheme, 1,254 subsequently transferred to B&B on 1 November 2010 and were eligible to join that company's defined contribution pension scheme (the Bradford & Bingley Group Pension Plan). The NRAM Group had no liabilities or prepayments associated with the B&B defined contribution scheme as at 31 December 2012 (2011: £nil). The cost in the year to the NRAM Group arising from amounts recharged by B&B in respect of employees providing services to the NRAM Group who participate in this scheme was £2.0m (2011: £2.2m).

Notes to the Financial Statements (continued)

19. Retirement benefit assets and obligations (continued)

Accounting treatment

The full net surplus or deficit is carried on the UKAR Group's Balance Sheet, and gains and losses arising due to actuarial revaluations are taken to other comprehensive income rather than being credited or charged in the Income Statement. The actuarial loss recognised in the UKAR Group's other comprehensive income during the year was £22.4m (2011: gain £19.1m). The cumulative actuarial loss recognised in the UKAR Group since transition to IFRS on 1 January 2004 is £38.2m (2011: £15.8m).

The UKAR Group continues to determine benefit obligations under this scheme based on the Retail Prices Index ('RPI').

Defined benefit section of the Scheme

The amounts carried on the UKAR Group Balance Sheet are as follows:

	2012 £m	2011 £m
Present value of defined benefit obligations	**(459.2)**	(423.7)
Fair value of defined benefit assets	**502.2**	473.5
Net defined benefit asset	**43.0**	**49.8**

The trustees of the Scheme have passed a resolution for the ultimate refund to NRAM of any future surpluses on the Scheme.

The amounts recognised in the UKAR Group Income Statement were as follows:

	2012 £m	2011 £m
Interest on defined benefit obligations	**19.6**	19.5
Expected return on defined benefit assets	**(19.9)**	(20.0)
Defined benefit pension gain	**–**	(3.5)
Net credit	**(0.3)**	**(4.0)**

The defined benefit pension gain in 2011 was calculated in accordance with IAS 19 and arose due to the transfer in of certain assets and obligations from the Northern Rock (2010) Pension Scheme.

The actual return on defined benefit assets for the year was a gain of £24.7m (2011: £77.9m).

Movements in the present value of defined benefit obligations were as follows:

	2012 £m	2011 £m
At 1 January	**423.7**	371.9
Interest on defined benefit obligations	**19.6**	19.5
Actuarial loss	**27.2**	38.8
Benefits paid	**(11.3)**	(9.7)
Other adjustments	**–**	3.2
At 31 December	**459.2**	**423.7**

Other adjustments in 2011 represented obligations arising from the transfer in from members of the Northern Rock (2010) Pension Scheme.

Notes to the Financial Statements (continued)

19. Retirement benefit assets and obligations (continued)

Movements in the fair value of defined benefit assets were as follows:

	2012 £m	2011 £m
At 1 January	**473.5**	380.2
Expected return on defined benefit assets	**19.9**	20.0
Defined benefit company contributions	**15.3**	18.4
Actuarial gain	**4.8**	57.9
Benefits paid	**(11.3)**	(9.7)
Other adjustments	**–**	6.7
At 31 December	**502.2**	473.5

Other adjustments in 2011 represented assets arising from the transfer in from members of the Northern Rock (2010) Pension Scheme.

The UKAR Group expects to contribute £34.3m to this Scheme in 2013 under a funding plan to address the deficit on the Scheme as calculated on a trustees funding basis.

The major categories of defined benefit assets as a percentage of total defined benefit assets at 31 December were as follows:

	2012	2011
Equities	**3%**	3%
Bonds	**23%**	20%
Gilts	**35%**	39%
Cash and other	**39%**	38%
Total	**100%**	100%

Summary actuarial assumptions (expressed as weighted averages) were as follows:

	2012	2011
To determine benefit obligations:		
Discount rate at 31 December	**4.5%**	4.7%
Inflation (RPI)	**3.0%**	3.0%
Future pension increases	**2.9% – 3.6%**	2.9% – 3.5%
To determine net pension cost:		
Expected return on plan assets	**4.1%**	5.1%
Discount rate	**4.7%**	5.3%

In determining the expected long-term return on defined benefit assets, the NRAM Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns on each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long-term return for the portfolio.

Notes to the Financial Statements (continued)

19. Retirement benefit assets and obligations (continued)

The table below shows the life expectancy assumptions from age 60:

	2012		2011	
	Pensioner	Non-retired member	Pensioner	Non-retired member
Male	**27.5**	**29.0**	27.5	28.5
Female	**29.9**	**31.5**	30.0	30.8

The basis of estimation of life expectancy was changed during the year to use of data which is believed closer to reflect the characteristics of the membership of the Scheme.

The table below illustrates the 5 year history of experience gains and losses:

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Defined benefit obligations	**(459.2)**	(423.7)	(371.9)	(391.4)	(335.8)
Fair value of assets	**502.2**	473.5	380.2	386.5	367.5
Surplus/(deficit)	**43.0**	49.8	8.3	(4.9)	31.7
Experience (loss)/gain on liabilities	**(2.7)**	(6.5)	9.3	12.2	2.8
Experience gain/(loss) on assets	**4.8**	57.9	(22.0)	(6.3)	(1.9)

Sensitivity

The following table illustrates the sensitivity of the defined benefit pension Scheme obligations to three key assumptions: the discount rate, the rate of inflation and the mortality assumption:

Assumption	Change in assumption	Impact on net obligations
Discount rate	Decrease by 0.5%	Increase by 12%
Inflation	Increase by 0.5%	Increase by 9%
Mortality	Decrease by 1 year	Increase by 3%

If the assumptions were to change by the same amount in the opposite direction to those illustrated, the defined benefit obligations would decrease by a similar percentage to those shown in the table in each case.

Notes to the Financial Statements (continued)

20. Investment property

The Group carries its investment property at fair value. Fair value is determined by independent professional valuers who apply recognised valuation techniques.

During the year, rental income and direct property repair and maintenance costs in respect of the property of £3.3m and £nil respectively (2011: £6.5m and £0.6m respectively) have been recognised in the Income Statement.

The property was sold to Virgin Money on 22 June 2012.

Movements in the value of investment property are analysed as follows:

	2012 £m	2011 £m
Investment properties at fair value at 1 January	**26.6**	26.6
Fair value movement	**2.9**	–
Disposals	**(29.5)**	–
Investment properties at fair value at 31 December	**–**	26.6

21. Property, plant and equipment

2012	Land and buildings £m	Plant, equipment, fixtures, fittings and vehicles £m	Total £m
Cost			
At 1 January 2012	63.2	88.7	151.9
Additions	–	4.5	4.5
Disposals	(25.5)	(22.3)	(47.8)
At 31 December 2012	37.7	70.9	108.6
Depreciation			
At 1 January 2012	34.2	68.5	102.7
Charged in year	1.2	3.8	5.0
Accelerated depreciation	8.3	–	8.3
Disposals	(17.1)	(19.0)	(36.1)
At 31 December 2012	26.6	53.3	79.9
Net book amount:			
At 1 January 2012	29.0	20.2	49.2
At 31 December 2012	11.1	17.6	28.7

Notes to the Financial Statements (continued)

21. Property, plant and equipment (continued)

2011	Land and buildings	Plant, equipment, fixtures, fittings and vehicles	Total
	£m	£m	£m
Cost			
At 1 January 2011	63.2	75.9	139.1
Additions	–	13.5	13.5
Disposals	–	(0.7)	(0.7)
At 31 December 2011	63.2	88.7	151.9
Depreciation			
At 1 January 2011	22.4	56.0	78.4
Charged in year	2.7	2.7	5.4
Accelerated depreciation	9.1	10.0	19.1
Disposals	–	(0.2)	(0.2)
At 31 December 2011	34.2	68.5	102.7
Net book amount:			
At 1 January 2011	40.8	19.9	60.7
At 31 December 2011	29.0	20.2	49.2

An accelerated depreciation charge of £8.3m was made in 2012 relating mainly to NRAM's Doxford site. This followed an external property valuation carried out during the year.

An accelerated depreciation charge of £19.1m was made in 2011 relating to NRAM's Gosforth site, and IT assets which will no longer be of use to the business following the decision to change IT service provider.

At 31 December 2012, work in progress of £2.0m (2011: £8.2m) has been capitalised and is not being depreciated. During 2012, £8.2m of work in progress held at 31 December 2011(2011: £8.5m) and £2.5m of additions in 2012 (2011: £4.6m) have begun depreciating. The work in progress relates to an IT investment programme to simplify existing infrastructure and reduce ongoing costs.

Sale proceeds from asset disposals were £11.3m (2011: £0.5m) resulting in a loss on sale of £0.4m (2011: £nil). NRAM's Gosforth site was sold to Virgin Money on 22 June 2012.

22. Intangible assets

2012	£m
Cost	
At 1 January 2012	**58.4**
Additions	**20.0**
Disposals	**(3.2)**
At 31 December 2012	**75.2**
Impairment and amortisation	
At 1 January 2012	**23.9**
Amortisation charged in year	**7.2**
Disposals	**(3.2)**
At 31 December 2012	**27.9**
Net book amount:	
At 1 January 2012	**34.5**
At 31 December 2012	**47.3**

Notes to the Financial Statements (continued)

22. Intangible assets (continued)

2011	Total £m
Cost	
At 1 January 2011	29.9
Additions	31.3
Disposals	(2.8)
At 31 December 2011	58.4
Impairment and amortisation	
At 1 January 2011	26.6
Amortisation charged in year	0.1
Disposals	(2.8)
At 31 December 2011	23.9
Net book amount:	
At 1 January 2011	3.3
At 31 December 2011	34.5

Intangible assets comprise capitalised software.

At 31 December 2012, work in progress of £4.1m (2011: £32.8m) has been capitalised and is not being amortised. During 2012, £32.8m of work in progress held at 31 December 2011 (2011: £0.2m) and £20.0m of additions in 2012 (2011: £0.4m) has begun amortising. The work in progress relates to an IT investment programme to simplify existing infrastructure and reduce ongoing costs.

Sale proceeds from asset disposals were £nil (2011: £nil) resulting in a profit on sale of £nil (2011: £nil).

23. Amounts due to banks

At 31 December	2012 £m	2011 £m
Cash collateral received	**4,754.0**	4,031.9
Other	**40.9**	44.0
Total	**4,794.9**	4,075.9

24. Statutory Debt and HM Treasury loans

	2012 £m	2011 £m
HM Treasury loan to NRAM	**18,063.1**	19,726.4
B&B Statutory Debt	**18,416.2**	18,416.2
HM Treasury Working Capital Facility to B&B	**7,008.0**	8,439.6
Total	**43,487.3**	46,582.2

Notes to the Financial Statements (continued)

24. Statutory Debt and HM Treasury loans (continued)

The HM Treasury loan to NRAM is repayable on demand. Interest has been charged at Bank of England Base Rate + 100 bps since 4 May 2012 (prior to that date interest was charged at Bank of England Base Rate + 25 bps). At the signing date of these Financial Statements, HM Treasury has confirmed its intentions to continue to fund NRAM as a going concern, and to enable NRAM to meet its debts as and when they fall due until at least 1 November 2014. It has also committed to convert up to £1.6bn of its loan to NRAM to meet regulatory capital requirements if so required. It is expected that the HM Treasury loan will be repaid out of the cash flows generated by NRAM during its wind-down. These cash flows will principally comprise interest and redemptions arising on loans to customers. The redemption profile of loans to customers is uncertain; many of these loans have contractual maturities of 25 years or more from the date of advance, but experience has been that most loans to customers redeem earlier than their contractual maturity dates. Consequently, the timing of the repayment of the HM Treasury loan to NRAM is uncertain.

B&B has an interest-free Statutory Debt of £18,416.2m as at 31 December 2012 and 31 December 2011. This replaced B&B's savings-related assets and liabilities which were transferred to Banco Santander Group on 29 September 2008. £15,654.5m of the Statutory Debt is owed to the Financial Services Compensation Scheme ('FSCS'). At the time of nationalisation, the FSCS covered the first £35,000 per depositor; HM Treasury agreed to cover the excess over £35,000, amounting to a total of £2,761.7m. It is expected that the Statutory Debt will be repaid out of the cash flows generated by B&B during its wind-down. These cash flows will principally comprise interest and redemptions arising on loans to customers. The redemption profile of loans to customers is uncertain; many of these loans have contractual maturities of 25 years or more from the date of advance, but experience has been that most loans to customers redeem earlier than their contractual maturity dates. Consequently, the timing of the repayment of the Statutory Debt is uncertain.

B&B has an interest-bearing Working Capital Facility ('WCF') provided by HM Treasury. Since 1 August 2011 the rate charged has been Bank of England Base Rate + 500bps, and prior to that date the rate was Bank of England Base Rate + 150bps. HM Treasury has the option to vary the rate charged. At 31 December 2012 B&B had drawn £6,975.0m (2011: £8,400.0m) of this facility; £7,008.0m including accrued interest (2011: £8,439.6m). HM Treasury has confirmed its intentions to continue to fund B&B as a going concern, and to enable B&B to meet its debts as and when they fall due, until at least 1 November 2014. HM Treasury has indicated that it expects the WCF to be repaid out of the cash flows generated by B&B during its wind-down. These cash flows will principally comprise interest and redemptions arising on loans to customers. The redemption profile of loans to customers is uncertain; many of these loans have contractual maturities of 25 years or more from the date of advance, but experience has been that most loans to customers redeem earlier than their contractual maturity dates. Consequently, the timing of the repayment of the WCF is uncertain.

25. Debt securities in issue

	Securitised notes £m	Covered Bonds £m	Other £m	Total £m
At 1 January 2012	**23,883.5**	**12,096.0**	**2,082.0**	**38,061.5**
Repayments	**(3,186.9)**	**(440.3)**	**(1,122.0)**	**(4,749.2)**
Repurchase	**(537.8)**	**–**	**–**	**(537.8)**
Other movements	**(534.1)**	**(572.3)**	**(48.0)**	**(1,154.4)**
At 31 December 2012	**19,624.7**	**11,083.4**	**912.0**	**31,620.1**
Securitised assets	**28,328.9**	**18,126.2**	**–**	**46,455.1**

	Securitised notes £m	Covered Bonds £m	Other £m	Total £m
At 1 January 2011	29,129.7	14,913.7	4,385.3	48,428.7
Repayments	(4,867.2)	(2,495.6)	(2,245.5)	(9,608.3)
Other movements	(379.0)	(322.1)	(57.8)	(758.9)
At 31 December 2011	23,883.5	12,096.0	2,082.0	38,061.5
Securitised assets	31,050.3	19,825.9	–	50,876.2

Notes to the Financial Statements (continued)

25. Debt securities in issue (continued)

On 19 June 2012 the Group announced tender offers in respect of securitised notes issued by B&B and NRAM securitisation structures. The tender process closed on 4 July 2012, resulting in the purchase of notes with a face value of £537.2m, and generating a profit of £143.4m (see note 8).

Other movements comprise exchange rate movements, accrued interest and hedge accounting adjustments.

The B&B and NRAM Groups issued debt securities to securitise loans to customers through SPVs and Covered Bonds, the amounts of which are shown above. Certain of these were subject to fair value hedge designation, and the carrying values of these instruments include unamortised adjustments in respect of the risks that were hedged.

HM Treasury has provided guarantees with regard to certain wholesale borrowings of the B&B and NRAM Groups; the Group pays fees for these guarantees, as detailed in note 3.

Securitised assets represent loans to customers which have been used to securitise issued notes, including notes which are held by other Group companies. B&B and NRAM pass to their SPVs cash received in relation to the securitised assets. The SPVs use the cash to service the bonds, retain a margin specified under the terms of the issue, and return any surplus cash to B&B and NRAM. To the extent that the total cash receipts in relation to the securitised assets are insufficient to satisfy interest and principal payments in relation to the bonds, the holders of the bond have no recourse against the Group. Provided that the total cash receipts in relation to the securitised assets are sufficient to satisfy interest and principal payments in relation to the bonds, B&B/NRAM bear the cost of any impairment of the securitised assets. While the assets remain securitised, the Group may not use, sell or pledge these assets.

In respect of Covered Bonds, B&B and NRAM pass to Bradford & Bingley Covered Bonds LLP and Northern Rock Covered Bond LLP all receipts, cash received in relation to the securitised assets. Bradford & Bingley Covered Bonds LLP and Northern Rock Covered Bond LLP use cash to service the bonds, and return any surplus cash to B&B/NRAM. B&B and NRAM bear the cost of any impairment of the securitised assets. While the assets remain securitised, the Group may not use, sell or pledge the these assets.

Further details of debt securities in issue are provided in the Annual Reports and Accounts of B&B and NRAM, copies of which are available on the corporate website of each of these companies.

At 31 December 2012 the SPVs had cash deposits (including accrued interest) amounting to £3,594.2m, including collateral deposits of £1,568.9m (2011: £3,371.0m, including collateral deposits of £1,311.8m). These deposits (excluding the collateral deposits) are restricted in use to the repayment of the debt securities issued by the SPVs and other legal obligations.

On 10 May 2012 a Non-Asset Trigger Event (as defined in the Offering Circular) occurred within B&B's Master Trust securitisation structure, due to the aggregate current balance of loans comprising the Trust Property falling below the minimum trust size of £10.7bn. The impact of this event is to change the order of priority of the Funding 1 Available Principal Receipts. As a result of the Non-Asset Trigger Event, all principal receipts from customers are allocated to Funding 1 and will continue to be so allocated until all holders of Aire Valley residential mortgage-backed securities have been repaid in full if sufficient funds are available. The principal is then passed to the Issuers based on their respective notes outstanding. Each Issuer then utilises this principal to pay down notes pro-rata and sequentially by class. The timing of future redemptions will be dependent on the availability of funds.

On 11 November 2008, as a result of a breach of a non asset trigger, the Granite Master Trust moved into pass through. The main consequence of this is that the repayments of the loan notes no longer adhere to the controlled amortisation schedules detailed in the SPVs' offering circulars. All principal cash received by the Trust is allocated between Granite Finance Funding Limited and Granite Finance Funding 2 Limited in accordance with their respective shares of the Trust's property as at 1 November 2008, this being the last determination date prior to the breach of the non asset trigger. The principal cash allocated to Granite Finance Funding Limited is then distributed pro-rata between the relevant issuers in the Granite Finance Funding Limited group by reference to the size of their inter-company loans outstanding with Granite Finance Funding Limited at each determination date. The principal cash received by the issuers is utilised in full on each quarterly payment date to make repayments in respect of the loan notes. The priority of loan note repayment is by reference to their original credit ratings on issue, with AAA notes repaid first, then AA notes, then A notes and finally BBB notes. The principal cash allocated to Granite Finance Funding 2 Limited is used to repay the loan from Granite Master Issuer plc, which in turn uses the cash to repay the loan notes in issue by reference to their original credit ratings on issue in the same manner as detailed above. The average time taken to repay the loan notes is now expected to be significantly extended beyond the maturity profiles envisaged by the original controlled amortisation schedules. It is therefore highly unlikely that the loan notes will be called on their step up and call dates.

Other debt securities in issue comprise notes issued under B&B's and NRAM's Medium Term Notes programmes.

26. Other liabilities

	2012 £m	2011 £m
Accruals and deferred income	**71.7**	61.7
Other	**98.1**	102.2
Total	**169.8**	163.9

Notes to the Financial Statements (continued)

27. Provisions

	Customer redress £m	Onerous contracts £m	Restructuring £m	Total £m
At 1 January 2012	**173.7**	**12.2**	**29.1**	**215.0**
Utilised in the year	**(194.7)**	**(3.0)**	**(13.4)**	**(211.1)**
Charged in the year	**419.0**	**–**	**34.7**	**453.7**
Released in the year	**–**	**(0.8)**	**–**	**(0.8)**
Allocation against customer balances	**(229.2)**	**–**	**–**	**(229.2)**
At 31 December 2012	**168.8**	**8.4**	**50.4**	**227.6**

The PPI provision was increased by £129.8m during the year, with £96.7m remaining at the year end. In addition, a separate provision of £271.4m was created in 2012 in relation to Consumer Credit Act non-compliance (including £66m that has been recognised as income during 2012), of which £229.2m reduced loans to customer balances at 31 December 2012. Additional provisions of £17.8m were created during 2012 for other forms of customer redress. Total customer compensation payments made during 2012 were £194.7m (2011: £50.4m). The provision is calculated on the basis of a reasonable estimate of the size and expected timing of claims. It is expected that the current high level of claims will continue during 2013 and decline thereafter. Based on current evidence, the Company believes the provision for customer redress to be adequate.

The onerous contracts provision relates to empty leasehold premises which, as at the Balance Sheet date, were no longer used by the business, but were subject to a lease agreement. The rental payments are due to be made during the period to 2025.

During the year restructuring costs of £32.6m have been provided in relation to the change in primary IT service provider and £2.1m for costs associated with the phased exit from the Gosforth site. Payments are expected to be made during 2013.

	Customer redress £m	Onerous contracts £m	Restructuring £m	Total £m
At 1 January 2011	223.7	17.5	8.5	249.7
Utilised in the year	(50.4)	(7.3)	(4.0)	(61.7)
Charged in the year	0.4	2.0	26.1	28.5
Released in the year	–	–	(1.5)	(1.5)
At 31 December 2011	173.7	12.2	29.1	215.0

Notes to the Financial Statements (continued)

28. Capital instruments

	Initial interest rate	First due or callable	Final maturity	Issuer	At 31 December 2012 Carrying amount £m	At 31 December 2012 Principal £m	At 31 December 2011 Carrying amount £m	At 31 December 2011 Principal £m
Dated subordinated notes	7.625%	2010	2049	B&B	**16.1**	**12.2**	15.2	12.4
Dated fixed rate step-up subordinated notes	5.50%	2018	2018	B&B	**5.4**	**4.4**	5.2	4.4
Callable perpetual subordinated notes	5.625%	2013	Undated	B&B	**21.5**	**18.1**	20.8	18.1
Callable perpetual subordinated notes	6.00%	2019	Undated	B&B	**23.1**	**20.0**	21.9	20.0
Undated perpetual subordinated bonds	13.00%	Perpetual	Undated	B&B	**42.6**	**41.5**	35.8	41.5
Undated perpetual subordinated bonds	11.625%	Perpetual	Undated	B&B	**37.5**	**35.7**	32.2	35.7
Subordinated loan	11.734%	See below	2016	NRAM	**19.6**	**16.0**	25.0	20.0
HM Treasury PIK interest	See below	See below	2013	NRAM	**150.9**	**150.7**	150.8	150.7
Tier one notes	7.053%	2027	Undated	NRAM	**42.5**	**30.5**	43.5	30.7
Total					**359.2**	**329.1**	350.4	333.5

The capital instruments are all denominated in sterling.

The carrying values of these instruments are on an EIR basis which takes into account issue costs. Carrying values include hedge accounting adjustments.

The 11.734% subordinated loan 2016 is repayable in five equal annual instalments from 2012 to 2016.

The HM Treasury PIK interest represents the amount of margin payable to HM Treasury which was subordinated under the terms of the facility (see note 24). Repayment of this amount is due on 1 April 2013. Interest is payable on this loan at a floating rate above the Bank Base Rate.

The tier one notes carry a coupon of 7.053% payable annually in arrears on 21 September.

Since mid-June 2009, the B&B Board have deferred payment of all principal and coupons in respect of B&B's capital instruments. Each decision was taken on a case-by-case basis until 23 February 2010. Following the Board meeting of 23 February 2010, the B&B Group announced that it had resolved not to make any payment of principal or interest in respect of the B&B Group's capital instruments as listed in the table above during the period prior to the date on which it repays in full the Statutory Debt described in note 24. This Board decision followed the notification to the B&B Group on 25 January 2010 of the EC's approval of State Aid. The EC's decision set various conditions on the B&B Group receiving State Aid, one of which was that the B&B Group should not make payments of principal or interest on its capital instruments during the period prior to the date on which it repays in full the Statutory Debt.

As a consequence of the announcement of 23 February 2010, the carrying value of B&B's capital instruments was reduced by £104.3m, with an equal gain being recognised in the Income Statement, to reflect the revised present value of the new expected cash flows of these instruments. Following this reduction, for accounting purposes, interest, including unwind of the reduction in carrying value, accrues on the reduced liabilities on an EIR basis at the original EIR of the liability, such that the carrying value will ultimately accrete up to principal plus interest due. For capital instruments where interest is compound, the interest accrual also takes into account interest on the deferred coupons, on an EIR basis.

As detailed in note 8, in 2012 and 2011 the Group bought back certain of its capital instruments.

Redemptions of any capital instruments prior to their final maturity date are subject to obtaining prior consent of the FSA.

The rights of repayment of holders of capital instruments are subordinated to the claims of other creditors.

Further details of capital instruments are provided in the Annual Reports and Accounts of B&B and NRAM, copies of which are available on the corporate website of each of these companies.

Notes to the Financial Statements (continued)

29. Called up share capital

Group and Company	25p Ordinary shares Number	25p Preference shares Number	25p Ordinary shares £	25p Preference shares £	Total share capital £
At 1 January and 31 December 2012 and 2011	**4,955,595**	**4,000**	**1,238,899**	**1,000**	**1,239,899**

In accordance with the Companies Act 2006, the Company does not have authorised capital other than its issued capital.

The Ordinary shares rank equally in respect of rights attached to voting, dividends and in the event of a winding up.

Dividends on Preference shares are discretionary and, subject to Board approval, are payable annually on 4 July at a rate of 6.8509% based on a principal amount of £1,000 per share.

No dividends were declared or paid in 2012 or 2011 on the Company's Ordinary or Preference shares.

30. Reserves

Reserves comprise the following:

	2012 £m	2011 £m
Available-for-sale reserve	**(53.4)**	(106.9)
Cash flow hedge reserve	**250.1**	210.4
Merger reserve	**1,122.6**	1,122.6
Total	**1,319.3**	1,226.1

Available-for-sale reserve

	2012 £m	2011 £m
At 1 January	**(106.9)**	(211.7)
Amounts recognised in equity	**55.2**	107.6
Amounts transferred to net income	**(1.7)**	(2.8)
At 31 December	**(53.4)**	(106.9)

The available-for-sale reserve represents cumulative fair value movements on assets classified as available-for-sale.

Notes to the Financial Statements (continued)

30. Reserves (continued)

Cash flow hedge reserve

	2012 £m	2011 £m
At 1 January	**210.4**	(93.0)
Amounts recognised in equity	**(589.8)**	61.2
Amounts transferred to net income	**629.5**	242.2
At 31 December	**250.1**	210.4

The cash flow hedge reserve represents cumulative fair value movements on financial instruments which are effective cash flow hedges.

Merger reserve

	2012 £m	2011 £m
At 1 January and 31 December	**1,122.6**	1,122.6
Generated on acquisition of B&B	**589.3**	589.3
Generated on acquisition of NRAM	**533.3**	533.3
Total	**1,122.6**	1,122.6

The merger reserve was generated on 1 October 2010 when the Company acquired all the issued shares of B&B and NRAM from the Treasury Solicitor via a share-for-share exchange. The merger reserve represents the difference between the value attributed to the Company's investment in each company and the capital and non-distributable reserves of the acquired groups.

31. Non-shareholders' funds

In accordance with the requirements of IAS 32, the following instruments are classified as equity:

	2012 £m	2011 £m
Reserve capital instruments	**101.4**	102.3
Subordinated notes	**23.4**	23.4
Total non-shareholders' funds	**124.8**	125.7

(a) Reserve capital instruments

Reserve capital instruments were issued by NRAM for a value of £200.0m in September 2000 and for £100.0m in May 2001 and are undated. They carry a coupon of 8.399% payable annually in arrears on 21 September. At each payment date NRAM will decide whether to declare or defer the coupon. If NRAM decides to declare the coupon, the holder will receive a cash payment equivalent to the coupon which will be achieved either by the payment of cash directly, or while NRAM is in public ownership, as per the terms of Article 5 of The Northern Rock Transfer Order 2008 (the 'Transfer Order') which was made on 21 February 2008 pursuant to the Banking (Special Provisions) Act 2008. If NRAM elects to defer the coupon, it may not declare or pay a dividend on any share until the deferred coupons are satisfied. While NRAM is in public ownership, deferred coupons and any interest accruing thereon can only be satisfied in accordance with the terms of Article 5 of the Transfer Order.

NRAM has a call option after 15 years, which it can only exercise with the consent of the FSA. If the issue is not called, the coupon resets to yield 4.725% above the prevailing 5-year benchmark Gilt rate.

As detailed in note 8, in 2012 and 2011 the Group bought back certain of its reserve capital instruments.

The reserve capital instruments are all denominated in sterling.

Notes to the Financial Statements (continued)

31. Non-shareholders' funds (continued)

(b) Subordinated notes

	Interest rate	Terms	Denomination	2012 £m	2011 £m
Perpetual subordinated notes	12.625%	Not redeemable	Sterling	13.5	13.5
Perpetual fixed to floating rate subordinated notes	6.594%	Not redeemable before 28/06/17	US$	1.2	1.2
Undated subordinated notes	5.60%	Not redeemable before 30/04/14	US$	8.7	8.7
Total				23.4	23.4

Redemptions of any subordinated notes are at the issuer's option only and are subject to obtaining prior consent of the FSA.

The rights of repayment of holders of subordinated notes are subordinated to the claims of other creditors.

As detailed in note 8, in 2011 the Group bought back certain of its subordinated notes.

(c) Appropriations

Coupons on non-shareholders' funds are treated as appropriations.

One of the conditions resulting from NRAM's State Aid approval in October 2009 requires NRAM to withhold coupon payments on all subordinated instruments where possible. Consequently no appropriations have been made in respect of NRAM's reserve capital instruments or subordinated notes during 2012 (2011: £nil).

32. Off-Balance Sheet commitments

(a) Commitments payable

At 31 December 2012	Within one year £m	In one to five years £m	Over five years £m	Total £m
Loan commitments:				
– Lifetime mortgages	**59.0**	**249.1**	**1,023.7**	**1,331.8**
– Other loans	**1,967.3**	**–**	**–**	**1,967.3**
Total loan commitments	**2,026.3**	**249.1**	**1,023.7**	**3,299.1**
Operating lease commitments:				
– Land and buildings	**0.2**	**0.6**	**0.1**	**0.9**
Capital commitments	**2.8**	**–**	**–**	**2.8**
Total	**2,029.3**	**249.7**	**1,023.8**	**3,302.8**

Notes to the Financial Statements (continued)

32. Off-Balance Sheet commitments (continued)

At 31 December 2011	Within one year £m	In one to five years £m	Over five years £m	Total £m
Loan commitments:				
– Lifetime mortgages	57.9	246.3	1,102.2	1,406.4
– Other loans	2,160.0	–	–	2,160.0
Total loan commitments	2,217.9	246.3	1,102.2	3,566.4
Operating lease commitments:				
– Land and buildings	2.0	1.8	0.1	3.9
Capital commitments	7.9	–	–	7.9
Total	2,227.8	248.1	1,102.3	3,578.2

Loan commitments represent contractual amounts to which the Group is committed for extension of credit to customers. In respect of lifetime mortgages which involved the advance of a lump sum on which interest continues to accrue but is not payable until the loan is redeemed, the commitment reflects an estimate of the interest expected to roll up until redemption. In respect of monthly drawdown products, the commitment reflects an estimate of the future drawdowns to redemption. On other loans, the commitment comprises cash which could be drawn down by customers in respect of further advances and re-drawal of amounts voluntarily overpaid.

Operating lease commitments represent minimum future lease payments under non-cancellable operating leases.

Capital commitments represent contractual amounts to which the Group is committed in respect of IT infrastructure investment.

(b) Commitments receivable

At 31 December 2012	Within one year £m	In one to five years £m	Over five years £m	Total £m
Operating lease commitments:				
– Land and buildings	**–**	**0.1**	**–**	**0.1**
Total	**–**	**0.1**	**–**	**0.1**

At 31 December 2011	Within one year £m	In one to five years £m	Over five years £m	Total £m
Operating lease commitments:				
– Land and buildings	**7.0**	**7.6**	**–**	**14.6**
Total	**7.0**	**7.6**	**–**	**14.6**

Operating lease commitments represent minimum future lease payments receivable under non-cancellable operating leases.

Notes to the Financial Statements (continued)

33. Related party disclosures

(a) Key management personnel

The Group considers the Boards of Directors and the members of the Executive Committees of UKAR, B&B and NRAM to be the key management personnel. All remaining loans to key personnel, which had all been advanced in the normal course of business, were redeemed during 2011. The volumes of related party transactions, outstanding balances at the year end and related income for the year are set out below.

Loans:	2012 £000	2011 £000
Loans outstanding at 1 January	–	17
Net movement over the year	–	(17)
Loans outstanding at 31 December	–	–
Interest charged to key management personnel	–	1

Interest was charged at a market rate on all loans to key management personnel.

A summary of the Group's remuneration of the 16 (2011: 15) key management personnel is set out in the table below. These amounts include the remuneration of the Directors which is set out in more detail in the Directors' Remuneration Report on pages 25 to 31. The Directors' Remuneration Report gives details of the UKAR Group's Directors' salaries, fees, bonuses, pension benefits, other incentives and other benefits.

Remuneration of key management personnel	2012 £000	2011 £000
Short-term employee benefits	3,240	2,996
Post-employment benefits	293	269
Termination benefits	103	–
Total	3,636	3,265

Further details of the accounting treatment of pensions and of the Group's and Company's transactions and balances with the Group's pension schemes are given in note 19. There were no amounts due to or from the schemes at 31 December 2012 (2011: £nil). The key management personnel contributed £59,000 (2011: £40,000) to Group pension schemes during the year.

Included in the Group's Income Statement, the aggregate Directors' emoluments and the emoluments of the highest paid Director amounted to £1,680,357 and £642,820 respectively (2011: £1,444,757 and £596,697 respectively).

(b) Her Majesty's Government

As described in note I to the Parent Company Financial Statements, the Company considers Her Majesty's Government to be its ultimate controlling party. The Group's material balances with departments and bodies of Her Majesty's Government comprise deposits with the Bank of England (see note 11), loans from HM Treasury (see note 24), the Statutory Debt (see note 24) and UK Government securities held. HM Treasury has also provided guarantee arrangements to the Group, for which the Group pays fees (see note 3). In addition to these loans and guarantees, the Group has balances and transactions with numerous Government bodies on an arm's length basis in relation to the payment of corporation tax, VAT and employee taxes, and the payment of regulatory fees and levies.

(c) UKAR Company

The UKAR Company's balances and transactions with related parties are detailed in note G to the Parent Company Financial Statements.

Notes to the Financial Statements (continued)

34. Capital structure

The UK financial regulator the FSA regulates three of the Company's Principal Subsidiaries, B&B, NRAM and Mortgage Express, under the MIPRU regime, which applies to mortgage administration companies. Each of these companies manages its capital resources in order to meet the FSA's regulatory requirements. Capital adequacy is monitored on an ongoing basis by the Group's executive management and Board, based on the regulations established by the FSA. Each of these three companies met its capital requirements in full throughout 2012 and 2011, and has received no additional capital from HM Treasury since the nationalisation of B&B and NRAM; further information is available in the Annual Reports and Accounts of each company, which do not form part of these Financial Statements. The Board considers core equity, formerly tier 1 capital, to be of pre-eminent importance in the capital structure of the regulated companies, and continues to monitor this closely, in addition to the total level of capital. The Directors believe that each regulated Group company has an appropriate and adequate level of capital to support its activities, subject to the continuing support of HM Treasury. Strictly the regulated companies within the Group are required to hold capital in excess of 1% of total Balance Sheet assets plus any undrawn commitments. However, the Board believes they should hold capital above 1% and at the year end capital in B&B represented 4.6% of B&B Company assets, and NRAM capital represented 5.7% of NRAM Company assets.

The primary objectives of the Group's capital management are to maintain capital resources to support the objectives of the business, to cover risks inherent in its activities and to ensure compliance with externally imposed capital requirements. The capital structure is managed in response to changes in the nature of the Group's activities and economic conditions.

The Group defines equity and certain other capital instruments as capital. Capital excludes accounting reserves for available-for-sale assets and cash flow hedges. The Group's capital adequacy and capital resources are managed and monitored in accordance with the regulatory capital rules of the FSA. The Group must at all times monitor and demonstrate compliance with the relevant regulatory capital requirements of the FSA. The required capital information is filed with the FSA on a quarterly basis.

35. Financial instruments

(a) Categories of financial assets and financial liabilities: carrying value compared to fair value

The following table summarises the carrying amounts and fair values of financial assets and liabilities. Assets are presented at bid prices, whereas offer prices are used for liabilities. The accounting policy note 1(g) sets out the key principles used for estimating the fair values of financial instruments. This note provides some additional information in respect of the methodologies used.

At 31 December 2012	Available-for-sale	Assets at fair value through profit or loss	Loans and receivables	Hedging adjustments	Total carrying value	Fair value
	£m	£m	£m	£m	£m	£m
Financial assets:						
Balances with the Bank of England	–	–	5,599.8	–	5,599.8	5,599.8
Cash at bank and in hand	–	–	4,129.2	–	4,129.2	4,129.2
Investment securities	623.2	–	1,414.4	12.3	2,049.9	2,007.3
Loans to customers	–	–	68,729.7	3.9	68,733.6	68,796.7
Fair value adjustments on portfolio hedging	–	–	–	493.8	493.8	–
Derivative financial instruments	–	5,720.2	–	–	5,720.2	5,720.2
Other financial assets	–	–	33.4	–	33.4	33.4
Total financial assets	623.2	5,720.2	79,906.5	510.0	86,759.9	86,286.6

Notes to the Financial Statements (continued)

35. Financial instruments (continued)

At 31 December 2012	Liabilities at fair value through profit or loss	Liabilities at amortised cost	Hedging adjustments	Total carrying value	Fair value
	£m	£m	£m	£m	£m
Financial liabilities:					
Amounts due to banks	–	**4,794.9**	–	**4,794.9**	**4,794.9**
Statutory Debt and HM Treasury loans	–	**43,487.3**	–	**43,487.3**	**43,487.3**
Derivative financial instruments	**783.7**	–	–	**783.7**	**783.7**
Debt securities in issue	–	**30,729.0**	**891.1**	**31,620.1**	**30,011.3**
Capital instruments	–	**342.8**	**16.4**	**359.2**	**263.0**
Other financial liabilities	–	**125.4**	–	**125.4**	**125.4**
Total financial liabilities	**783.7**	**79,479.4**	**907.5**	**81,170.6**	**79,465.6**

At 31 December 2011	Available-for-sale	Assets at fair value through profit or loss	Loans and receivables	Hedging adjustments	Total carrying value	Fair value
	£m	£m	£m	£m	£m	£m
Financial assets:						
Balances with the Bank of England	–	–	6,170.7	–	6,170.7	6,170.7
Cash at bank and in hand	–	–	2,746.5	–	2,746.5	2,746.5
Investment securities	953.4	–	1,877.7	17.0	2,848.1	2,585.8
Loans to customers	–	–	75,288.7	5.7	75,294.4	75,399.2
Fair value adjustments on portfolio hedging	–	–	–	597.5	597.5	–
Derivative financial instruments	–	7,369.1	–	–	7,369.1	7,369.1
Other financial assets	–	–	27.3	–	27.3	27.3
Total financial assets	953.4	7,369.1	86,110.9	620.2	95,053.6	94,298.6

At 31 December 2011	Liabilities at fair value through profit or loss	Liabilities at amortised cost	Hedging adjustments	Total carrying value	Fair value
	£m	£m	£m	£m	£m
Financial liabilities:					
Amounts due to banks	–	4,075.9	–	4,075.9	4,075.9
Statutory Debt and HM Treasury loans	–	46,582.2	–	46,582.2	46,582.2
Derivative financial instruments	965.4	–	–	965.4	965.4
Debt securities in issue	–	36,885.0	1,176.5	38,061.5	33,718.6
Capital instruments	–	331.2	19.2	350.4	209.8
Other financial liabilities	–	113.7	–	113.7	113.7
Total financial liabilities	965.4	87,988.0	1,195.7	90,149.1	85,665.6

Notes to the Financial Statements (continued)

35. Financial instruments (continued)

No financial assets or liabilities were reclassified during 2012 or 2011 between amortised cost and fair value categories.

At 31 December 2012 assets carried by NRAM at amortised cost which were previously carried at fair value were carried at £1,243.9m (2011: £1,586.9m). The difference between the carrying value at the date of reclassification and the expected value at the redemption date is recognised in profit and loss on an effective interest rate basis over the expected lives of the assets; their carrying amounts will accrete up to their redemption amounts over their expected lives. The amount recognised in profit and loss during the year was a gain of £67.8m (2011: £102.3m), which was exactly offset by losses transferred from the available-for-sale reserve during the year. If the assets had not been reclassified, it is estimated that fair value gains of £195.4m would have been reflected in the available-for-sale reserve during 2012 in respect of these assets (2011: losses of £51.1m). The expected redemption value of the remaining assets is £1,442.9m (2011: £1,884.0m). The fair value of these assets at 31 December 2012 was £1,182.1m (2011: £1,380.5m).

Valuation methods for calculations of fair values in the table above for those financial assets and liabilities not presented on the Balance Sheet at their fair value are set out below:

Balances with the Bank of England

Fair value approximates to carrying value because they have minimal credit losses and are either short term in nature or reprice frequently.

Cash at bank and in hand

Fair value was estimated by using discounted cash flows applying either market rates where practicable or rates offered by other financial institutions for accounts with similar characteristics. The fair value of floating rate placements, fixed rate placements with less than six months to maturity and overnight deposits is their carrying amount.

Investment securities

The fair value of investment securities held as loans and receivables are based on quoted prices where available or by using discounted cash flows applying market rates. The fair value of unsecured investment loans is based on prices supplied by third parties.

The fair value of unsecured investment loans is based on prices supplied by third parties.

Loans to customers

The Group provides loans of varying rates and maturities to customers. The fair value of loans with variable interest rates is considered to approximate to carrying value as the rate charged on these loans varies in line with changes in market rates. For loans with fixed interest rates, fair value was estimated by discounting cash flows using market rates or rates normally offered by the Group. The change in interest rates since the majority of these loans were originated means that their fair value can vary significantly from their carrying value. However, as the Group's policy is to hedge fixed rate loans in respect of interest rate risk, this does not indicate that the Group has an exposure to this difference in value.

Amounts due to banks

Fair values of deposit liabilities repayable on demand or with variable interest rates are considered to approximate to carrying value. The fair value of fixed interest deposits with less than six months to maturity is their carrying amount. The fair value of all other deposit liabilities was estimated using discounted cash flows, applying market rates.

Statutory Debt and HM Treasury loans

The fair value is assumed to be the carrying amount as the interest rate charged varies in line with changes in market rates, or the loans are considered to be repayable on demand subject to timing of repayment of loans to customers.

Debt securities in issue and capital instruments

Fair values are based on quoted prices where available, or by using discounted cash flows, applying market rates.

(b) Interest income and expense on financial instruments that are not at fair value through profit or loss

	2012 £m	2011 £m
Interest income	**2,876.2**	3,366.3
Interest expense	**(1,458.7)**	(1,530.6)
Net interest income	**1,417.5**	1,835.7

These amounts represent interest income and expense before hedging arrangements.

Notes to the Financial Statements (continued)

35. Financial instruments (continued)

(c) Impaired financial assets

Allowance accounts for credit losses in respect of impairment of loans to customers are detailed in note 15 and in respect of investment securities in note 13. No impairment loss has been recognised in respect of any other class of financial asset, and no other class of financial asset includes assets that are past due.

(d) Hedge accounting

Strategy in using derivative financial instruments

The Board has authorised the use of derivative instruments for the purpose of supporting the strategic and operational business activities of the Group and reducing the risk of loss arising from changes in interest rates and exchange rates. All use of derivative instruments within the Group is to hedge risk exposure, and the Group takes no trading positions in derivatives.

The objective when using any derivative instrument is to ensure that the risk-to-reward profile of any transaction is optimised. The intention is only to use derivatives to create economically effective hedges. However IAS 39 requires certain tests to be satisfied before hedge accounting is permitted. Consequently not all economic hedges are designated as accounting hedges, either because natural accounting offsets are expected or because obtaining hedge accounting would be especially onerous.

(i) Fair value hedges

The Group designates a number of derivatives as fair value hedges. In particular, the Group has three approaches establishing relationships for:

- Hedging the interest rate and foreign currency exchange rate risk of non-prepayable, foreign currency denominated fixed rate assets or liabilities on a one-for-one basis with fixed/floating or floating/fixed cross currency interest rate swaps.
- Hedging the interest rate risk of a single currency portfolio of sterling, US Dollar or Euro non-prepayable fixed rate assets/liabilities on a one-for-one basis with vanilla fixed/floating or floating/fixed interest rate swaps.
- Hedging the interest rate risk of a portfolio of prepayable fixed rate assets with interest rate derivatives. This solution is used to establish a macro fair value hedge for derivatives hedging fixed rate mortgages. The Group believes this solution is consistent with its policy for hedging fixed rate mortgages on an economic basis.

(ii) Cash flow hedges

The Group designates a number of derivatives as cash flow hedges. In particular, the Group adopts the following approaches:

- Using fixed interest rate swaps to hedge floating rate sterling liabilities.
- To address the volatility generated by floating/floating cross currency swaps, they are placed into cash flow hedges; the accounting hedge relationship is to hedge the foreign currency exchange rate risk of the foreign currency denominated asset/liability.
- Fixed/floating cross currency swaps are split into their separate risk components and separately designated into cash flow hedges.
- Basis swaps are split into their separate risk components and separately designated into cash flow hedges.

(iii) Net investment hedges

The Group has not designated any derivatives as net investment hedges in 2012 or 2011.

The Group had the following types of hedges:

At 31 December 2012	Fair value hedges	Cash flow hedges	Economic hedges	Total	Nominal amounts
	£m	£m	£m	£m	£m
Exchange rate contracts	6.5	5,674.9	18.5	5,699.9	22,646.7
Interest rate contracts	11.8	1.6	6.9	20.3	4,016.1
Total asset balances	**18.3**	**5,676.5**	**25.4**	**5,720.2**	**26,662.8**
Exchange rate contracts	–	3.9	7.1	11.0	723.1
Interest rate contracts	531.0	180.1	61.6	772.7	26,429.8
Total liability balances	**531.0**	**184.0**	**68.7**	**783.7**	**27,152.9**
Fair value of hedging instruments	**(512.7)**	**5,492.5**	**(43.3)**	**4,936.5**	**(490.1)**

Notes to the Financial Statements (continued)

35. Financial instruments (continued)

At 31 December 2011	Fair value hedges £m	Cash flow hedges £m	Economic hedges £m	Total £m	Nominal amounts £m
Exchange rate contracts	8.6	7,075.5	138.3	7,222.4	24,562.2
Interest rate contracts	20.3	3.8	122.6	146.7	30,303.2
Total asset balances	28.9	7,079.3	260.9	7,369.1	54,865.4
Exchange rate contracts	–	–	7.9	7.9	960.9
Interest rate contracts	675.6	163.6	118.3	957.5	13,935.7
Total liability balances	675.6	163.6	126.2	965.4	14,896.6
Fair value of hedging instruments	(646.7)	6,915.7	134.7	6,403.7	39,968.8

(e) Fair value measurement

Financial assets and liabilities carried at fair value are valued on the following bases:

At 31 December 2012	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets:				
Investment securities – available-for-sale	**224.7**	**410.8**	**–**	**635.5**
Derivative financial instruments	**–**	**3,434.7**	**2,285.5**	**5,720.2**
Financial liabilities:				
Derivative financial instruments	**–**	**768.1**	**15.6**	**783.7**
Net financial assets	**224.7**	**3,077.4**	**2,269.9**	**5,572.0**

At 31 December 2011	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets:				
Investment securities – available-for-sale	399.7	570.7	–	970.4
Derivative financial instruments	–	3,962.5	3,406.6	7,369.1
Financial liabilities:				
Derivative financial instruments	–	883.1	82.3	965.4
Net financial assets	399.7	3,650.1	3,324.3	7,374.1

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, whether directly (ie as price) or indirectly (ie derived from the implications of prices).

Level 3: Inputs for the asset or liability that are not based on observable market data, or have significant unobservable inputs.

Notes to the Financial Statements (continued)

35. Financial instruments (continued)

The movement in assets and liabilities measured using a valuation technique for which any significant input is not based on observable market data (Level 3) is as follows:

	Financial assets £m	Financial liabilities £m	Total £m
At 1 January 2012	**3,406.6**	**(82.3)**	**3,324.3**
Total (losses)/gains in the Income Statement	**(957.0)**	**60.9**	**(896.1)**
Total losses in the cash flow hedge reserve	**(158.3)**	**–**	**(158.3)**
Transfers from assets to liabilities	**(5.8)**	**5.8**	**–**
At 31 December 2012	2,285.5	(15.6)	2,269.9

	Financial assets £m	Financial liabilities £m	Total £m
At 1 January 2011	4,491.6	(68.5)	4,423.1
Total losses in the Income Statement	(832.5)	(13.8)	(846.3)
Total losses in the cash flow hedge reserve	(252.5)	–	(252.5)
At 31 December 2011	3,406.6	(82.3)	3,324.3

All Level 3 financial assets and liabilities are derivative financial instruments.

Total losses in the Income Statement of £896.1m (2011: £1,098.8m) are a result of fair value losses of £1,218.4m (2011: £1,693.7m) less settlement gains of £322.3m (2011: £594.9m). These amounts are included within 'unrealised fair value movements on financial instruments', and all relate to assets and liabilities which were still held at the Balance Sheet date.

The main unobservable input that affects the valuation of the Group's derivative financial instruments is the forecast level of customer prepayments in respect of mortgage loans assigned to securitisation structures. An increase in forecast prepayments will cause interest rate and cross currency swaps associated with the notes in issue to pay down in an accelerated manner, so affecting their fair values. The following table shows the impact on reported fair values of a hypothetical 10% increase in customer prepayments.

2012	Reported fair value £m	Revised fair value £m	Favourable changes to Income Statement £m	Unfavourable changes to Income Statement £m
Financial assets:				
Derivative financial instruments	**2,285.5**	**2,281.7**	**–**	**(3.8)**
Financial liabilities:				
Derivative financial instruments	**(15.6)**	**(15.2)**	**0.4**	**–**

2011	Reported fair value £m	Revised fair value £m	Favourable changes to Income Statement £m	Unfavourable changes to Income Statement £m
Financial assets:				
Derivative financial instruments	3,406.6	3,404.3	–	(1.7)
Financial liabilities:				
Derivative financial instruments	(82.3)	(82.3)	–	–

Notes to the Financial Statements (continued)

35. Financial instruments (continued)

(f) Transferred financial assets

As set out in note 25, the Group has transferred financial assets (loans and receivables) to securitisation structures. The Group retains all of the risks and rewards associated with these loans and they are therefore retained on the Group's Balance Sheet.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For securitisation structures, the associated liabilities represent the external notes in issue (see note 25). None of these notes have recourse to the transferred assets.

At 31 December 2012	Transferred Assets Carrying amount £m	Associated Liabilities Carrying amount £m
Loans to customers securitised	**45,662.5**	**30,708.1**

36. Collateral pledged and received

	2012 £m	2011 £m
Cash collateral which the Group has provided in respect of derivative contracts	**667.8**	751.4
Total collateral pledged	**667.8**	751.4

	2012 £m	2011 £m
Cash collateral which the Group has received in respect of derivative contracts	**4,754.0**	4,031.9
Securities collateral held	**4.7**	66.7
Total collateral received	**4,758.7**	4,098.6

In addition to the collateral amounts shown above, certain loans to customers provide security in respect of securitised note and Covered Bond funding as detailed in note 25. These loans, and also cash collateral pledged shown above, are carried on the Balance Sheet. The liability to repay the cash collateral received is included within amounts due to banks in the Balance Sheet. In the absence of counterparty default, the Group has no right to sell or re-pledge the securities collateral received, and therefore in accordance with the provisions of IAS 39 such securities are not recognised on the Balance Sheet.

37. Financial risk management

A description of the principal risks to which the Group is exposed is provided on pages 40 to 43 which form an integral part of the audited Financial Statements.

(a) Financial and market risk

The following table describes the significant activities undertaken by the Group which give rise to financial or market risk, the potential consequences associated with such activities and the derivative instruments used by the Group to mitigate the risks arising.

Activity	Risk	Type of derivative instrument used
Funding activities in sterling involving either fixed rate instruments or instruments with embedded options	Sensitivity to changes in interest rates	Interest rate swaps
Fixed and capped rate mortgage lending and investment activities involving either fixed rate instruments or instruments with embedded options	Sensitivity to changes in interest rates	Interest rate swaps and options
Variable rate mortgage products	Sensitivity to changes in interest rates	Interest rate swaps
Investment and funding in foreign currencies	Sensitivity to changes in foreign currency exchange rates	Cross-currency interest rate swaps and foreign exchange contracts

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

The accounting policy for derivatives and hedge accounting is described in note 1(i), and further details of hedge accounting are provided in note 35(d).

(b) Credit risk

The Board has approved a framework for maximum credit counterparty limits against which total exposures are continually monitored and controlled. The credit limit structure adopts a risk based matrix whereby lower rated counterparties are afforded lower overall levels of limit. Although publicly available ratings produced by rating agencies provide a useful guide to the creditworthiness of counterparties, an internal evaluation is also used in the limit assignment process. Counterparties are assigned maximum limits in accordance with the ratings matrix, based on the lowest rating afforded to any part of the counterparty group.

Maximum credit risk exposure at 31 December before taking account of any collateral and other credit enhancements:

	2012 £m	2011 £m
On Balance Sheet:		
Balances with the Bank of England	**5,599.8**	6,170.7
Cash at bank and in hand	**4,129.2**	2,746.5
Investment securities	**2,049.9**	2,848.1
Loans to customers	**68,733.6**	75,294.4
Derivative financial instruments	**5,720.2**	7,369.1
Other financial assets	**33.4**	27.3
Total on Balance Sheet	**86,266.1**	94,456.1
Off Balance Sheet:		
Loan commitments (see note 32)	**3,299.1**	3,566.4

Cash at bank and in hand includes reverse repurchase agreements in support of which the Group holds gilts as security (see note 36). Loans to customers include loans which are secured on property. Additional information in respect of credit risk is provided in note 13 (for wholesale assets) and note 16 (for loans to customers).

(c) Liquidity risk

The Group closely monitors its liquidity position against the Board's liquidity policy. Minimum and target liquidity levels are established through stress testing and cash flow forecasting, taking into consideration an assessment of any emerging and potentially extreme funding conditions.

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

The table below analyses the Group's financial assets and liabilities into relevant maturity groupings:

At 31 December 2012	On demand £m	Within three months £m	After three months but within six months £m	After six months but within one year £m	After one year but within five years £m	After five years £m	Total £m
Financial assets:							
Balances with the Bank of England	**5,599.8**	**–**	**–**	**–**	**–**	**–**	**5,599.8**
Cash at bank and in hand	**2,685.7**	**1,443.5**	**–**	**–**	**–**	**–**	**4,129.2**
Investment securities	**–**	**91.5**	**82.0**	**45.6**	**627.4**	**1,203.4**	**2,049.9**
Loans to customers	**424.9**	**123.1**	**130.5**	**394.7**	**4,061.5**	**63,598.9**	**68,733.6**
Fair value adjustments on portfolio hedging	**–**	**10.5**	**20.0**	**26.1**	**146.9**	**290.3**	**493.8**
Derivative financial instruments	**–**	**400.6**	**147.4**	**210.5**	**3,242.3**	**1,719.4**	**5,720.2**
Other financial assets	**–**	**33.4**	**–**	**–**	**–**	**–**	**33.4**
Total financial assets	**8,710.4**	**2,102.6**	**379.9**	**676.9**	**8,078.1**	**66,812.0**	**86,759.9**
Financial liabilities:							
Amounts due to banks	**4,754.2**	**–**	**40.7**	**–**	**–**	**–**	**4,794.9**
Statutory Debt and HM Treasury loans	**43,487.3**	**–**	**–**	**–**	**–**	**–**	**43,487.3**
Derivative financial instruments	**–**	**13.4**	**7.0**	**22.9**	**257.2**	**483.2**	**783.7**
Debt securities in issue	**–**	**2,617.5**	**901.5**	**1,544.3**	**17,654.9**	**8,901.9**	**31,620.1**
Capital instruments	**–**	**0.2**	**150.7**	**5.5**	**14.7**	**188.1**	**359.2**
Other financial liabilities	**–**	**125.4**	**–**	**–**	**–**	**–**	**125.4**
Total financial liabilities	**48,241.5**	**2,756.5**	**1,099.9**	**1,572.7**	**17,926.8**	**9,573.2**	**81,170.6**
Net liquidity gap	**(39,531.1)**	**(653.9)**	**(720.0)**	**(895.8)**	**(9,848.7)**	**57,238.8**	**(5,589.3)**

At 31 December 2011	On demand £m	Within three months £m	After three months but within six months £m	After six months but within one year £m	After one year but within five years £m	After five years £m	Total £m
Financial assets:							
Balances with the Bank of England	6,170.7	–	–	–	–	–	6,170.7
Cash at bank and in hand	1,895.2	846.3	5.0	–	–	–	2,746.5
Investment securities	–	74.4	40.7	251.4	662.4	1,819.2	2,848.1
Loans to customers	384.9	408.6	356.2	778.3	6,983.8	66,382.6	75,294.4
Fair value adjustments on portfolio hedging	–	39.2	47.6	93.8	136.5	280.4	597.5
Derivative financial instruments	–	218.1	184.8	204.0	3,224.9	3,537.3	7,369.1
Other financial assets	9.9	7.2	–	–	10.2	–	27.3
Total financial assets	8,460.7	1,593.8	634.3	1,327.5	11,017.8	72,019.5	95,053.6
Financial liabilities:							
Amounts due to banks	4,034.0	–	0.1	–	41.8	–	4,075.9
Statutory Debt and HM Treasury loans	46,582.2	–	–	–	–	–	46,582.2
Derivative financial instruments	–	42.7	26.0	63.0	215.2	618.5	965.4
Debt securities in issue	–	2,241.7	1,381.4	1,550.0	17,984.7	14,903.7	38,061.5
Capital instruments	–	0.1	–	5.6	170.7	174.0	350.4
Other financial liabilities	–	113.1	–	–	0.6	–	113.7
Total financial liabilities	50,616.2	2,397.6	1,407.5	1,618.6	18,413.0	15,696.2	90,149.1
Net liquidity gap	(42,155.5)	(803.8)	(773.2)	(291.1)	(7,395.2)	56,323.3	4,904.5

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

HM Treasury has indicated that it expects the loans and the WCF provided to the Group by HM Treasury and the Statutory Debt due to the Financial Services Compensation Scheme to be repaid out of the cash flows generated by the Group during its wind-down. It is not possible to specify the contractual maturity dates of the loans to the Group from HM Treasury and from the Financial Services Compensation Scheme, and therefore they have been included in the table above as though repayable on demand.

Debt securities in issue include notes which securitise loans to customers through SPVs. Certain of these notes are repaid on a pass-through or controlled amortisation basis. In the above table, maturities of such notes are based on the expected repayment of notes which, in turn, are derived from the expected redemption profiles of securitised loans.

In the above table, where derivatives have been entered into to hedge mortgage backed securitised notes, the timings of derivative payments are based on the expected repayment dates of the hedged notes.

As described in note 28, B&B announced in 2010 that it had resolved not to make any payment of principal or interest in respect of capital instruments during the period prior to the date on which it repays in full the Statutory Debt. Given the uncertainty of the timing of this, the table above includes payments of principal and interest on capital instruments at the earliest date they would have become contractually payable as per the original terms, regardless of the announcement. Capital instruments include perpetual instruments, as shown in note 28: the table above assumes these instruments will be redeemed on 31 December 2055.

Other assets and liabilities are included in the above table according to the earliest date that payment can be contractually demanded. It should be noted that many financial instruments are settled earlier than their contractual maturity date; in particular, many mortgage loans are repaid early, in full or in part.

Assets and liabilities with a remaining period to contractual maturity of within one year are classed as current and those with a remaining period of more than one year are classed as non-current. Non-financial assets and liabilities amount to £126.3m and £450.5m respectively (2011: £176.3m and £404.4m) of which £7.3m and £64.1m respectively are classed as current (2011: £nil and £114.6m) and £119.0m and £386.4m respectively are classed as non-current (2011: £176.3m and £289.8m).

Non-derivative cash flows

The table below analyses the Group's non-derivative cash flows payable into relevant periods. The assumptions used in the preparation of this table are consistent with those used in the maturity table on page109. The amounts disclosed are the contractual undiscounted cash outflows. These differ from Balance Sheet values due to the effects of discounting on certain Balance Sheet items and due to the inclusion of contractual future interest flows.

At 31 December 2012	On demand £m	Within three months £m	After three months but within six months £m	After six months but within one year £m	After one year but within five years £m	After five years £m	Total £m
Financial liabilities:							
Amounts due to banks	4,754.2	–	40.7	–	–	–	4,794.9
Statutory Debt and HM Treasury loans	43,487.3	–	–	–	–	–	43,487.3
Debt securities in issue	–	2,642.9	1,016.5	1,707.7	18,678.5	9,239.4	33,285.0
Capital instruments	–	1.1	152.0	7.1	38.2	637.7	836.1
Other financial liabilities	–	125.4	–	–	–	–	125.4
Loan commitments	1,967.3	0.4	0.3	0.7	6.0	26.1	2,000.8
Total	50,208.8	2,769.8	1,209.5	1,715.5	18,722.7	9,903.2	84,529.5

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

At 31 December 2011	On demand £m	Within three months £m	After three months but within six months £m	After six months but within one year £m	After one year but within five years £m	After five years £m	Total £m
Financial liabilities:							
Amounts due to banks	4,034.0	–	0.4	0.4	42.2	–	4,077.0
Statutory Debt and HM Treasury loans	46,583.0	–	–	–	–	–	46,583.0
Debt securities in issue	–	2,333.9	1,537.7	1,799.2	20,166.4	15,236.1	41,073.3
Capital instruments	–	0.3	1.5	7.9	180.5	600.0	790.2
Other financial liabilities	–	113.1	–	–	0.6	–	113.7
Loan commitments	2,160.0	0.3	0.3	0.6	4.6	16.1	2,181.9
Total	52,777.0	2,447.6	1,539.9	1,808.1	20,394.3	15,852.2	94,819.1

Derivative cash flows

The following table analyses cash outflows for the Group's derivative financial liabilities. The amounts are allocated into relevant periods using assumptions consistent with those used in the preparation of the maturity table on page 109.

At 31 December 2012	On demand £m	Within three months £m	After three months but within six months £m	After six months but within one year £m	After one year but within five years £m	After five years £m	Total £m
Derivative financial liabilities to be settled on a net basis	–	**51.5**	**50.2**	**88.3**	**406.8**	**976.8**	**1,573.6**
Derivative financial liabilities to be settled on a gross basis:							
– Outflows	–	**80.3**	**6.9**	**13.6**	**135.6**	**101.0**	**337.4**
– Inflows	–	**(79.4)**	**(6.8)**	**(13.4)**	**(134.7)**	**(98.6)**	**(332.9)**
Total	–	**52.4**	**50.3**	**88.5**	**407.7**	**979.2**	**1,578.1**

At 31 December 2011	On demand £m	Within three months £m	After three months but within six months £m	After six months but within one year £m	After one year but within five years £m	After five years £m	Total £m
Derivative financial liabilities to be settled on a net basis	–	102.4	67.4	101.7	420.0	918.5	1,610.0
Derivative financial liabilities to be settled on a gross basis:							
– Outflows	–	944.7	1.5	14.5	354.9	51.9	1,367.5
– Inflows	–	(941.7)	(1.8)	(14.9)	(357.8)	(49.5)	(1,365.7)
Total	–	105.4	67.1	101.3	417.1	920.9	1,611.8

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

Cash flow hedges

Interest Rate Swaps:

The notional principal amounts of the outstanding interest rate swap contracts in Cash Flow Hedge Relationships ('CFHR') as at 31 December 2012 were £20.0bn (2011:£3.0bn).

Gains and losses recognised in the cash flow hedge reserve on interest rate swap contracts as at 31 December 2012 will be continually released to the Income Statement up until the maturity of the hedging instruments (August 2019).

Cross Currency Swaps:

The notional principal amounts of the outstanding cross currency swaps in an eligible CFHR as at 31 December 2012 were £22.1bn (2011: £24.2bn).

The hedged transactions denominated in foreign currency are expected to occur at various intervals over the next 34 years. Gains and losses recognised in the cash flow hedge reserve on cross currency swap contracts as at 31 December 2012 will be released to the Income Statement during the periods in which the hedged transactions affect the Income Statement, the latest maturity of these transactions being February 2047.

(d) Interest rate risk

Interest rate risk typically arises from mismatches between the repricing dates of interest-bearing assets and liabilities on the Group's Balance Sheet, and from the investment profile of the Group's capital and reserves. Corporate Treasury is responsible for managing this exposure within the risk exposure limits set out in the Market Risk policy, as approved by the Board. This policy sets out the nature of the market risks that may be taken along with aggregate risk limits, and stipulates the procedures, instruments and controls to be used in managing market risk.

Market risk is the potential adverse change in income or net worth arising from movements in interest rates, exchange rates or other market prices. Effective identification and management of market risk is essential for maintaining stable net interest income.

The Group measures, monitors and controls the following interest rate risks and sensitivities:

- Mismatch risk
- Curve
- Prepayment risk
- Basis risk
- Reset risk

Exposures are reviewed as appropriate by senior management and the Board with a frequency between daily and monthly, related to the granularity of the position.

Interest rate risk exposure is predominantly managed through the use of interest rate derivatives, principally interest rate swaps. The Group also uses asset and liability positions to offset exposures naturally wherever possible to minimise the costs and risks of arranging transactions external to the Group.

Interest rate sensitivities are reported to ALCO monthly and are calculated using a range of interest rate scenarios, including non-parallel shifts in the yield curve. The main metrics used by management are:

(i) the change in value of the Group's net worth due to a notional 2% parallel move in market and base rates.

	2012 £m	2011 £m
2% increase	**10.9**	15.7
2% decrease	**3.5**	(2.3)

(ii) the sensitivity of the Group's interest margin over 12 months to a notional 2% parallel move in market and base rates.

	2012 £m	2011 £m
2% increase	**491.0**	465.7
2% decrease	**(124.4)**	(120.9)

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

(e) Foreign currency risk

The Group's policy is to hedge all material foreign currency exposures by use of naturally offsetting foreign currency assets and liabilities or by the use of derivatives. Consequently, at 31 December 2012 and 31 December 2011 the Group had no net material exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates. The impact on the Group's profit and equity of reasonably possible changes in exchange rates compared to actual rates would not have been material at 31 December 2012 or 31 December 2011.

The table below summarises the Group's exposure to foreign currency exchange rate risk at the year end, based on the information presented to management. Included in the table are the Group's financial instruments, including those classified as equity, under the relevant currency headings. The amounts disclosed are the sterling equivalents of the notional amounts due on maturity, including interest accrued at the Balance Sheet date, less any impairment provisions. Although equity instruments denominated in foreign currency are recorded in the Balance Sheet at their original settlement rates, closing rates are used here to provide sterling equivalents of the currency amounts.

At 31 December 2012	€ £m	$ £m	Other £m	Total £m
Financial assets:				
Cash at bank and in hand	2,291.7	472.4	–	2,764.1
Investment securities	1,026.7	126.3	–	1,153.0
Derivative financial instruments	16,990.3	6,926.2	918.9	24,835.4
Total financial assets	20,308.7	7,524.9	918.9	28,752.5
Financial liabilities:				
Amounts due to banks	2,689.1	434.2	–	3,123.3
Derivative financial instruments	849.8	44.7	–	894.5
Debt securities in issue	16,758.2	7,002.7	919.3	24,680.2
Total financial liabilities	20,297.1	7,481.6	919.3	28,698.0
Non-shareholders' funds	–	10.7	–	10.7
Total	20,297.1	7,492.3	919.3	28,708.7
Net currency gap	11.6	32.6	(0.4)	43.8

At 31 December 2011	€ £m	$ £m	Other £m	Total £m
Financial assets:				
Cash at bank and in hand	1,252.0	37.7	–	1,289.7
Investment securities	1,384.4	150.2	–	1,534.6
Derivative financial instruments	18,856.7	8,334.1	1,355.3	28,546.1
Total financial assets	21,493.1	8,522.0	1,355.3	31,370.4
Financial liabilities:				
Amounts due to banks	1,746.4	0.1	–	1,746.5
Derivative financial instruments	130.5	96.9	–	227.4
Debt securities in issue	19,639.3	8,408.1	1,355.2	29,402.6
Total financial liabilities	21,516.2	8,505.1	1,355.2	31,376.5
Non-shareholders' funds	–	11.2	–	11.2
Total	21,516.2	8,516.3	1,355.2	31,387.7
Net currency gap	(23.1)	5.7	0.1	(17.3)

Notes to the Financial Statements (continued)

37. Financial risk management (continued)

(f) Concentration risk

The Group has investments in a range of investment securities issued by government bodies, banks and building societies, and in asset-backed securities, in both the UK and overseas. UK government securities, bank and supranational bonds comprise 15% (2011: 20%) of investment securities held. 53% (2011: 53%) of the asset-backed securities are backed by UK assets. Further details in respect of concentrations in the wholesale assets portfolio are given in note 13.

The Group operates primarily in the UK, and adverse changes to the UK economy could impact all areas of the Group's business. Residential loans to customers are all secured on property in the UK. 37% (2011: 36%) of residential loans to customers are concentrated in the buy-to-let market; most of the remaining balances are secured on residential owner-occupied properties.

The residential loan book of £66.1bn (2011: £71.9bn) is geographically spread across the UK broadly in line with the country's housing stock. Consequently, there is a geographic concentration of mortgages secured on properties in London and the South-East representing 42% (2011: 43%) of the book.

Within the commercial mortgage portfolio and housing association loans, there are 147 loans (2011: 176) totalling £0.8bn (2011: £0.9bn), with the largest 10 loans accounting for 67% (2011: 63%) of the portfolio. All of these loans are secured on commercial properties.

38. Contingent liabilities

The Consumer Credit Act ('CCA') regulates certain classes of mortgages and loans, including the unsecured element of the Together mortgage product. As detailed in note 27, the Group has not complied with the requirements of the CCA in respect of some documentation provided to certain customers with CCA-regulated loans and has, therefore, made a provision for the Group's best estimate of the cost of providing remediation to those customers. The Directors believe that the loans covered by this provision are the only loans which are entitled to remediation under the provisions of the CCA. If any customers were to make a claim against the Group in respect of other loans, the Group would incur costs in defending its position, and should any such claim result in proceedings which are pursued through the courts and which succeed, the Group could be liable for remediation to those claimant customers and potentially other customers with the same circumstances. No claims have been received from any customers in respect of loans which are not CCA-regulated and no provision has been made.

On 20 January 2009 a solicitor's letter was received notifying B&B and certain present and former B&B directors of a potential claim by former individual shareholders who subscribed for additional shares in the £401m rights issue approved on 17 July 2008. These former shareholders claim to have suffered loss through having been induced to subscribe for shares in the rights issue by allegedly materially misleading and/or incomplete statements made in the associated prospectus dated 24 June 2008 as revised and supplemented by the supplementary prospectus dated 11 July 2008. Should such a claim result in proceedings which are pursued through the courts and which succeed, the defendant directors and/or B&B could be liable in damages to certain former shareholders in B&B who subscribed for shares in the rights issue. In May 2009 B&B together with its legal advisors responded to the allegations raised. Nothing further was heard until 23 January 2012 when further correspondence was received from the solicitors representing the former shareholders, to which B&B together with its legal advisors responded. This correspondence contained no further allegations or details of the former shareholders' potential claim. It is not possible at this stage to determine the outcome or timing of any conclusion to this matter. No provision has been made in respect of these allegations.

As described in note 14, on 23 July 2012 NRAM announced the sale of £465m of loans to customers, at par, secured on residential property, to Virgin Money. Under the terms of the sale, NRAM provided certain warranties. Any claim under the warranties must be made by 28 March 2014. The UKAR Group's maximum liability under these warranties is limited to £35m.

39. Events after the reporting period

The Directors are of the opinion that there have been no significant events which have occurred since 31 December 2012 to the date of this report that are likely to have a material effect on the Group's or the Company's financial position as disclosed in these Financial Statements.

Independent Auditors' report to the Members of UK Asset Resolution Limited

We have audited the Parent Company Financial Statements of UK Asset Resolution Limited for the year ended 31 December 2012, which comprise the Company Balance Sheet, the Company Statement of Changes in Equity, the Company Cash Flow Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ('IFRS') as adopted by the European Union, and as applied in accordance with the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 46, 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 of 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 Parent 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 Annual Report & Accounts 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 parent Company Financial Statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2012 and of its cash flows for the year then ended;
- have been properly prepared in accordance with IFRS as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; 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 Directors' Report for the financial year for which the parent Company Financial Statements are prepared is consistent with the parent Company 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 by the parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent Company 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.

Other matter

We have reported separately on the Group Financial Statements of UK Asset Resolution Limited for the year ended 31 December 2012.

Craig Gentle (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
22 March 2013

Company Balance Sheet

	Note	31 December 2012 £m	31 December 2011 £m
Assets			
Investments in Group undertakings	E	**2,634.1**	2,634.1
Total assets		**2,634.1**	2,634.1
Equity			
Issued capital and reserves attributable to equity holder:			
– Share capital	29	**1.2**	1.2
– Merger reserve	F	**2,632.8**	2,632.8
– Retained earnings		**0.1**	0.1
Share capital and reserves		**2,634.1**	2,634.1

The notes on pages 117 and 118 form an integral part of these Financial Statements.

The Financial Statements were approved by the Board of Directors and authorised for issue on 22 March 2013 and signed on its behalf by:

Richard Banks
Chief Executive Officer

Phillip McLelland
Finance Director

UK Asset Resolution Limited is registered in England and Wales under company number 07301961.

Company Statement Of Changes In Equity

For the year ended 31 December 2012	**Share capital £m**	**Merger reserve £m**	**Retained earnings £m**	**Total share capital and reserves £m**
At 1 January and 31 December 2012	**1.2**	**2,632.8**	**0.1**	**2,634.1**

For the 18 month period ended 31 December 2011	Share capital £m	Merger reserve £m	Retained earnings £m	Total share capital and reserves £m
On incorporation: 1 July 2010	–	–	–	–
Issue of share capital	1.2	–	–	1.2
Acquisition of subsidiary undertakings	–	2,632.8	–	2,632.8
Profit for the financial period	–	–	0.1	0.1
At 31 December 2011	**1.2**	**2,632.8**	**0.1**	**2,634.1**

Company Cash Flow Statement

During the year ended 31 December 2012 and the comparative 18 month period ended 31 December 2011 the Company had no material cash flows or balances. Consequently no Cash Flow Statement has been presented.

The Company had no significant non-cash transactions during the year.

Notes to the Financial Statements

A. Principal accounting policies

The Company is a private limited company incorporated on 1 July 2010 and domiciled in the United Kingdom. The principal activity of the Company is to provide management services to its subsidiary undertakings. The Company applies the accounting policies of the UKAR Group, set out on pages 56 to 64, with the following additional item.

Investments in Group undertakings

In the Financial Statements of the UKAR Company, investments in Group undertakings are carried at cost less any impairment. UKAR's acquisition of the entire issued share capital of B&B and NRAM in a share-for-share exchange has been accounted for under 'predecessor accounting' and the cost of each of these investments has been deemed to be the net assets of the B&B company and the NRAM company at 30 June 2010. Investments are reviewed at each published Balance Sheet date for any indications of impairment. If there is indication of impairment of any investment, the carrying value of the investment is reviewed, and any impairment identified is charged immediately to the Income Statement.

B. Critical judgements and accounting estimates

In preparing the Financial Statements, management have made the following critical judgement.

Investments in Group undertakings

The Directors consider the value of the Company's investments in subsidiary undertakings to be supported by their underlying assets.

C. Profit

The Company's profit after tax for the year was £23,000 (18 months to 31 December 2011: £92,000). As permitted by s408 of the Companies Act 2006 the Company's individual Income Statement, Statement of Comprehensive Income and related notes have not been presented.

D. Taxation

The Company bears tax at the standard weighted average rate of UK corporation tax of 24.5% (2011: 27%), and has no deferred tax provided or unprovided.

E. Investments in Group undertakings

The investments in Group undertakings represent the Company's holdings of the entire issued share capital of B&B and NRAM, which were acquired in a share-for-share exchange on 1 October 2010.

The Company's principal subsidiary undertakings at 31 December 2012 held directly or indirectly, all of which are wholly owned and are fully consolidated into the Group Financial Statements, are listed below. All operate in their country of incorporation.

	Nature of business	Country of incorporation	Class of shares held
Direct			
Bradford & Bingley plc ('B&B')	Mortgage administration	UK	Ordinary
Northern Rock (Asset Management) plc ('NRAM')	Mortgage administration	UK	Ordinary and preference
Indirect			
Mortgage Express	Mortgage administration	UK	Ordinary
Northern Rock Mortgage Indemnity Company Limited	Provision of mortgage indemnity insurance	Guernsey	Ordinary

Further details of the subsidiaries of the B&B and NRAM company's, including their SPVs, are provided in the Annual Reports and Accounts of B&B and NRAM.

The Directors consider that to give full particulars of all subsidiaries would lead to a statement of excessive length. A full list of the Company's subsidiaries at 31 December 2012 will be annexed to the Company's next Annual Return to be filed at Companies House.

The Directors consider the value of investments in Group undertakings to be supported by their underlying assets.

Notes to the Financial Statements (continued)

F. Merger reserve

	2012 £m	2011 £m
At 1 January 2012 /1 July 2010	**2,632.8**	–
Generated on acquisition of B&B	–	1,488.0
Generated on acquisition of NRAM	–	1,144.8
At 31 December	**2,632.8**	2,632.8

The merger reserve was generated on 1 October 2010 when the Company acquired all the issued shares of B&B and NRAM from the Treasury Solicitor via a share-for-share exchange. The merger reserve represents the difference between the value attributed to the Company's investment in each company and the nominal value of the share capital issued by the Company in exchange.

G. Related party disclosures

(a) Subsidiary companies

The Company had no material balances outstanding with subsidiary companies during the period:
The Company had transactions with its subsidiaries as follows:

	2012 £000	2011 £000
Management charges to subsidiary undertakings	**709**	981
Costs recharged by subsidiary undertakings	**678**	889

(b) Key management personnel

The Group considers the Boards of Directors and the members of the Executive Committees of UKAR, B&B and NRAM to be the key management personnel. The Company had no transactions or balances directly with any key management personnel during the period. The Company's non-executive Directors have service contracts with the Company. Their fees are paid by B&B and recharged at cost to the Company, along with other related costs.

(c) Directors' emoluments

The aggregate UKAR Group emoluments of the Directors of the UKAR Company for the year ended 31 December 2012 were £1,680,357, and of the highest paid Director £642,820 (for the 18 months ended 31 December 2011: £2,028,438 and £974,128 respectively).

H. Financial risk management

The Company has no significant financial risks.

I. Ultimate controlling party

All shares in the Company are owned by the Treasury Solicitor as nominee for HM Treasury, and the Company considers Her Majesty's Government to be its ultimate controlling party.