TESCO PERSONAL FINANCE PLC

DIRECTORS' REPORT AND FINANCIAL STATEMENTS
FOR THE YEAR ENDED 28 FEBRUARY 2011

COMPANY NUMBER SC173199

TESCO PERSONAL FINANCE PLC

CONTENTS

TESCO PERSONAL FINANCE PLC

DIRECTORS AND ADVISERS

Directors:	Iain Clink Shaun Doherty Bernard Higgins Andrew Higginson – Chairman Adrian Hill* Rick Hunkin William Main* Raymond Pierce* Graham Pimlott* John Reed* *Indicates independent non-executive Director
Company Secretary:	Jonathan Lloyd
Registered Office:	Interpoint Building 22 Haymarket Yards Edinburgh EH12 5BH
Independent Auditors:	PricewaterhouseCoopers LLP Chartered Accountants and Statutory Auditors Erskine House 68-73 Queen Street Edinburgh EH2 4NH
Bankers:	The Royal Bank of Scotland plc 36 St Andrew Square Edinburgh EH2 2YB HSBC Bank plc 8 Canada Square London E14 5HQ

TESCO PERSONAL FINANCE PLC

DIRECTORS' REPORT

The Directors present their annual report and the audited financial statements for the year ended 28 February 2011.

In the Directors' Report and financial statements, unless specified otherwise, the 'Company' means Tesco Personal Finance plc.

PRINCIPAL ACTIVITIES

The Company is engaged in the provision of banking and general insurance services. The Company operates using the trading name of Tesco Bank. The Company is primarily focused on providing financial services and products to UK personal customers although there is a small international presence in the Republic of Ireland and Poland.

REVIEW OF BUSINESS AND FUTURE DEVELOPMENTS

The Company has continued to perform strongly during the year to 28 February 2011, with an increase in customer numbers and strong lending growth leading to a rise in underlying year on year profit. At the year end the Company had more than 6.5 million customers across its range of banking and insurance products.

At an operational level there have been many significant changes during the year. The Company has progressed with its programme of work to create its own infrastructure, and the migration from the Royal Bank of Scotland's (RBS) accounting, banking and insurance systems is well advanced.

To allow the Company to manage the sales and service for the Motor and Home Insurance business (previously undertaken by RBS) two new customer service centres in Glasgow and Newcastle were opened in October 2010. These also supported the successful launch of the Fixed Rate Saver product in late 2010, the first new product to be operational on the Company's own banking platforms.

The majority of Home and Motor Insurance business sold since October 2010 has been underwritten by Tesco Underwriting Limited. Tesco Underwriting Limited is an authorised insurance company owned 49.9% by the Company and 50.1% by Ageas Insurance Limited. The Company's general insurance products also include Pet, Travel and Motor Rescue cover. New distribution arrangements have been put in place for these products with a variety of providers and these also became effective in October 2010.

Systems migration is set to continue well into 2011 as the Company continues to migrate its banking products onto the Company's own Information Technology (IT) platforms. A key priority as part of this IT migration is to ensure that the impact on customers is minimised and that customer service is ultimately enhanced through improved intranet platforms and dedicated Tesco Bank customer services staff.

During the year, the Financial Services Authority (FSA) formally issued Policy Statement 10/12 (PS 10/12), which introduces new guidance in respect of Payment Protection Insurance (PPI) customer redress and evidential provisions to the FSA Handbook with an implementation date of 1 December 2010. In September 2010 the Company took direct control from RBS over the handling of complaints relating to the sale of PPI and ensured that complaints were handled in accordance with PS10/12. The Company continues to analyse the nature of these complaints and, consistent with the requirements of PS10/12, will consider the need to contact customers and offer redress in the event that this analysis highlights that historic sales practices have not complied with applicable sales standards.

The Company recognised a provision for customer redress in the prior year in respect of compensation for potential customer complaints relating to the sale of PPI policies. The volume of complaints in the year to 28 February 2011 has been materially lower than anticipated at the date the provision was established. As a result £50.0m of this provision has been released to the income statement at the year end. This release is

DIRECTORS' REPORT (continued)

included within non interest income.

The calculation of the provision for customer redress involves estimating a number of variables including the volume of cases in which compensation is paid and is based on the level of complaints received to date. Uncertainty inherent in estimating the volume of cases in which compensation is payable, which includes the potential requirement for the Company to contact customers as a result of the analysis of historical sales practices referred to above, may have a significant impact on the ultimate cost of compensation. Further details are provided in note 31.

During the prior year a review was undertaken of the corporate structure in relation to the ATM business. This structure was originally created during the period that 50% of the Company was owned by RBS. Following change of control there was no longer a need to maintain this structure and therefore the decision was taken to wind up the Company's subsidiary, TPF ATM Services Limited, and it's indirect subsidiary TPF Services Limited Liability Partnership.

As a result of this decision both of these companies ceased trading from 1 March 2010. There are two significant impacts of this on the Company's results for the current year. Firstly dividend income received from TPF ATM Services Limited has fallen and secondly the Company now retains 100% of the profits of the ATM business, and is no longer required to pay a management fee to TPF Services Limited Liability Partnership.

Subject to regulatory approval, Tesco Bank mortgages will be launched during 2011. The operational and commercial plans to support this launch are at an advanced stage and the Company believes it is well placed to capitalise on the strength of the Tesco brand in this market.

Other than the developments highlighted above, the Directors do not anticipate any material change in either the type or level of activities of the Company in the next financial year. The parent company, Tesco Personal Finance Group Limited, increased its investment in the Company by £445.5m during the year, increasing total equity to £1,060.0m at the balance sheet date. An initial dividend in respect of ordinary share capital of £12.2m was paid to the parent company in September 2010, and a final dividend of £150.0m was paid in February 2011. Taking both the current performance and the Company's outlook into account, the Directors' consider the Company to be in a strong financial position and confirm that the Company has adequate resources to continue in business in the foreseeable future. Accordingly, the Directors continue to adopt the going concern basis in preparing the financial statements.

FINANCIAL PERFORMANCE

Headlines:

- Profit before tax is up 694.7% to £134.9m (2010: £17.0m)
- Underlying profit before tax is up 57.4% to £184.2m (2010: £117.0)
- Total income has increased by 20.3% to £592.1m (2010: £492.0m)
- Net interest margin has improved to 4.6% (2010 4.1%)
- Dividend income has decreased by 86.9% to £3.7m (2010: £28.2m)
- Operating expenses have increased by 9.2% to £325.8m (2010: £298.4m), reflecting both the migration programme and the new insurance operating model.
- Impairment losses have fallen by 25.6% to £131.4m (2010: £176.6m)

DIRECTORS' REPORT (continued)

Income Statement

The Company's financial performance is presented in the income statement on page 16. A summary is presented below.

	2011 £'000	2010 £'000
Net interest income	**272,958**	231,309
Non-interest income	**319,119**	260,682
Operating expenses	**(325,849)**	(298,387)
Impairment	**(131,356)**	(176,633)
Profit before tax	**134,872**	16,971
Net interest margin [1]	**4.6%**	4.1%
Cost: income ratio [2]	**55.0%**	60.6%
Bad debt asset ratio [3]	**2.7%**	4.1%

1 Net interest margin is calculated by dividing net interest income by average interest bearing assets
2 The cost: income ratio is calculated by dividing operating expenses by total income
3 The bad debt asset ratio is calculated by dividing the impairment loss by the average customer balance

Net Interest Income

The 18.0% year on year growth in net interest income reflects a further widening of the net interest margin (4.6% compared to 4.1% for the year ended 28 February 2010) and strong balance growth in key lending products.

Non Interest Income

Retail banking has benefitted from strong credit card fee income and improved margins on personal loans during the year. The Company has continued to see a steady increase in its share of Credit Card transactions in the UK, with transaction values 20% higher than in the prior year.

In addition to lending products, the ATM business also performed strongly. This continues to expand with 3,051 ATM machines now in operation across the UK.

Non interest income also includes insurance commission receivable. The migration to the new insurance arrangements has made good progress and following several years of decline and despite the challenges associated with system migration, Motor Insurance customers rose by 8% in the year to 28 February 2011. Under the pre migration insurance distribution agreement with RBS, the Directors concluded that, following a year end actuarial review, an additional charge of £99.3m should be recorded in the year to reflect higher reserves for the cost of settlement of personal injury claims incurred under this legacy arrangement. This amount is shown as a reduction in fee and commission income for the year in the income statement.

Dividend income received from TPF ATM Services Limited has reduced from £28.2m in the prior year to £3.7m in the current year. The current year dividend received reflects the final amounts owing from this company for the year ended 28 February 2010.

DIRECTORS' REPORT (continued)

Operating Expenses

The Company's cost base has increased in the year as a result of the ongoing migration from RBS. Expenditure on the migration programme itself has contributed to an increase in operating expenses during the year, through both increased IT costs and depreciation of new systems infrastructure. The change to the operating model for insurance with the creation of operational centres in Newcastle and Glasgow has been a further factor in the growth in expenditure.

The change in company structure for the ATM business as described above has resulted in a reduction in ATM operating expenses during the year as the Company no longer pays a management fee to TPF Services Limited Liability Partnership.

The reduction in ATM management fee costs has resulted in a decrease in the cost income ratio to 55.0% at 28 February 2011 from 60.6% at the prior year end.

Impairment

Impairment losses have reduced from £176.6m at the prior year end to £131.4m at 28 February 2011, despite strong lending growth over a number of years. This reflects both the quality of the Company's lending and relative stability in economic conditions compared to the prior year. As a result the bad debt to asset ratio has decreased to 2.7% at year end (2010: 4.1%).

Profit before tax

Profit before tax increased by 694.7% during the year to £134.9m (2010: £17.0m). Excluding the impact of material accounting adjustments for both the provision for customer redress in the current and prior year and Motor insurance claims in the current year, underlying profit before tax at 28 February 2011 was £184.2m, an increase of 57.4% against the previous year.

Balance Sheet

The Company's statement of financial position is presented on page 18. A summary position is presented below.

	2011 £'000	2010 £'000
Loans and advances to customers	**4,679,184**	4,297,217
Total assets	**7,009,191**	5,786,833
Deposits from customers	**5,077,464**	4,370,225

Loans and Advances to customers

Loans and Advances to customers have grown by 8.9% in the year to £4,679.2m (2010: £4,297.2m). This is reflective of an increase in customer numbers; active credit cards numbers increased by 11% and personal loans by 17% during the year.

Total Assets

Total assets increased by £1,222.4m, to £7,009.2m at 28 February 2011 (2010: £5,786.8m). This increase is driven by strong lending growth combined with an increase in fixed assets balances as a result of investment in new systems. The Company also increased its investment in Tesco Underwriting Limited by £103.3m (£68.9m in equity and a £34.4m subordinated loan) during the year.

DIRECTORS' REPORT (continued)

Deposits from customers

Deposits from customers grew to £5,077.5m at 28 February 2011 (2010: £4,370.2m), an increase in the year of £707.2m. The launch of the Fixed Rate Saver product in October 2010 generated £397.0m of this increase.

Capital and Liquidity Ratios

	2011 £'000	2010 £'000
Tier 1 capital ratio [1]	**15.9%**	12.9%
Risk asset ratio [2]	**13.6%**	12.8%
Net Stable Funding Ratio [3]	**112.3%**	120.9%

1 The tier 1 capital ratio is calculated by dividing total tier 1 capital at the end of the year by total risk weighted assets (note 45).
2 The risk asset ratio is calculated by dividing Total regulatory capital by total risk weighted assets (note 45).
3 The Net stable funding ratio is calculated by dividing long term funding by customer deposits and other illiquid assets.

The Company's capital position has strengthened during the year resulting in an improved regulatory risk asset ratio of 13.6% (2010: 12.8%) and an increase in the Core Tier 1 Ratio to 15.9% (2010: 12.9%).

The net stable funding ratio, a key measure of the Company's liquidity position, has fallen to 112.3% from 120.9% at 28 February 2010. This reduction reflects planned management of the Company's liquidity position and resulted in a ratio at 28 February 2011, in excess of the Company's target of 110.0%.

The Company received capital injections totalling £445.5m from Tesco Personal Finance Group Limited during the course of the year. This funded planned expenditure on systems development and infrastructure as well as the additional investment in Tesco Underwriting Limited.

The Company maintains a liquid asset portfolio of high quality securities in line with regulatory guidance, and additional treasury assets which offer a high degree of liquidity. At 28 February 2011 treasury assets totalled more than £1.2bn. Given its strong liquidity position, the Company returned £205m of Special Liquidity Scheme Treasury Bills to the Bank of England during the year, ahead of schedule.

The Company has diversified its funding base during the year through the new fixed rate savings products, together with the issue of a seven and a half year term retail bond in February 2011. These raised over £500m of term funding in the last five months of the financial year, with balances at 28 February 2011 being £397.0m and £125.6m respectively. This new term funding places the Company in a strong position ahead of the planned launch of mortgages during 2011.

TREATING CUSTOMERS FAIRLY

Treating Customers Fairly (TCF) is central to the FSA's principles for businesses and is fully aligned with the Tesco Values. These values are designed to ensure that customer outcomes match their understanding and expectations.

The Company has taken the six TCF principles in turn to ensure its' fully embedded policy delivers the desired outcome for customers. The Company has a clear set of principals for doing business. Establishing the right culture is at the core of enabling management and staff to deliver the Company's commitments to its customers. Significant consideration is given to this area in the existing business and also in developing new products and processes.

DIRECTORS' REPORT (continued)

DIRECTORS

The present Directors and Secretary who have served throughout the year and up to the date of signing the financial statements, except where noted below, are listed on page 2.

Since 1 March 2010 to date the following changes have taken place:

	Appointed	Resigned
Alison Horner		17 December 2010
Laura Wade-Gery		28 January 2011
Rick Hunkin	28 January 2011	
John Reed	30 March 2011	

RISK MANAGEMENT

Risk is an accepted part of doing business. The real challenge for any business is to identify the principal risks it faces and to develop and monitor appropriate controls. A successful risk management framework balances risks and rewards and relies on a sound judgement of their likelihood and consequence.

The Board has overall responsibility for ensuring that the Company has an appropriate approach to risk management and internal control within the context of achieving the Company's objectives. Executive management is responsible for implementing and maintaining the necessary control systems. The independent Risk function, led by the Chief Risk Officer (CRO) who reports directly to the Chief Executive Officer (CEO), is responsible for providing oversight and assurance in relation to risk profiles. The role of Internal Audit is to monitor the overall internal control systems and report on their effectiveness.

The Company has established a risk management framework to manage the risks arising across the Company's businesses. The framework is driven at a strategic level by the Company's Risk Appetite, which is approved by the Board. The Company's approach to Risk Management is detailed in note 38 within the financial statements.

The Internal Capital Adequacy Assessment Process (ICAAP) is the Company's internal assessment of capital adequacy designed to address the requirements under Pillar 2 of the Basel II framework. The ICAAP process considers all of the risks faced by the Company, how these risks are mitigated and the amount of capital that requires to be held both currently and in the future. The Company performs a full ICAAP at least annually.

The Company maintains a Key Risk Register, which details the key risks faced by the Company together with the controls and procedures implemented to mitigate each of these risks. Management regularly consider the evolution of the nature and scale of these risks, the main controls that mitigate these risks and the assurance activities that have been conducted to evidence control effectiveness. This enables management to determine additional mitigating actions in cases where the residual risk is greater than the Company's risk appetite. The content of the Register is determined through regular discussions with senior management and reviewed by the Board Risk Committee and the Board on a six monthly basis.

On a monthly basis information is presented to the Board in relation to performance of "Key Risk Indicators", identification and analysis of emerging risks and a dynamic assessment of ICAAP risks.

The table below sets out the key risks faced by the Company and examples of relevant controls and mitigating factors. The Board considers these to be the most significant risks. They do not comprise all risks associated with the Company and are not set out in any order of priority. Additional risks not presently known to management, or currently deemed to be less material, may also have an adverse effect on the business.

DIRECTORS' REPORT (continued)

Principal risk	Nature of risk	Key controls and mitigating factors
Liquidity & funding	Liquidity Risk is the risk that the Company, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such resources only at excessive cost. Funding risk is defined as the risk that the Company does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.	• Dedicated Treasury function responsible for the management of funding and liquidity risks within the framework approved by the Board. • Conservative Balance Sheet structure with prudent risk appetite supported by explicit targets and metrics which enable funding and liquidity to be managed in excess of regulatory requirements. • Strong liquid position with a diversified stock of highly marketable liquid assets that can be used as a buffer against unforeseen impacts on cash flow or in stressed environments. • Customer lending activities are not funded by short term wholesale funding. • Daily monitoring and management of key funding and liquidity ratios with monthly reporting to Assets & Liabilities Management Committee and the Board. • Regular stress testing undertaken to assess the adequacy of funding and liquidity resources during periods of market dislocation and stress. • Limited reliance on Bank of England Special Liquidity Scheme which will be repaid in advance of contractual maturity in 2012. • Continued diversification of funding sources including successful launch of a seven and a half year retail bond that raised £125.6m of new funding.
External Environment	The Company is exposed to general UK economic conditions as well as general market trends in the areas in which it operates. Economic conditions are subject to significant uncertainty with commentators split on the sustainability of the economic recovery. General economic and market conditions are likely to have an impact on the Company's credit portfolios.	• Independent Credit Risk team, reporting directly to the CRO, responsible for the development and oversight of the credit risk framework and supporting the business in the implementation of policies and processes. • Low credit risk appetite with focus on responsible lending and maintaining a risk profile better than the industry average. • Whilst credit performance has remained strong and favourable to industry averages, credit portfolios continue to be closely monitored and changes made to business acquisition and credit limit management strategies to mitigate, as far as possible, downside economic risks. • The impact of extreme but plausible deterioration in economic conditions is considered as part of the Company's stress testing programme. • Regular reporting of credit risk information and performance against risk appetite to the Risk Management Committee, the Board Risk Committee and the Board.
Insurance Risk	The Company is exposed to insurance risks through its historic distribution agreement with RBS and indirectly through its 49.9% ownership of Tesco Underwriting Limited, an authorised insurance company.	• Independent Insurance Risk team, reporting directly to the Company's CRO, that operates as the primary contact across all risk disciplines for the insurance business. • Underwriting risks actively managed in Tesco Underwriting Limited with close monitoring of performance metrics. Independent oversight conducted by the Company. • Performance against insurance risk appetite is monitored closely at a senior level and reported to the Company's Risk Management Committee, Board Risk Committee and the Board. • Reinsurance programme to limit the Company's exposure above pre-determined levels. • The impact of specific Motor and Home insurance events is considered as part of the Company's stress testing programme and ICAAP.

DIRECTORS' REPORT (continued)

Principal risk	Nature of risk	Key controls and mitigating factors
Regulatory Environment	Regulatory risk is the risk of failure to meet the Company's obligations under the Financial Services and Market's Act (FSMA), the Consumer Credit Act and the Data Protection Act and to meet the expectations of regulators. The Company is subject to significant regulatory oversight, including supervision by the FSA which has substantial powers of intervention. There is currently a significant amount of regulatory change including the continued evolution of capital and liquidity requirements. The regulatory landscape is changing with current FSA responsibilities due to migrate to the new Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). Detailed proposals for the new regulatory authorities are due to be published later this year. There remains continued regulatory focus in relation to "Conduct Risk" or "Treating Customer's Fairly" (TCF). Specifically there has been continued focus on complaints relating to the sale of Payment Protection Insurance (PPI).	• Independent Regulatory Risk team, reporting directly to the CRO, providing oversight and support to the business to ensure that regulatory risks are identified and managed appropriately. • The Company has minimal appetite for regulatory risks and it maintains a control framework, including a suite of risk policies, to comply with regulatory requirements. • Ongoing monitoring to identify regulatory change initiatives supplemented by regular and ad-hoc compliance monitoring and a programme of risk assurance activities. • Regular reporting of regulatory risks to Risk Management Committee, Board Risk Committee and Board as well as to the FSA. • Significant senior management time and focus allocated to management of regulatory risks and the ongoing regulatory relationship. • Significant consideration is given to customer treatment in the existing business and also in developing new products and services where TCF considerations are a mandatory element of any proposal. • PPI complaints handling brought in-house to improve the customer experience and to ensure that the outcomes are aligned with the policy introduced by the Company. • The Company has recognised a provision for potential customer redress, including compensation that may be required in relation to PPI complaints.
Operations	Operational Risk is the risk of loss caused by human error, ineffective or inadequately designed processes, system failure or improper conduct (including criminal activity). A significant amount of services and processes are provided by third party service providers and currently a key operational risk to the business is a failure by an outsourced provider.	• Independent Operational Risk team, reporting directly to the CRO, responsible for three key areas: operational risk framework, financial crime and anti money laundering. • The Company has low appetite for Operational Risk, although it accepts higher risk in the short term as a result of the migration programme, with the operational risk framework overseen by a dedicated unit within the independent risk function. • Risk registers maintained across the business which capture and quantify the risks arising in each of the commercial, insurance, operations and central functions areas. • Third party services are managed through a series of Commercial Services Agreements (CSAs) with oversight arrangements established to check that CSAs are delivered in compliance with the terms of the contract. • Regular reporting of operational risk information and performance against risk appetite, including Financial Crime, to the Risk Management Committee, Board Risk Committee and the Board.

TESCO PERSONAL FINANCE PLC

DIRECTORS' REPORT (continued)

Principal risk	Nature of risk	Key controls and mitigating factors
Transformation Programme	The Transformation Programme is the name given to a series of projects which are designed to develop alone, or in conjunction with partners or outsourcers, a banking and insurance IT platform and set of processes to enable the Company to conduct banking and insurance business independently of RBS. The programme also includes the recruitment and training of relevant staff and the development of the necessary supporting infrastructure. In addition, the Company has developed plans for launching mortgages, subject to FSA approval. The addition of new products adds further to the complexity and delivery challenge of the Transformation Programme.	• The Transformation Delivery Group (TDG) is the top governance forum for the delivery of the programme objectives. The forum is chaired by the Chief Operating Officer with representation across all areas of the Company, including Commercial, Operations, IT, Risk and Finance. • Strong programme governance in place with TDG supported by Programme Implementation Boards and Project Control Committees. • Project management disciplines are in place, including detailed programme plans and risk and issue management, to deliver effective management of the programme scope, delivery timelines and adherence to budget. • Ongoing programme of audit reviews, risk profiles and "health checks" with monthly reporting to the Risk Management Committee, Audit Committee and the Board.

Pillar 3

The Pillar 3 disclosure report for the Company is published on the Tesco PLC website (www.tescoplc.com/investors/results-and-events/), providing a range of additional information in relation to risk management and risk exposure, capital resources and capital adequacy.

DIRECTORS' REPORT (continued)

DIRECTORS' INDEMNITIES

In terms of Section 236 of the Companies Act 2006: Andrew Higginson has been issued a Qualifying Third Party Indemnity Provision by Tesco plc; Graham Pimlott, Adrian Hill, William Main, Raymond Pierce and John Reed have been issued a Qualifying Third Party Indemnity Provision by Tesco Personal Finance Group Limited.

CHARITABLE DONATIONS

The Company actively supports charity activity and made the following charitable donations in the year:

Charitable organisation	2011 £'000	2010 £'000
Marie Curie	4	-
Muscular Dystrophy Campaign	9	63
Tartan Army Children's Charity	-	1
The Prince's Trust	63	-
CLIC Sargent	85	-
	161	64

SUPPLIER PAYMENT POLICY

During the year ending 28 February 2011, the Company continued to adhere to its procurement policy in respect to payment of its suppliers. The Company is committed to maintaining a sound commercial relationship with its suppliers in line with the Business Code of Conduct. Consequently, it is the Company's policy to negotiate and agree terms and conditions with its suppliers. The standard payment terms to suppliers of goods and services will be 34 days from the receipt of a correctly submitted invoice for goods or services that have been ordered and received in accordance with the terms of the contract.

Trade creditors of the Company for the year ended 28 February 2011 were equivalent to 42 days, based on the ratio of Company trade creditors at the end of the year to the amounts invoiced during the year by trade creditors.

OUR PEOPLE

The Company depends on the skills and commitment of its employees in order to achieve its objectives. There are processes for understanding and responding to employees' needs through the people agenda team, staff surveys and regular performance reviews. Business developments are communicated frequently to ensure that employees are well informed about the business of the Company. Ongoing training programmes also seek to ensure that employees understand the Company's objectives and the regulatory environment in which it operates.

Employees are encouraged to become involved in the financial performance of the wider Tesco plc Group through a variety of schemes, principally the Tesco employee profit-sharing scheme (Shares in Success), the savings related share option scheme (Save As You Earn) and the partnership share plan (Buy As You Earn).

The Company's selection, training, development and promotion policies are designed to ensure equal opportunities for all employees regardless of factors such as gender, marital status, race, age, sexual preference and orientation, colour, creed, ethnic origin, disability, religion or belief.

DIRECTORS' REPORT (continued)

INDEPDENDENT AUDITORS

The auditors, PricewaterhouseCoopers LLP, have indicated their willingness to continue in office.

STATEMENT OF DISCLOSURE TO AUDITORS

So far as each Director at the date of approving this report is aware, there is no relevant audit information, being information needed by the auditors in connection with preparing their report, of which the auditors are unaware. Having made enquiries of fellow Directors and the Company's Auditors, all of the Directors have taken all the steps that they ought to have taken as Directors in order to make themselves aware of any relevant audit information and to establish that the auditors are aware of that information.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The directors are responsible for preparing the Directors' 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 financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that year. 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 IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

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

Approved by the Board of Directors and signed on behalf of the Board

Jonathan Lloyd
Company Secretary
25 May 2011

TESCO PERSONAL FINANCE PLC

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF TESCO PERSONAL FINANCE PLC

We have audited the financial statements of Tesco Personal Finance plc for the year ended 28 February 2011 which comprise the Income Statement, the Statement of Comprehensive Income, the Statement of Financial Position, the Statement of Changes in Equity, the Cash Flow Statement and the Notes to the Financial Statements. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS
As explained more fully in the Directors' Responsibilities Statement set out on page 13, 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 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.

OPINION ON FINANCIAL STATEMENTS
In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 28 February 2011 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

OPINION ON OTHER MATTER PRESCRIBED BY THE COMPANIES ACT 2006
In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

TESCO PERSONAL FINANCE PLC

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF TESCO PERSONAL FINANCE PLC (CONTINUED)

MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

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

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

Catrin Thomas

Catrin Thomas (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
25 May 2011

TESCO PERSONAL FINANCE PLC

INCOME STATEMENT
FOR THE YEAR ENDED 28 FEBRUARY 2011

	Note	2011 £'000	2010 £'000
Interest and similar income	4	420,087	367,169
Interest expense and similar charges	4	(147,129)	(135,860)
Net interest income		**272,958**	**231,309**
Fees and commissions income	5	285,730	352,215
Fees and commissions expense	5	(20,291)	(20,988)
Provision for customer redress		50,000	(100,000)
Net fees and commissions income		**315,439**	**231,227**
Dividend income		3,726	28,216
(Losses)/gains on financial assets	6	(610)	1,100
Realised gain on investment securities	7	564	139
		3,680	**29,455**
Total income		**592,077**	**491,991**
Administrative expenses	8	(306,458)	(292,041)
Depreciation and amortisation	9	(19,391)	(6,346)
Operating expenses		**(325,849)**	**(298,387)**
Impairment	10	(131,356)	(176,633)
Profit before tax		**134,872**	**16,971**
Income tax expense	12	(35,503)	2,278
Profit for the year		**99,369**	**19,249**
Profit attributable to:			
Owners of the parent		99,369	19,249
		99,369	**19,249**

STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 2011

	Note	2011 £'000	2010 £'000
Profit for the year		**99,369**	**19,249**
Net gains on available for sale investment securities			
Unrealised net gains during year, before tax		2,243	1,163
Cash flow hedges			
Net gains/(losses) arising on hedges recognised in other comprehensive income, before tax		1,099	(1,821)
Income tax relating to components of other comprehensive income	14	(938)	59
Total comprehensive income for the year		101,773	18,650
Total comprehensive income attributable to:			
Owners of the parent		101,773	18,650
		101,773	18,650

TESCO PERSONAL FINANCE PLC

STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 2011

Company number SC173199

	Note	2011 £'000	2010 £'000
Assets			
Cash and balances with central banks	15	136,808	181,855
Loans and advances to banks	16	323,136	61,937
Loans and advances to customers	17	4,679,184	4,297,217
Derivative financial instruments	18	16,378	1,547
Investment securities:			
- Available for sale	19	849,831	604,262
- Loans and receivables	19	292,931	258,500
Prepayments and accrued income	20	111,676	91,000
Other assets	21	200,891	142,874
Current income tax asset		-	18,451
Investment in group undertaking	22	-	-
Investment in associate	23	71,708	2,857
Deferred income tax asset	24	-	4,930
Intangible assets	25	215,275	60,328
Property, plant and equipment	26	111,373	61,125
Total assets		**7,009,191**	5,786,883
Liabilities			
Deposits from banks	27	36,200	29,856
Deposits from customers	28	5,077,464	4,370,225
Debt securities in issue	29	350,255	224,390
Derivative financial instruments	18	37,369	64,759
Provisions for liabilities and charges	30	39,477	100,000
Accruals and deferred income	31	185,151	119,118
Current income tax liability		3,366	-
Other liabilities	32	24,919	12,836
Deferred income tax liability	24	5,022	-
Subordinated liabilities	33	190,000	190,000
Total liabilities		**5,949,223**	5,111,184
Equity			
Shareholders' funds:			
- Share capital	34	92,340	47,790
- Share premium account	34	831,060	430,110
- Retained earnings		89,317	152,952
- Other reserves	35	2,251	(153)
Subordinated notes	36	45,000	45,000
Total equity		**1,059,968**	675,699
Total liabilities and equity		**7,009,191**	5,786,883

The financial statements were approved by the Board of Directors and authorised for issue on 25 May 2011 and were signed on its behalf by:

Andrew Higginson
Director

TESCO PERSONAL FINANCE PLC

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 28 FEBRUARY 2011

	Share capital £'000	Share premium £'000	Retained earnings £'000	Subordinated notes £'000	Other reserves £'000	Total equity £'000
Balance at 1 March 2009	24,790	223,110	287,569	45,000	446	580,915
Comprehensive income						
Profit for the year	-	-	19,249	-	-	19,249
Net gains on available for sale investment securities	-	-	-	-	837	837
Net losses on cash flow hedges	-	-	-	-	(1,436)	(1,436)
Total comprehensive income	-	-	19,249	-	(599)	18,650
Transactions with owners						
Shares issued in the year	23,000	207,000	-	-	-	230,000
Dividends to ordinary shareholders	-	-	(152,800)	-	-	(152,800)
Dividends to other equity holders	-	-	(1,066)	-	-	(1,066)
Total transactions with owners	23,000	207,000	(153,866)			76,134
Balance at 28 February 2010	47,790	430,110	152,952	45,000	(153)	675,699
Comprehensive income						
Profit for the year	-	-	99,369	-	-	99,369
Net gains on available for sale investment securities	-	-	-	-	1,615	1,615
Net gains on cash flow hedges	-	-	-	-	789	789
Total comprehensive income	-	-	**99,369**	-	**2,404**	**101,773**
Transactions with owners						
Shares issued in the year	44,550	400,950	-	-	-	445,500
Dividends to ordinary shareholders	-	-	(162,150)	-	-	(162,150)
Dividends to other equity holders	-	-	(854)	-	-	(854)
Total transactions with owners	**44,550**	**400,950**	**(163,004)**	-	-	**282,496**
Balance at 28 February 2011	**92,340**	**831,060**	**89,317**	**45,000**	**2,251**	**1,059,968**

TESCO PERSONAL FINANCE PLC

CASH FLOW STATEMENT

FOR THE YEAR ENDED 28 FEBRUARY 2011

	Note	2011 £'000	2010 £'000
Operating activities			
Profit before taxation		134,872	16,971
Adjusted for:			
Non-cash items included in profit before taxation	44	(174,281)	164,391
Changes in operating assets and liabilities	44	426,493	(819,932)
Income taxes paid		(3,734)	(13,625)
Cash flows from operating activities		**383,350**	(652,195)
Investing activities			
Purchase of non-current assets		(206,586)	(68,741)
Purchase of available for sale investment securities		(424,357)	(482,304)
Sale of available for sale investment securities		165,756	50,004
Loan to associate		(34,431)	-
Investment in associate	23	(68,851)	(2,857)
Cash flows from investing activities		**(568,469)**	(503,898)
Financing activities			
Proceeds from issue of debt securities		125,559	-
Proceeds from issue of subordinated liabilities		-	30,000
Proceeds from issue of share capital	34	445,500	230,000
Dividends paid to ordinary share holders		(162,150)	(152,800)
Dividends paid to other equity holders		(714)	(935)
Interest paid on subordinated liabilities		(2,783)	(2,663)
Cash flows from financing activities		**405,412**	103,602
Net increase/(decrease) in cash and cash equivalents		220,293	(1,052,491)
Cash and cash equivalents at the beginning of the year		405,468	1,457,959
Cash and cash equivalents at the end of the year	43	**625,761**	405,468

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES

BASIS OF PREPARATION

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB, as endorsed by the European Union (EU), and those parts of the Companies Act applicable to companies reporting under IFRS.

The 'Company' means Tesco Personal Finance plc.

The financial statements are presented in Sterling which is the functional currency of the Company. The figures shown in the financial statements are rounded to the nearest thousand unless otherwise stated.

PRINCIPAL ACCOUNTING POLICIES

a) ACCOUNTING CONVENTION

The Company is incorporated and domiciled in the UK and registered in Scotland. The financial statements have been prepared on the historical cost basis as modified by the revaluation of certain financial assets and liabilities (including derivative instruments) at fair value. A summary of the Company's accounting policies is set out below. These policies have been consistently applied to all of the years presented, unless otherwise stated.

b) NET INTEREST INCOME RECOGNITION

Interest income on financial assets that are classified as loans and receivables or available for sale, and interest expense on financial liabilities are determined using the effective interest rate method. The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability (or group of financial assets or liabilities) and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows to the instrument's initial carrying amount. Calculation of the effective interest rate takes into account fees receivable, that are an integral part of the instrument's yield, premiums or discounts on acquisition or issue, early redemption fees and transaction costs. All contractual terms of a financial instrument are considered when estimating future cash flows.

c) NON INTEREST INCOME RECOGNITION

Fees in respect of services (primarily credit card interchange fees and ATM revenue) are recognised as the right to consideration accrues through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable.

The Company generates commission from the sale and service of Motor and Home insurance policies underwritten by Tesco Underwriting Limited, or in a minority of cases by a third party underwriter. This is based on commission rates which are independent of the profitability of underlying insurance policies. Similar commission income is also generated from the sale of white label insurance products underwritten by other third party providers.

The Company continues to receive insurance commission arising from the sale of insurance policies sold under the Tesco brand through the legacy arrangement with the Royal Bank of Scotland (RBS). This commission income is variable and dependant upon the profitability of the underlying insurance policies.

Revenue recognition – customer loyalty programmes

The Company participates in the customer loyalty programme operated by Tesco Stores Limited. The programme operates by allowing customers to accumulate Clubcard points on products for future redemption in Tesco stores. The cost of providing Clubcard points to customers is recharged by Tesco Stores Limited to the Company and is treated as a deduction from non-interest income in the financial statements of the Company in the period the costs are incurred.

The Company has no obligation to customers in respect of Clubcard points once the obligation with Tesco Stores Limited is settled.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

d) DIVIDEND INCOME

Dividends are recognised in the income statement when the entity's right to receive payment is established.

e) TAXATION

The tax expense included in the income statement consists of current and deferred tax.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted by the balance sheet date. Tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in other comprehensive income or equity, respectively.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is calculated at the tax rates that have been enacted or substantively enacted by the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity or other comprehensive income, in which case the deferred tax is also recognised in equity, or other comprehensive income, respectively.

Deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

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

f) FOREIGN CURRENCIES

Foreign currency transactions that are transactions denominated, or that require settlement, in a foreign currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions.

Monetary items denominated in foreign currency are translated with the closing rate as at the reporting date. Non-monetary items measured at historical cost denominated in a foreign currency are translated with the exchange rate as at the date of initial recognition; non-monetary items in a foreign currency that are measured at fair value are translated using the exchange rates at the date when the fair value was determined.

Foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as gains or losses from qualifying cash flow hedging instruments.

All foreign exchange gains and losses recognised in the income statement are presented net in the income statement within the corresponding item. Foreign exchange gains and losses on other comprehensive income items are presented in other comprehensive income within the corresponding item.

In the case of changes in the fair value of monetary assets denominated in foreign currency classified as available for sale, a distinction is made between translation differences resulting from changes in amortised cost of the security and other changes in the carrying amount of the security. Translation differences related to changes in the amortised cost are recognised in the income statement, and other changes in the carrying amount, except impairment, are recognised in equity.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

g) CASH AND CASH EQUIVALENTS

Cash and cash equivalents comprise cash on hand and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of changes in value.

h) FINANCIAL ASSETS

The Company classifies its financial assets into the following categories: financial assets at fair value through profit or loss, loans and receivables and available-for-sale. Management determines this classification at initial recognition.

i) Financial assets at fair value through profit and loss – This can be classified into the following two categories; assets designated at fair value through profit and loss at inception and financial assets held for trading.

The Company does not currently hold any financial assets designated at fair value through profit and loss at inception. Where the Company holds derivatives that are unable to be designated as hedging instruments these are classified as held for trading.

Financial instruments included in this category are recognised initially at fair value; transaction costs are taken directly to the income statement. Gains and losses arising from changes in fair value are included directly in the income statement and reported separately.

ii) Loans and receivables – The Company's loans and advances to banks and customers with fixed or determinable repayments that are not quoted in an active market, are classified as loans and receivables. Loans and receivables are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at amortised cost using the effective interest method less any impairment losses.

iii) Available for sale – Available for sale investments are those intended to be held for an indefinite period of time, which may be sold in response to the need for liquidity or changes in interest rates, exchange rates or other market prices.

Available for sale financial assets are initially recognised at fair value plus transaction costs and measured subsequently at fair value with gains and losses being recognised in the statement of comprehensive income, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised.

If an available for sale financial asset is determined to be impaired, the cumulative gain or loss previously recognised in the statement of comprehensive income is recognised in the income statement. Interest on available for sale assets is calculated using the effective interest method, and foreign currency gains and losses on monetary assets classified as available for sale are recognised in the income statement.

The Company records contracts that take place on the date at which the contract has been entered into.

i) FINANCIAL LIABILITIES

The Company classifies its financial liabilities in two categories: those held at amortised cost and derivatives which are held at fair value. Management determines this classification at initial recognition.

i) Financial liabilities held at amortised costs – This includes the following balance sheet categories; deposits from banks or customers, debt securities in issue for which the fair value option is not applied, and subordinated debt.

ii) Financial liabilities at fair value through profit and loss – This includes derivatives which are held at fair value.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

j) DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

Financial assets and liabilities are derecognised when the rights to receive cash flows have expired or where substantially all of the risks and rewards of ownership have been transferred and the transfer qualifies for derecognition.

Collateral furnished by the Company under standard repurchase agreements is not derecognised because the Company retains substantially all the risks and rewards on the basis of the predetermined repurchase price, and the criteria for derecognition are therefore not met. This also applies to certain securitisation transactions in which the Company retains a portion of the risks.

k) OFFSETTING OF FINANCIAL INSTRUMENTS

Financial assets and liabilities are offset and the net amount reported in the statement of financial position if, and only if, there is a current enforceable legal right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise an asset and settle the liability simultaneously.

l) IMPAIRMENT OF FINANCIAL ASSETS

The Company assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. A financial asset or portfolio of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

i) Financial assets carried at amortised cost - if there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables has been incurred, the Company measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of estimated future cash flows from the asset or group of assets discounted at the effective interest rate of the instrument at initial recognition. Impairment losses are assessed individually for financial assets that are individually significant and collectively for assets that are not individually significant. In making collective assessment of impairment, financial assets are grouped into portfolios on the basis of similar risk characteristics. Future cash flows from these portfolios are estimated on the basis of the contractual cash flows and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted, on the basis of currently observable data, to reflect the effects of current conditions that did not affect the historical period.

Impairment losses are recognised in profit or loss and the carrying amount of the financial asset or group of financial assets reduced by establishing an allowance for impairment losses. If in a subsequent year the amount of the impairment loss reduces and the reduction can be related objectively to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance. Once an impairment loss has been recognised on a financial asset or group of financial assets, interest income is recognised on the carrying amount using the rate of interest at which estimated future cash flows were discounted in measuring impairment.

ii) Financial assets classified as available for sale – in the case of investment securities classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is objective evidence of impairment resulting in the recognition of an impairment loss. If any such evidence exists for available for sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the income statement. Impairment losses recognised in the income statement on investment securities are not reversed through the income statement. If, in a subsequent year, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

m) DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

The Company uses derivative financial instruments to hedge its exposure to interest rate and foreign exchange risks arising from operating, financing and investment activities. The Company does not hold or issue derivative financial instruments for trading purposes.

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value. Fair values are obtained from valuation techniques (for example for swaps and currency transactions) including discounted cash flow models using solely observable market data. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

The method of recognising the resulting fair value gain or loss depends on whether the derivative is designated and qualifies as a hedging instrument, and if so, the nature of the item being hedged. The Company designates certain derivatives as either:

i) Hedges of highly probable future cash flows attributable to a recognised asset or liability, or a forecasted transaction (cash flow hedges); or

ii) Hedges of the fair value of recognised assets or liabilities or firm commitments (fair value hedges).

The Company documents, at the inception of the transaction, the relationship between hedged items and hedging instruments, as well as its risk management objective and strategy for undertaking various hedge transactions. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in other comprehensive income. The gain or loss relating to the ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the years when the hedged item affects profit or loss. They are recorded in the revenue or expense lines in which the related hedged item is reported.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Fair value hedges

The Company currently applies fair value hedge accounting for hedging fixed interest rate risk which is inherent in the writing of fixed rate loans business and the holding of fixed rate investment securities. The hedge protects against fluctuations in fair value of the fixed rate loans as interest rates move. The hedge achieves the desired risk management objective of a floating rate LIBOR based return by swapping the fixed rates receivable on loans and investment securities for floating rates.

Changes in fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. The net result is included as ineffectiveness within net interest income.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item is amortised to profit or loss over the period to maturity and recorded as net interest income.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

Derivatives not in hedge accounting relationships
The gain or loss relating to derivatives classified as trading is recognised in the income statement within (losses)/gains on financial assets.

n) INVESTMENT IN ASSOCIATE
An associate is an entity over which the Company has significant influence and can participate in the financial and operating policy decisions of the entity.

Investments in associates are carried in the statement of financial position at cost, less any impairment in value.

o) INVESTMENT IN GROUP UNDERTAKING
The Company's investment in its subsidiary is stated at cost less any impairment.

p) IMPAIRMENT OF INVESTMENTS IN SUBSIDIARIES AND ASSOCIATES
At each reporting date, the Company assesses whether there is any indication that its investments held in subsidiaries and associates are impaired. If any such indication exists, the Company estimates the recoverable amount of the asset. If the carrying value exceeds the recoverable amount then a provision for impairment is made to reduce the carrying value to the recoverable amount. No investments in subsidiaries or associates were impaired as at 28 February 2011 (2010: nil).

q) PROPERTY, PLANT AND EQUIPMENT
Items of plant, property and equipment are stated at cost less accumulated deprecation (refer below) and any impairment losses. Where an item of plant and equipment comprises major components having different useful lives, they are accounted for separately.

Depreciation is charged to the income statement on a straight-line basis so as to write off the depreciable amount of property, plant and equipment over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Depreciation commences on the date that the asset is brought into use. Work In Progress assets are not depreciated until they are brought into use and transferred to the appropriate category of property, plant and equipment. Estimated useful lives for property, plant and equipment are:

• Plant and Equipment	2 to 8 years
• Fixture and Fittings	4 to 5 years
• Computer Hardware	3 to 7 years
• Leasehold Improvements	15 to 20 years
• Freehold buildings	40 years

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in administrative expenses in the income statement.

Property, plant and equipment are reviewed for impairment in accordance with IAS 36 'Impairment of Assets' annually or when there are indications that the carrying value may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use. No property, plant and equipment were impaired as at 28 February 2011 (2010: nil)

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

r) INTANGIBLE ASSETS

Acquired intangible assets
Intangible assets that are acquired by the Company are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to the income statement on a straight-line basis over their estimated useful lives. The estimated useful lives are as follows:

- Computer software 3 to 10 years

Internally generated intangible assets – research and development expenditure
Research costs are expensed as incurred.

Development expenditure incurred on an individual project is capitalised only if the following criteria are met:

- An asset is created that can be identified (such as software);
- It is probable that the asset created will generate future economic benefits; and
- The development cost of the asset can be measured reliably.

Following the initial recognition of development expenditure, the cost is amortised over the estimated useful lives of the assets created. Amortisation commences on the date that the asset is brought into use. As assets categorised as Work In Progress are brought into use the assets are transferred to the appropriate classification within intangible assets.

Intangible assets are reviewed for impairment in accordance with IAS 36 'Impairment of Assets' annually or when there are indications that the carrying value may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use. No intangible assets were impaired as at 28 February 2011 (2010: nil)

s) LEASES

If the lease does not transfer the risks and rewards of ownership of the asset, the lease is recorded as an operating lease.

Operating lease payments are charged to the income statement on a straight line basis over the period of the 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 the termination is made. The Company has entered into a number of operating leases for office buildings.

t) EMPLOYEE BENEFITS

The Company accounts for pension costs on a contributions basis in line with the requirements of IAS 19. The Company makes contributions to the Tesco plc scheme.

IAS 19 requires that where there is no policy or agreement for sharing the cost of the IAS 19 charge across the subsidiaries that the Sponsoring employer recognises the net defined benefit cost of a defined benefit scheme. The Sponsoring employer is Tesco plc and the principal pension plan is the Tesco plc pension scheme. The scheme is a funded defined benefit scheme in the UK, the assets of which are administered by trustees. Tesco plc has recognised the appropriate net liability of the scheme.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

u) SHARE BASED PAYMENTS
Employees of the Company receive part of their remuneration in the form of share-based payment transactions, whereby employees render services in exchange for Tesco plc shares or rights over shares (equity-settled transactions) or in exchange for entitlements to cash based payments based on the value of the shares (cash-settled transactions).

The fair value of employee share option plans is calculated at the grant date using the Black-Scholes model. In accordance with IFRS 2 ‘Share-based payment’, the resulting cost is charged to the income statement over the vesting period. The value of the charge is adjusted to reflect expected and actual levels of vesting.

v) PROVISIONS FOR LIABILITIES AND CHARGES AND CONTINGENT LIABILITIES
A provision is recognised where there is a present legal or constructive obligation as a result of a past event, it is probable that the obligation will be settled and the amount of the obligation can be reliably estimated.

w) CAPITAL INSTRUMENTS
The Company classifies a financial instrument that it issues as a financial asset, financial liability or an equity instrument in accordance with the substance of the contractual arrangement. An instrument is classified as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms.

An instrument is classified as equity if it evidences a residual interest in the assets of the Company after the deduction of liabilities.

x) SHARE CAPITAL
i) Share issue costs – Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

ii) Dividends on shares – Dividends on shares are recognised in equity in the period they are approved by the Company’s Board.

y) SEGMENT REPORTING
Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker is the person or group that allocates resources to and assesses the performance of the operating segments of an entity. The Company has determined the Board of Directors as its chief operating decision-maker.

Income and expenses directly associated with each segment are included in determining business segment performance.

In accordance with IFRS 8, the Company has the following business segments: retail banking and insurance.

NOTES TO THE FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES (continued)

z) STANDARDS, AMENDMENTS AND INTERPRETATIONS, WHICH BECAME EFFECTIVE IN 2010 AND ARE RELEVANT TO THE COMPANY

The following standards, amendments and interpretations, which became effective in 2010, are relevant to the Company:

i) Amendment to IFRS 2, 'Share based payments – Group cash-settled share based payment transactions'. The amendment incorporates IFRIC 8 and IFRIC 11 into the standard and amends the definitions included within IFRS2. This has no impact on the Company.

ii) Amendment to IAS 32 'Financial Instruments: Presentation on classification of rights issues'. The amendment addresses the accounting for rights issues (rights, options or warrants) that are denominated in a currency other than the functional currency of the issuer. This has no impact on the Company.

iii) Improvements to IFRS (2009) (effective 1 January 2010) – These improvements contain numerous amendments to IFRS that the IASB consider non-urgent but necessary. This has no material impact on accounting policies.

aa) STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE

The following standards and interpretations have been issued and are mandatory for the Company's accounting periods beginning on or after 1 March 2011 or later periods and are expected to be relevant to the Company:

- IFRIC 18, 'Extinguishing financial liabilities with equity instruments' (effective annual periods beginning on or after 1 July 2010)
- IFRIC 14 , 'Prepayments of a minimum funding requirement' (effective annual periods beginning on or after 1 January 2011)
- IAS 24 'Related party disclosure' (effective annual periods on or after 1 January 2011)
- IAS 12, 'Income taxes' on deferred tax' (effective annual periods beginning on or after 1 January 2012)
- IFRS 9, 'Financial Instruments' (effective annual periods beginning 1 January 2013, not yet endorsed by the EU)

ab) EARLY ADOPTION STANDARDS

The Company did not early-adopt any new or amended standards in the year ended 28 February 2011.

NOTES TO THE FINANCIAL STATEMENTS

2 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

The reported results of the Company are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. The Company's principal accounting policies are set out above. United Kingdom company law and IFRS require the Directors, in preparing the Company's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. Where accounting standards are not specific and management have to choose a policy, International Accounting Standard ("IAS") 8 'Accounting Policies, Changes in Accounting Estimates and Errors' requires them to adopt policies that will result in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB Framework for the Preparation and Presentation of Financial Statements.

The judgements and assumptions involved in the Company's accounting policies that are considered to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Company would affect its reported results.

a) LOAN IMPAIRMENT PROVISIONS

The Company's loan impairment provisions are established to recognise incurred impairment losses in its portfolio of loans classified as loans and receivables and carried at amortised cost. A loan is impaired when there is objective evidence that events since the loan was granted have affected expected cash flows from the loan. The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows at the loan's original effective interest rate.

At 28 February 2011, gross loans and receivables totalled £4,861,005,000 (2010: £4,611,208,000) and loan impairment provisions amounted to £181,821,000 (2010: £313,991,000).

The Company's loan impairment provisions are established on a portfolio basis taking into account the level of arrears, security, past loss experience and defaults based on portfolio trends. The most significant factors in establishing these provisions are the expected loss rates. These portfolios include credit card receivables and other personal advances. The future credit quality of these portfolios is subject to uncertainties that could cause actual credit losses to differ materially from reported loan impairment provisions. These uncertainties include the economic environment, notably interest rates and their effect on customer spending, the unemployment level, payment behaviour and bankruptcy trends.

b) PROVISION FOR CUSTOMER REDRESS

The Company has a provision for potential customer redress. During the year, the Financial Services Authority (FSA) formally issued Policy Statement 10/12 (PS 10/12), which introduces new guidance in respect of Payment Protection Insurance (PPI) customer redress and evidential provisions to the FSA Handbook with an implementation date of 1 December 2010. The Company will continue to handle complaints and redress customers in accordance with PS 10/12. This will include ongoing analysis of historical claims experience in accordance with the guidance.

The calculation of this provision involves estimating a number of variables, principally the level of customer complaints which may be received and the level of any compensation which may be payable to customers. The number of cases on which compensation is ultimately payable may also be influenced by the outcome of the analysis of historical claims referred to above. A change in the estimate of any of the key variable in this calculation could have the potential to significantly impact the provision recognised.

c) INSURANCE RESERVES

Until October 2010 all Tesco Bank branded insurance products were sold through the RBS insurance partner. The Company continues to recognise insurance commission arising from sales made prior to this date on unexpired policies and outstanding claims. The level of commission on such sales is dependent upon the profitability of the underlying insurance policies, which is in turn dependent on the level of reserves held by the insurance trading partner to underwrite the policies in place. Calculation of the required level of insurance claims reserves is dependent on a detailed actuarial review. Management also undertakes an assessment of other risks which are outside the scope of this review but that are inherent in assessing potential claims liabilities. A change in the estimate of any of the key variables in this calculation could have

NOTES TO THE FINANCIAL STATEMENTS

2 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES (continued)

the potential to significantly impact the reserve balance recognised which would therefore also impact the insurance commission revenue recognised in the income statement. As new sales are no longer made using the RBS insurance partner the sensitivity of commission income relates only to the cost of settlement of historic insurance policies.

Following the year end actuarial review of RBS insurance reserves in relation to these historic claims the Company has recognised a reduction in commission income of £99,347,000 in relation to Motor Insurance claims at 28 February 2011. This reduced total insurance commission for the year ended 28 February 2011 to £15,175,000 (2010: £119,173,000).

Since October 2010 all new insurance sales have been underwritten by Tesco Underwriting Limited and other white label providers. Commission recognised on these sales is independent of the profitability of the underlying insurance policies.

d) EFFECTIVE INTEREST RATE

In calculating the effective interest rate of a financial instrument the Company takes into account all amounts that are integral to the yield. In the case of loans and advances to customers judgement is applied in estimating future cash flows. Judgement is also required in estimating the expected average life of customer debt balances. A change in the estimate of any of the key variables in this calculation could have the potential to significantly impact income recognised in the income statement.

NOTES TO THE FINANCIAL STATEMENTS

3 OPERATING SEGMENTS

Following the management approach of IFRS 8, operating segments are reported in accordance with the internal reporting provided to the Chief Executive and the Board of Directors, who are responsible for allocating resources to the reporting segments and assessing their performance. All operating segments used by the Company meet the definition of a reportable segment under IFRS 8.

The Company has two main operating segments:
- Retail banking - incorporating loans, credit cards, savings accounts and ATMs; and
- Insurance - incorporating motor, home, pet, travel and other insurance products.

There are no transactions between the operating segments.

Segment assets and liabilities comprise operating assets and liabilities, being the majority of the statement of financial position, but exclude items such as taxation. Tax balances are reflected in the adjustments column in part b) of this note.

a) Segment results of operations

2011	**Retail banking £'000**	**Insurance £'000**	**Total £'000**
Interest and similar income	420,087	-	420,087
Interest expense and similar charges	(147,129)	-	(147,129)
Fees and commissions income *	270,555	15,175	285,730
Fees and commissions expense	(20,291)	-	(20,291)
Provision for customer redress	50,000	-	50,000
Dividend income	3,726	-	3,726
Losses on financial assets	(610)	-	(610)
Realised gain on investment securities	564	-	564
Administrative expenses**	(287,041)	(19,417)	(306,458)
Depreciation and amortisation	(19,391)	-	(19,391)
Impairment	(130,942)	(414)	(131,356)
Profit/(Loss) before tax	**139,528**	**(4,656)**	**134,872**
Total assets	**6,527,542**	**481,649**	**7,009,191**
Total liabilities	**5,923,875**	**16,960**	**5,940,835**

* The Insurance commission income for the year is after a reduction of £99,347,000 in relation to Motor Insurance claims (refer note 2c)

** The Insurance segment includes only directly attributable administrative costs such as marketing and operational costs. Central overhead costs are reported within the Retail banking segment.

NOTES TO THE FINANCIAL STATEMENTS

3 OPERATING SEGMENTS (continued)

2010	Retail banking £'000	Insurance £'000	Total £'000
Interest and similar income	367,169	-	367,169
Interest expense and similar charges	(135,860)	-	(135,860)
Fees and commissions income	233,042	119,173	352,215
Fees and commissions expense	(20,988)	-	(20,988)
Provision for customer redress	(100,000)		(100,000)
Dividend income	28,216	-	28,216
Gains on financial assets	1,100	-	1,100
Realised gain on investment securities	139	-	139
Administrative expenses	(289,713)	(2,328)	(292,041)
Depreciation and amortisation	(6,346)	-	(6,346)
Impairment	(176,633)	-	(176,633)
(Loss)/Profit before tax	**(99,874)**	**116,845**	**16,971**
Total assets	**5,454,081**	**309,421**	**5,763,502**
Total liabilities	**5,111,184**	**-**	**5,111,184**

b) Reconciliation of segment results of operations to results of operations

2011	Total management reporting £'000	Consolidation and adjustments £'000	Total consolidated £'000
Interest and similar income	420,087	-	420,087
Interest expense and similar charges	(147,129)	-	(147,129)
Fees and commissions income	285,730	-	285,730
Fees and commissions expense	(20,291)	-	(20,291)
Provision for customer redress	50,000	-	50,000
Dividend income	3,726	-	3,726
Losses on financial assets	(610)	-	(610)
Realised gain on investment securities	564	-	564
Administrative expenses	(306,458)	-	(306,458)
Depreciation and amortisation	(19,391)	-	(19,391)
Impairment	(131,356)	-	(131,356)
Profit before tax	**134,872**	**-**	**134,872**
Total assets	**7,009,191**	**-**	**7,009,191**
Total liabilities	**5,940,835**	**8,388**	**5,949,223**

NOTES TO THE FINANCIAL STATEMENTS

3 OPERATING SEGMENTS (continued)

2010	Total management reporting £'000	Consolidation and adjustments £'000	Total consolidated £'000
Interest and similar income	367,169	-	367,169
Interest expense and similar charges	(135,860)	-	(135,860)
Fees and commissions income	352,215	-	352,215
Fees and commissions expense	(20,988)	-	(20,988)
Provision for customer redress	(100,000)		(100,000)
Dividend income	28,216	-	28,216
Gains on financial assets	1,100	-	1,100
Realised gain on investment securities	139	-	139
Administrative expenses	(292,041)	-	(292,041)
Depreciation and amortisation	(6,346)	-	(6,346)
Impairment	(176,633)	-	(176,633)
Profit before tax	**16,971**	**-**	**16,971**
Total assets	**5,763,502**	**23,381**	**5,786,883**
Total liabilities	**5,111,184**	**-**	**5,111,184**

4 NET INTEREST INCOME

	2011 £'000	2010 £'000
Interest and similar income		
Loans and advances to customers	386,318	329,826
Loans and advances to banks	9,759	18,030
Fair value hedge ineffectiveness	11,359	9,824
Interest on investment securities	11,983	7,161
Other	668	2,328
	420,087	**367,169**
Interest expense and similar charges		
Deposits from customers	(99,850)	(91,307)
Deposits from banks and interest rate swap expenses	(44,086)	(41,335)
Subordinated liabilities	(3,193)	(3,218)
	(147,129)	**(135,860)**

NOTES TO THE FINANCIAL STATEMENTS

5 NET FEES AND COMMISSIONS INCOME

	2011 £'000	Restated 2010 £'000
Fees and commissions income		
Banking fees and commission	259,784	232,522
Insurance income	15,175	119,173
Other fees	10,771	520
	285,730	**352,215**
Fees and commissions expense		
Banking expenses	(17,230)	(14,399)
Other expenses	(3,061)	(6,589)
	(20,291)	**(20,988)**

6 (LOSSES)/GAINS ON FINANCIAL ASSETS

	2011 £'000	2010 £'000
Foreign exchange loss on financial assets	(7,923)	
Net gains arising on derivatives not designated as hedging instruments under the terms of IAS 39.	7,313	1,100
	(610)	**1,110**

7 REALISED GAIN ON INVESTMENT SECURITIES

	2011 £'000	2010 £'000
Financial assets classified as available for sale		
Realised gain on disposals	**564**	**139**

NOTES TO THE FINANCIAL STATEMENTS

8 ADMINISTRATIVE EXPENSES

	2011 £'000	2010 £'000
Staff Costs (refer below)	77,571	49,741
Premises and equipment	67,667	50,003
Marketing	35,034	12,058
Auditors' remuneration (refer below)	350	194
Other administrative expenses	125,836	180,045
	306,458	**292,041**

The average monthly number of persons (including executive Directors) employed by the Company during the year was 1,274 (2010: 432), of which 22 (2010: 32) were seconded to another Group company, Tesco Personal Finance Compare Limited, during the year.

Staff costs (including executive Directors) for the year are as follows:

	2011 £'000	2010 £'000
Wages and salaries	47,304	29,296
Social security costs	3,888	2,177
Pension costs	3,161	1,589
Share based payments	6,162	4,279
Other costs including temporary staff	17,056	12,400
	77,571	**49,741**

Remuneration paid to the auditors for the year was as follows:

	2011 £'000	2010 £'000
Fees payable to the Company's auditors for the audit of the annual financial statements	280	160
Fees payable for the audit of the Company's subsidiaries pursuant to legislation	-	19
	280	**179**
Fees payable to the Company's auditors for other assurance services	70	15
	70	**15**

NOTES TO THE FINANCIAL STATEMENTS

9 DEPRECIATION AND AMORTISATION

	2011 £'000	2010 £'000
Depreciation of property, plant and equipment (refer note 26)	11,458	6,241
Amortisation of intangible assets (refer note 25)	7,933	105
	19,391	**6,346**

10 IMPAIRMENT

	2011 £'000	2010 £'000
Impairment loss on loans and advances (refer note 17)	130,942	176,633
Impairment loss on amounts due in respect of insurance premiums and commissions receivable	414	-
	131,356	**176,633**

11 DIRECTORS' EMOLUMENTS

The remuneration of the Directors paid by the Company during the year was as follows:

	2011 £'000	2010 £'000
Total emoluments received by Directors	3,338	3,477

The total emoluments of the highest paid Director were £1,326,000 (2010: £1,529,000).

NOTES TO THE FINANCIAL STATEMENTS

12 INCOME TAX EXPENSE

	2011 £'000	2010 £'000
Current tax charge for the year	25,861	(9,810)
Current tax under provided on profits for prior periods	-	446
Total current tax	**25,861**	**(9,364)**
Deferred tax charge for the year	11,308	7,204
Impact of tax rate change	(189)	-
Deferred tax over provided on profits for prior periods	(1,477)	(118)
Total deferred tax (refer note 24)	**9,642**	**7,086**
Income tax expense	**35,503**	**(2,278)**

The UK standard rate of corporation tax for the year ended 28 February 2011 was 28% (2010: 28%).

The actual tax charge for the current year and the previous year differs from the standard rate for the reasons set out in the following reconciliation.

	2011 £'000	2010 £'000
Profit before taxation	134,872	16,971
Tax on profit at standard rate	37,764	4,752
Factors affecting charge for the year:		
Group relief surrendered without payment	(108)	-
Income not subject to tax	(1,043)	(7,900)
Expenses not deductible for tax purposes	38	18
Adjustment to prior periods – current tax	-	445
Adjustment to prior periods – deferred tax	(1,477)	(118)
Share based payments	1,055	824
Other tax adjustments	(537)	(299)
Tax rate change	(189)	-
Income tax expense	**35,503**	**(2,278)**

A number of changes to the UK Corporation tax system were announced in the June 2010 Budget statement. The Finance (No.2) Act 2010 included legislation to reduce the main rate of corporation tax from 28% to 27% from 1 April 2011. The proposed reduction from 28% to 27% was substantively enacted at 28 February 2011 and has therefore been reflected in these financial statements.

In addition to the changes in rates of Corporation tax disclosed above a number of further changes to the UK Corporation tax system were announced in the March 2011 UK Budget Statement. A resolution passed by Parliament on 29 March 2011 reduced the main rate of corporation tax to 26% from 1 April 2011. Legislation to reduce the main rate of corporation tax from 26% to 25% from 1 April 2012 is expected to be included in the Finance Act 2011. Further reductions to the main rate are proposed to reduce the rate by 1% per annum to 23% by 1 April 2014. None of these expected rate reductions had been substantively enacted at the year end and, therefore, are not included in these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

13 DISTRIBUTIONS TO EQUITY HOLDERS

	2011 £'000	2010 £'000
Ordinary dividend paid	162,150	152,800
Interest paid on subordinated notes included within equity	854	1,066
	163,004	**153,866**

On 30 September 2010 a dividend of £0.01 per ordinary share was paid. On 25 February 2011 a further dividend of £0.16 per ordinary share was paid, resulting in a total dividend payment for the year of £162,150,000.

In the prior year, an interim dividend of £0.94 per ordinary share was paid on 19 October 2009, a further dividend of £0.31 per ordinary share was paid on 26 February 2010. This resulted in a total dividend payment for the year of £152,800,000.

Interest payable on the subordinated notes included within equity is based on three month LIBOR plus 120 basis points.

14 INCOME TAX RELATING TO COMPONENTS OF OTHER COMPREHENSIVE INCOME

28 February 2011	Before tax amount £'000	Tax (expense)/ benefit £'000	Net of tax amount £'000
Net gains on available for sale investment securities	2,243	(628)	1,615
Cash flow hedges	1,099	(310)	789
Other comprehensive income for the year	**3,342**	**(938)**	**2,404**
28 February 2010			
Net gains on available for sale investment securities	1,163	(326)	837
Cash flow hedges	(1,821)	385	(1,436)
Other comprehensive income for the year	**(658)**	**59**	**(599)**

NOTES TO THE FINANCIAL STATEMENTS

15 CASH AND BALANCES WITH CENTRAL BANKS

	2011 £'000	2010 £'000
Cash at Bank	11,714	107
Mandatory reserve deposits held with the Bank of England	4,240	3,330
Other balances held with the Bank of England	120,854	178,418
	136,808	**181,855**

Mandatory reserve deposits are not available for use in the Company's day to day operations and are non-interest bearing. Other balances are subject to variable interest rates based on the Bank of England base rates.

16 LOANS AND ADVANCES TO BANKS

	2011 £'000	2010 £'000
Loans and advances to banks	**323,136**	**61,937**

Loans and advances to banks represent cash and cash equivalents which had a maturity on original acquisition of less than three months.

17 LOANS AND ADVANCES TO CUSTOMERS

	2011 £'000	2010 £'000
Unsecured lending	4,845,499	4,583,444
Fair value hedge adjustment	15,506	27,764
Gross loans and advances to customers	**4,861,005**	**4,611,208**
Less: allowance for impairment	(181,821)	(313,991)
Net loans and advances to customers	**4,679,184**	**4,297,217**
Current	2,535,140	2,372,405
Non-current	2,144,044	1,924,812

As at the year end £1,355,995,000 of the credit card portfolio was securitised (2010: £1,458,764,000).

Fair value hedge adjustments amounting to £15,506,000 (2010: £27,764,000) are in respect of fixed rate loans. These adjustments reflect movements in interest rates from the date the loans were issued to the balance sheet date. These adjustments are largely offset by derivatives, which are used to manage interest rate risk and are designated as fair value hedges within loans and advances to customers.

NOTES TO THE FINANCIAL STATEMENTS

17 LOANS AND ADVANCES TO CUSTOMERS (continued)

The following table shows impairment provisions for loans and advances:

	2011 £'000	2010 £'000
At beginning of year	313,991	249,578
Amounts written off	(268,252)	(118,394)
Recoveries of amounts previously written off	8,636	10,430
Charge to the income statement	130,942	176,633
Unwind of discount	(3,496)	(4,256)
At end of year	**181,821**	**313,991**

Change in methodology

During the year the Company has amended its methodology for charging off loan and advances to customers. The impact of this is that loans balances are now manually charged off in the financial statements at an earlier date than in prior periods. This has resulted in an increase of £158,027,000 in uncollectible amounts written off within the provision movement in the current year and a corresponding decrease of £158,027,000 being recorded in the gross loan and advances to customers balance. Had a similar exercise been carried out last year, the effect on the prior year would have been to increase uncollectible amounts written off within the provision movement by £123,626,000 and to decrease the gross loan and advances to customers balance by the same amount. There is no change to the net carrying value of loan and advances to customers and no impact on the income statement in either the current or prior year.

18 DERIVATIVE FINANCIAL INSTRUMENTS

Strategy in using derivative financial instruments

The objective when using a derivative instrument is to ensure that the risk to reward profile of a transaction is optimised allowing the Company to manage its exposure to interest rate and foreign exchange rate risk. The intention is to only use derivatives to create economically effective hedges. There are specific requirements stipulated under IAS 39 which are necessary for a hedge to qualify for hedge accounting. As a result 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.

The Company does not intentionally hold trading positions in derivatives; however where a derivative held for economic hedging purposes does not qualify for hedge accounting, or if it has not specifically been designated as a hedge, these derivatives are categorised as held for trading in the statement of financial position. Gains and losses on these hedging instruments and the hedged items are offset in the income statement.

a) Fair value hedges

At 28 February 2011 the Company had a portfolio of micro hedge relationships in place with an aggregate notional principal of £2,188,582,000 (2010: £1,923,702,000).

The Company's risk management objective to create economically effective hedges is to use interest rate contracts to swap fixed rate exposures back to a floating rate LIBOR basis. This includes the hedging of fixed rate customer loans, holdings of fixed rate investment securities and issuances of fixed rate debt, which protects the Company against the fair value volatility of these financial assets and liabilities due to movements in LIBOR rates. Each swap is defined as hedging one or more fixed rate assets or liabilities.

The total fair value of derivatives held within fair value hedges at 28 February 2011 was a net liability of £22,470,000 (2010: £56,406,000).

NOTES TO THE FINANCIAL STATEMENTS

18 DERIVATIVE FINANCIAL INSTRUMENTS (continued)

b) Cash flow hedges
The Company designated two interest rate swaps (2010: three) as cash flow hedges and used these swaps to hedge the variability in cash flows associated with floating rate borrowings.

The total fair value of derivatives included within cash flow hedges as at 28 February 2011 was a net liability of £278,000 (2010: net liability of £1,391,000).

In 2011, there is no ineffectiveness recognised in the income statement in respect of cash flow hedges (2010: nil).

There were no transactions for which cash flow hedge accounting had to be ceased in the current or prior year as a result of the highly probable cash flows no longer being expected to occur.

c) Derivatives not in hedge relationships
All derivative financial instruments are held for economic hedging purposes, although not all derivatives are designated as hedging instruments under the terms of IAS 39. The Company has the following derivative contracts in economic hedge relationships but not in accounting hedge relationships.

- Forward foreign exchange contracts to hedge the exchange rate risk of the initial funding of the euro credit card business and eventual repayments by customers.
- Forward foreign exchange contracts and cross currency swaps to hedge the exchange rate risk inherent in the investment securities denominated in foreign currencies.
- Forward foreign exchange contracts to hedge the exchange rate risk inherent in holding stock denominated in foreign currencies in travel money bureaux.
- Interest rate swaps which have never been in hedge accounting relationships and are viewed as trading derivatives under IAS 39.

The total fair value of derivatives not in hedge relationships as at 28 February 2011 was a net asset of £1,757,000 (2010: net liability of £5,415,000).

The analysis below splits derivatives between those classified in hedge accounting relationships and those not in hedge accounting relationships.

Derivatives in accounting hedge relationships	**Notional 2011 £'000**	**Asset Fair value 2011 £'000**	**Liability Fair Value 2011 £'000**
Derivatives designated as fair value hedges			
Interest rate swaps	2,188,582	13,492	(35,962)
Derivatives designated as cash flow hedges			
Interest rate swaps	55,000	-	(278)
	2,243,582	**13,492**	**(36,240)**
Derivatives not in hedge accounting relationships			
Interest rate derivatives			
Interest rate swaps	50,000	821	(821)
Currency derivatives			
Forward foreign exchange contracts	63,769	117	(242)
Cross currency Swaps	86,155	1,948	(66)
	199,924	**2,886**	**(1,129)**
	2,443,506	**16,378**	**(37,369)**

NOTES TO THE FINANCIAL STATEMENTS

18 DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Derivatives in accounting hedge relationships	Notional 2010 £'000	Asset Fair value 2010 £'000	Liability Fair Value 2010 £'000
Derivatives designated as fair value hedges			
Interest rate swaps	1,923,702	-	(56,406)
Derivatives designated as cash flow hedges			
Interest rate swaps	155,000	-	(1,391)
	2,078,702	**-**	**(57,797)**
Derivatives not in hedge accounting relationships			
Interest rate derivatives			
Interest rate swaps	350,000	597	(2,856)
Currency derivatives			
Forward foreign exchange contracts	57,412	219	(1,005)
Cross currency Swaps	107,517	731	(3,101)
	514,929	**1,547**	**(6,962)**
	2,593,631	**1,547**	**(64,759)**

Derivatives whether designated in hedge accounting relationships or not, are regarded as current where they are expected to mature within one year. All other derivatives are regarded as non-current.

	Assets 2011 £'000	Assets 2010 £'000	**Liabilities 2011 £'000**	Liabilities 2010 £'000
Current	117	390	(6,723)	(13,858)
Non-current	16,261	1,157	(30,646)	(50,901)
	16,378	**1,547**	**(37,369)**	**(64,759)**

NOTES TO THE FINANCIAL STATEMENTS

19 INVESTMENT SECURITIES

	2011 £'000	2010 £'000
Available for sale:		
Government-backed investment securities	80,223	244,743
Gilts	188,059	-
Supranational investment securities	225,535	-
Other investment securities	112,696	97,685
Certificates of deposit	170,057	165,006
Asset-backed securities	73,261	96,828
	849,831	**604,262**
Loans and receivables:		
Loan to the Royal Bank of Scotland Insurance Group Limited	258,500	258,500
Loan to Tesco Underwriting Limited	34,431	-
	292,931	**258,500**
Current	202,346	223,970
Non-current	940,416	638,792

There were no impairment charges within the year (2010: £nil)

Available for sale
Included in investment securities are fixed-interest investment securities totalling £666,065,000 (2010: £322,205,000) and variable-interest investment securities amounting to £183,766,000 (2010: £282,057,000).

Loans and receivables
The loan to Royal Bank of Scotland Insurance Group Limited, a wholly owned subsidiary of The Royal Bank of Scotland plc, comprises an undated interest free subordinated loan of £258,500,000. During the year impairment charges of £nil (2010: £nil) were recognised on the loan.

The loan to Tesco Underwriting Limited comprises an LIBOR +3.5% subordinated loan of £34,431,000. During the year impairment charges of £nil (2010: £nil) were recognised on the loan.

Assets pledged as collateral
Available for sale investment securities with a market value of £44,554,000 (2010: £10,074,000) are pledged as collateral under repurchase agreements with other banks. All collateral agreements mature within 12 months.

NOTES TO THE FINANCIAL STATEMENTS

20 PREPAYMENTS AND ACCRUED INCOME

	2011 £'000	2010 £'000
Prepayments	9,142	4,341
Accrued income	102,534	86,659
	111,676	**91,000**

All amounts are receivable within one year.

21 OTHER ASSETS

	2011 £'000	2010 £'000
Amounts due from Tesco Group subsidiaries	393	2,560
Amounts due from subsidiary undertaking	-	9,485
Amount due from insurance premiums and commissions receivable	117,010	48,966
Other assets	83,488	81,863
	200,891	**142,874**

All amounts are receivable within one year.

22 INVESTMENT IN GROUP UNDERTAKING

Shares in group undertakings in the current and prior years relates to a 100% shareholding in TPF ATM Services Limited which is incorporated in Scotland, amounting to £2. This investment is classified as current as the entity is in the process of being liquidated.

23 INVESTMENT IN ASSOCIATE

Details of the Company's associate are as follows:

Name of company	**Nature of business**	**Place of incorporation**	**Ownership interest 28 February 2011**	**Ownership interest 28 February 2010**
Tesco Underwriting Limited (formerly Shoo 471 Limited)	Insurance	England	49.9%	49.9%

NOTES TO THE FINANCIAL STATEMENTS

23 INVESTMENT IN ASSOCIATE (continued)

On 8 October 2010 Shoo 471 Limited changed its name to Tesco Underwriting Limited.

The Company carries this investment at cost. The following table shows the aggregate movement in the Company's investment in the associate in the year:

	2011 £'000	2010 £'000
At beginning of year	2,857	-
Acquisition of ordinary share capital	68,851	-
Capitalised investment costs	-	2,857
At end of year	**71,708**	**2,857**

There are no contingent liabilities in respect of the associate. The investment in associate is non-current.

24 DEFERRED INCOME TAX ASSET/(LIABILITY)

The deferred tax asset/(liability) can be analysed as follows:

	Accelerated capital allowances £'000	Other £'000	Total £'000
At beginning of year	(4,813)	9,743	4,930
Charged to the income statement	(7,994)	(1,648)	(9,642)
Credited to equity	-	(310)	(310)
At end of year	**(12,807)**	**7,785**	**(5,022)**

The other deferred tax asset primarily relates to an asset created on transition to IFRS due to a change in accounting policy for loan relationship fees and bad debt provisions under IFRS. This deferred tax asset is being unwound over a period of 10 years.

The Directors consider that there will be sufficient future profits to support recognition of the deferred tax asset.

NOTES TO THE FINANCIAL STATEMENTS

25 INTANGIBLE ASSETS

	Work in Progress £'000	Computer Software £'000	Total £'000
Year ended 28 February 2010			
Opening net book value	-	-	-
Additions	59,875	558	60,433
Amortisation	-	(105)	(105)
Closing net book value	**59,875**	**453**	**60,328**
At 28 February 2010			
Cost	59,875	558	60,433
Accumulated amortisation	-	(105)	(105)
Net book value	**59,875**	**453**	**60,328**
Year ended 28 February 2011			
Opening net book value	59,875	453	60,328
Additions	138,847	24,033	162,880
Transfers	(120,901)	120,901	-
Amortisation	-	(7,933)	(7,933)
Closing net book value	**77,821**	**137,454**	**215,275**
At 28 February 2011			
Cost	77,821	145,492	223,313
Accumulated amortisation	-	(8,038)	(8,038)
Net book value	**77,821**	**137,454**	**215,275**

Work in progress relates primarily to the internal development of IT software assets as part of the migration to a new infrastructure for the Company.

Intangible asset balances are non-current.

NOTES TO THE FINANCIAL STATEMENTS

26 PROPERTY, PLANT AND EQUIPMENT

	Work in Progress £'000	Plant & Equipment £'000	Fixtures & Fittings £'000	Computer Hardware £'000	Freehold Building £'000	Leasehold Improvements £'000	Total £'000
At 28 February 2009							
Cost	-	6,124	3,868	55,553	-	-	65,545
Accumulated depreciation	-	(1,478)	(3,290)	(37,102)	-	-	(41,870)
Net book value	**-**	**4,646**	**578**	**18,451**	**-**	**-**	**23,675**
Year ended 28 February 2010							
Opening net book value	-	4,646	578	18,451	-	-	23,675
Additions	33,643	867	1,550	7,590	-	299	43,949
Transfers	-	(2,951)	-	-	-	2,951	-
Disposals	-	-	(31)	(227)	-	-	(258)
Depreciation charge	-	(520)	(321)	(5,238)	-	(162)	(6,241)
Closing net book value	**33,643**	**2,042**	**1,776**	**20,576**	**-**	**3,088**	**61,125**
At 28 February 2010							
Cost	33,643	4,040	5,387	62,916	-	3,250	109,236
Accumulated depreciation	-	(1,998)	(3,611)	(42,340)	-	(162)	(48,111)
Net book value	**33,643**	**2,042**	**1,776**	**20,576**	**-**	**3,088**	**61,125**
Year ended 28 February 2011							
Opening net book value	33,643	2,042	1,776	20,576	-	3,088	61,125
Additions	29,691	757	3,134	8,703	18,710	711	61,706
Transfers	(37,602)	(413)	663	21,790	-	15,562	-
Depreciation charge	-	(622)	(639)	(9,347)	-	(850)	(11,458)
Closing net book value	**25,732**	**1,764**	**4,934**	**41,722**	**18,710**	**18,511**	**111,373**
At 28 February 2011							
Cost	25,732	3,189	6,176	90,182	18,710	19,523	163,512
Accumulated depreciation	-	(1,425)	(1,242)	(48,460)	-	(1,012)	(52,139)
Net book value	**25,732**	**1,764**	**4,934**	**41,722**	**18,710**	**18,511**	**111,373**

Work in progress at 28 February 2011 relates primarily to the fit-out of a new office building and the development of IT infrastructure assets.

Property, plant and equipment balances are non-current.

NOTES TO THE FINANCIAL STATEMENTS

27 DEPOSITS FROM BANKS

	2011 £'000	2010 £'000
Deposits from banks	**36,200**	**29,856**

All amounts owed are repayable within one year.

28 DEPOSITS FROM CUSTOMERS

	2011 £'000	2010 £'000
Deposits from Tesco Personal Finance Group companies	3,090	13,489
Retail deposits	5,074,374	4,356,736
	5,077,464	**4,370,225**
Current	4,900,842	4,370,225
Non-current	176,622	-

29 DEBT SECURITIES IN ISSUE

	2011 £'000	2010 £'000
Floating rate bond maturing in 2012	224,696	224,390
Fired rate retail bond maturing in 2018	125,559	-
	350,255	**224,390**
Current	224,696	-
Non-current	125,559	224,390

On 27 February 2009 the Company issued a nominal £225,000,000 3 year floating rate bond guaranteed by the Commissioners of Her Majesty's Treasury. Interest payable is based on three month LIBOR plus 50 basis points.

On 24th February 2011 the Company issued a nominal £125,000,000 7.5 year fixed rate retail bond which is listed on the London Stock Exchange. Interest is payable at a fixed rate of 5.2%

30 PROVISIONS FOR LIABILITIES AND CHARGES

	2011 £'000	2010 £'000
At the beginning of the year	100,000	-
Charged to the income statement	-	100,000
Utilised during the year	(10,523)	-
Unused amounts reversed	(50,000)	-
At the end of the year	**39,477**	**100,000**

NOTES TO THE FINANCIAL STATEMENTS

30 PROVISIONS FOR LIABILITIES AND CHARGES (continued)

The provision balance relates to a provision for customer redress in respect of potential customer complaints arising from historic sales of Payment Protection Insurance (PPI). The provision is likely to be utilised over several years, although the timing of utilisation is uncertain. Hence the balance is classified as current at year end.

The provision as at 28 February 2010 was established based on a forecast of the level of complaints expected to be received. The number of complaints actually received and settled during the year has been lower than was expected, resulting in a reduction to the provision held at 28 February 2011 of £50,000,000. The Company will continue to handle claims and redress customers in accordance with PS 10/12 (refer note 2). This will include ongoing analysis of historical claims experience in accordance with the guidance.

The calculation of this provision involves estimating a number of variables. Further details provided in note 2b.

31 ACCRUALS AND DEFERRED INCOME

	2011 £'000	2010 £'000
Amounts accrued to Tesco plc	590	580
Amounts accrued to Tesco Group subsidiaries	2,651	1,335
Other accruals and deferred income	181,910	117,203
	185,151	**119,118**

All amounts accrued are repayable within one year.

32 OTHER LIABILITIES

	2011 £'000	2010 £'000
Amounts owed to Tesco Group subsidiaries	6,835	3,359
Other liabilities	18,084	9,477
	24,919	**12,836**

All amounts owed are repayable within one year.

NOTES TO THE FINANCIAL STATEMENTS

33 SUBORDINATED LIABILITIES

	2011 £'000	2010 £'000
Floating rate subordinated loan maturing 2017	30,000	30,000
Floating rate subordinated loan maturing 2018	35,000	35,000
Floating rate subordinated loan maturing 2020	30,000	30,000
Floating rate subordinated loan maturing 2022	95,000	95,000
	190,000	**190,000**

Subordinated liabilities comprise loan capital issued to Tesco Personal Finance Group Limited. All amounts are non-current.

The floating rate subordinated loans are repayable, in whole or in part, at the option of the issuer, prior to maturity, on conditions governing the debt obligation. Interest payable is based on three month LIBOR plus a range of 60 to 175 points.

34 SHARE CAPITAL AND SHARE PREMIUM

	2011 Number	2010 Number
Authorised		
Ordinary shares of 10p each	**Unlimited**	**Unlimited**

	2011 £'000	2010 £'000
Allotted, called up and fully paid		
Ordinary shares of 10p each	**92,340**	**47,790**

	2011 £'000	2010 £'000
Share Premium Account	**831,060**	**430,110**

During the year the Company issued 445,500,000 (2010: 230,000,000) ordinary shares to the parent company, Tesco Personal Finance Group Limited, for total consideration of £445,500,000 (2010: £230,000,000).

NOTES TO THE FINANCIAL STATEMENTS

35 OTHER RESERVES

	2011 £'000	2010 £'000
Cash flow hedge reserve	(201)	(990)
Available for sale reserve	2,452	837
	2,251	**(153)**

Cash flow hedge reserve
The effective portion of changes in the fair value derivative that are designated and qualify as cash flow hedges is included in the cash flow hedge reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement.

Available for sale reserve
Available-for-sale financial assets are initially recognised at fair value and measured subsequently at fair value with gains and losses being recognised in the statement of comprehensive income, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised.

36 SUBORDINATED NOTES

	2011 £'000	2010 £'000
Undated floating rate notes	**45,000**	**45,000**

The undated floating rate notes have no fixed maturity date and may not be repaid except under certain conditions such as the winding up of the Company.

37 EMPLOYEE BENEFIT LIABILITY

Tesco Personal Finance Group accounts for pension costs on a contributions basis in line with the requirements of IAS 19 and these contributions are made to the Tesco plc scheme by the Company.

IAS 19 requires that where there is no policy or agreement of sharing the cost of the IAS 19 charge across the subsidiaries that the Sponsoring employer recognises the net defined benefit cost of a defined benefit scheme. The Sponsoring employer is Tesco plc and the principal pension plan is the Tesco plc pension scheme. The scheme is a funded defined benefit scheme in the UK, the assets of which are held as a segregated fund and administered by trustees. Tesco plc has recognised the appropriate net liability of the scheme. Towers Watson Limited, an independent actuary, carried out the latest triennial actuarial assessment of the scheme as at 31 March 2008 using the projected unit method. The following disclosures relate to the Tesco plc pension scheme.

NOTES TO THE FINANCIAL STATEMENTS

37 EMPLOYEE BENEFIT LIABILITY (continued)

Principal assumptions

The valuations used for IAS 19 have been based on the most recent actuarial valuations and updated by Towers Watson to take account of the requirements of IAS 19 in order to assess the liabilities of the schemes as at 28 February 2011. The major assumptions, on a weighted average basis, used by the actuaries were as follows:

	2011 %	2010 %
Rate of increase in salaries	3.6	3.6
Rate of increase in pensions in payment*	3.3	3.4
Rate of increase in deferred pensions*	2.8	3.6
Rate of increase in career average benefits	3.5	3.6
Discount rate	5.9	5.9
Price inflation	3.5	3.6

*In excess of any Guaranteed Minimum Pension (GMP) element.

The main financial assumption is the real discount rate (i.e. the excess of the discount rate over the rate of price inflation). If this assumption increased/decreased by 0.1%, the UK defined benefit obligation would decrease/increase by approximately £150,000,000 and the annual UK current service cost would decrease/increase by approximately £14,000,000.

Rates of return on scheme assets

The assets in the Tesco plc defined benefit pension schemes and the expected rates of return were:

	2011		2010	
	Long term rate of return %	Market value £'000	Long term rate of return %	Market value £'000
Equities	8.5	3,032,000	8.7	2,521,000
Bonds	5.0	1,116,000	5.1	1,233,000
Property	6.8	511,000	7.0	343,000
Other (alternative assets)	8.5	563,000	8.7	484,000
Cash	4.0	386,000	4.1	115,000
Total market value of assets		**5,608,000**		**4,696,000**

The expected rate of return on assets is a weighted average based on the actual plan assets held and the respective returns expected on the separate asset classes. The expected rate of return on equities and cash have both been set with reference to the expected medium term, as calculated by Tesco plc's independent actuary. The expected rate of return on bonds was measured directly from actual yields for gilts and corporate bond stocks. The rate above takes into account the actual mixture of UK gilts, UK corporate bonds and overseas bonds held at the balance sheet date.

NOTES TO THE FINANCIAL STATEMENTS

37 EMPLOYEE BENEFIT LIABILITY (continued)

Movements in pension deficit during the year
Changes in the fair value of the Tesco plc defined benefit pension plan assets are as follows:

	2011 £'000	2010 £'000
Opening fair value of plan assets	4,696,000	3,420,000
Expected return	363,000	265,000
Actuarial gains	278,000	733,000
Contributions by employer	433,000	415,000
Actual Member Contributions	10,000	9,000
Foreign Currency translation differences	(9,000)	(2,000)
Benefits paid	(163,000)	(144,000)
Closing fair value of plan assets	**5,608,000**	**4,696,000**

Changes in the present value of defined benefits obligations are as follows:

	2011 £'000	2010 £'000
Opening defined benefit obligation	(6,536,000)	(4,914,000)
Current service cost	(499,000)	(391,000)
Interest cost	(381,000)	(313,000)
Gain/(Loss) on change of assumptions	342,000	(1,052,000)
Experience losses	(25,000)	(1,000)
Foreign currency translations differences	11,000	-
Benefits paid	163,000	144,000
Actual member contributions	(10,000)	(9,000)
Past service (costs)/gains	(29,000)	-
Closing defined benefit obligation	**(6,964,000)**	**(6,536,000)**

Post-retirement benefits other than pensions
Tesco plc operates a scheme offering post-retirement healthcare benefits. The cost of providing these benefits has been accounted for on a similar basis to that used for defined benefit pension schemes.

The liability in Tesco plc as at 28 February 2011 was £12,000,000 (2010: £12,000,000), which was determined in accordance with the advice of independent actuaries. £800,000 (2010: £700,000) has been charged to the Tesco plc income statement in the year and £600,000 (2010: £500,000) of benefits were paid.

A change of 1.0% in assumed healthcare cost trend rates would have the following effect:

	2011 £'000	2010 £'000
Effect on the annual service and interest cost	100	100
Effect on defined benefit obligations	1,800	1,500
Effect of 1.0% decrease in assumed medical cost rate on		
Service and interest cost	(100)	(100)
Defined benefit obligation	(1,400)	(1,500)

38 RISK MANAGEMENT

APPROACH TO RISK MANAGEMENT

Risk management is a strategic priority for the Company, with monitoring and actively managing the risk profile and conservatively managing the balance sheet being key objectives in the strategic plan. The Company is focused on developing a stable, cautious enterprise with a modest risk appetite and a conservative liquidity and funding profile.

The Board has overall responsibility for strategy and management of the business, including approval of the Company's risk appetite, approval of the risk and control framework and monitoring of the risk and capital adequacy profile.

The Company's risk appetite reflects the amount of risk that the Company is willing to accept in delivering its strategic objectives. Risk appetite provides a key link between strategic objectives and the risk management framework acting as a key reference point for decision-making and planning across the business. The Company measures risk appetite in both quantitative and qualitative terms with performance reported frequently to the Board Risk Committee (BRC) and the Board.

The Company has a framework of internal risk controls as more fully described below.

The Risk Management Committee (RMC) and the Asset & Liability Management Committee (ALCo) monitor and track performance against risk appetite at a detailed product and functional level. The BRC is responsible for reporting to the Board on overall risk appetite, tolerance and strategy, taking into account the current and prospective macroeconomic and financial environment, relevant and authoritative financial stability assessments and economic analysis; and capital and liquidity and its prospective adequacy over the cycle in light of the Company's overall strategy and risk appetite. Reporting to the BRC and the Board includes stress testing and scenario analysis which is designed to inform the Company of the required levels of capital and other financial resources, including liquidity, under various economic and business stressed scenarios.

RISK MANAGEMENT AND GOVERNANCE

The Chief Executive has executive responsibility for oversight of risk management and governance. The Board has ultimate responsibility for all material risk matters, but has delegated responsibility for the day to day identification of risks and managing them effectively to the Executive Committee, RMC and ALCo. A committee structure including the Board, Executive Committee, BRC, RMC, ALCo, Audit Committee and Remuneration Committee operated throughout the year as described below.

The Board

The Board has overall responsibility for the management of the business and acts as the main decision making forum for the Company. It agrees the strategy for the business and approves the Company's risk appetite and its policies, authorisations and the risk and control process. The Board monitors the risk management profile and capital adequacy position.

Executive Committee

The Board has delegated the day to day running of the business of the Company to the Chief Executive, who has chosen to manage day to day matters through an Executive Committee and a series of specialised sub committees.

The Executive Committee assists the Chief Executive in the performance of his duties, provides general executive management of the business and facilitates cross-functional communication and liaison. The operational management of the Company's business has been delegated to the Executive Committee which reviews and directs the ongoing operations of the business within the strategic framework, business plan, policies and risk appetite agreed by the Board. It monitors trade and financial performance on a regular basis and oversees risks and controls across the business.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

Board Risk Committee

The BRC operates under delegated authority from the Board and is comprised of no less than three independent non-executive Directors.

The role of the BRC is forward looking to anticipate future risks and also to align the business strategy (including new products) with risk appetite and to satisfy itself that adequate policies and processes are in place to promptly identify, assess and control the risks. The outputs of the RMC and ALCo are reviewed and challenged by the BRC to ensure that key risks are identified and managed. The BRC seeks to encourage the embedding of a supportive risk culture so that all employees are alert to the wider impact on the whole organisation of their actions and decisions.

Risk Management Committee

The RMC operates as a sub-committee of the Executive Committee. The main responsibility of the RMC is to oversee the management of key risks and issues in the business; to monitor and track performance against risk appetite at product and function level; to oversee the risk management framework; to seek to ensure that key risks are identified and managed; and to review and challenge the Regulatory, Operational, Credit and Insurance Risk disciplines regarding risks affecting or likely to affect the Company.

The RMC approves policies and procedures that have been delegated by the Board, to enable the effective management of risk for the Company.

The remit of the RMC includes all Credit, Operational (including fraud), Regulatory and Insurance risks affecting or likely to affect the Company.

Asset & Liability Management Committee

The ALCo operates as a sub-committee of the Executive Committee. The role of the ALCo is to optimise the Company's balance sheet structure and identify, manage and control balance sheet risks in the execution of the Company's chosen business strategy. The main areas of responsibility include: capital management, liquidity and funding risk management, large exposures, interest rate risk in the banking book, non trading foreign exchange risk management and intra Company limits. ALCo approves those policies delegated by the Company's Board in these areas.

ALCo provides policy and direction to the Treasury function for managing the Company's balance sheet.

Audit Committee

The role of the Audit Committee is to review the financial statements and to monitor accounting policies and practices for compliance with relevant standards. The Audit Committee examines arrangements in place to enable management to ensure compliance with requirements and standards under the regulatory system. The Audit Committee oversees the internal audit function and the internal and external audit programme, as well as managing the relationship with the external auditors.

Remuneration Committee

The role of the Remuneration Committee is to determine and approve remuneration arrangements for the Company's Leadership and to approve a remuneration framework for all employees below leadership level. The Remuneration Committee will seek to ensure that the levels and structures of remuneration are designed to attract, retain, and motivate the management talent needed to run the business of the Company in a way which is consistent with the risk appetite and ongoing sustainability of the business and to be compliant with all applicable legislation and regulation.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

RISK MANAGEMENT FRAMEWORK

The Company's Risk Management Framework consists of a number of inter-linking elements which support the embedding of risk management across the business. The framework is driven at a strategic level by the Company's overall risk appetite and comprises a series of activities that, when implemented together, sets out how risks are identified, measured, managed, controlled and reported risks across the Company's business.

The Risk Framework recognises five primary risk types:

- Regulatory Risk;
- Operational Risk;
- Credit Risk;
- Insurance Risk;
- Treasury Risk (including Capital Management, Market Risk, Interest Rate Risk in the Banking Book, Liquidity Risk, Foreign Exchange Risk and Large Exposures and Intra Group Limits).

RISK MODEL

The Company's Risk Management Framework is structured according to a 'Three Lines of Defence' model where:

- **First line of defence** - is the business which has primary responsibility for the identification, management and control of risk.
- **Second line of defence** - is the independent Risk function led by the Chief Risk Officer who reports directly to the Chief Executive Officer. The function comprises Credit, Operational, Insurance and Regulatory Risk teams which provide oversight and assurance in relation to risk profiles.
- **Third line of defence** - is the Internal Audit function which is responsible for the independent assessment of risk management and determining whether the internal control systems are effective both in design and practice.

Risk Assurance

Risk assurance is undertaken at a number of levels within the Company, reflecting the three lines of defence risk management approach. The objective of risk assurance activity is to provide comfort internally that risks are being managed in line with the Risk Framework and in line with the Company's agreed risk appetite.

The core components of risk assurance undertaken within the Company include:

- assessments of risk and controls undertaken by the business areas and functional units;
- Risk Assurance (including compliance monitoring) undertaken by the Company's Risk function. This is captured within the annual risk based Risk Assurance Plan which is agreed by the Chief Risk Officer and reported to the RMC and Audit Committee. This covers thematic, desk based and face to face assurance activity across all business areas and key processes across all risk disciplines; and
- internal Audit Assurance – The Audit Committee will obtain assurance about the internal control and risk management environment through an agreed programme of audits carried out by the Company's Internal Audit function. This is set out in the annual Audit Plan, which is reported to and agreed by the Audit Committee.

To assess the effectiveness of the Company's control environment, the Board reviews the reports of the Audit Committee. Certain responsibilities are delegated to the Audit Committee, including ensuring that there is regular review of the adequacy and efficiency of internal systems and controls.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

Internal Audit

The Internal Audit function supports the Audit Committee in providing an independent assessment of the adequacy and effectiveness of internal controls. Responsibility for Internal Audit within the Company lies with the Audit Director.

The role of Internal Audit in the Company is to assess the adequacy and effectiveness of internal systems and controls, procedures and policies. Internal Audit has the following responsibilities:

- to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the Company's systems, internal control mechanisms and arrangements;
- to report control weaknesses identified as a result of work carried out;
- to verify that actions are taken to address the reported control weaknesses; and
- to report to the Company's Audit Committee in relation to internal audit matters.

An Audit Plan is submitted to the Company's Audit Committee for approval on an annual basis. The Audit Director makes regular reports to the Audit Committee on progress against the Audit Plan and key audit findings. The scope of work of Internal Audit covers the whole of the Company. The annual Audit Plan is risk based, focusing on the areas of highest risk.

Risk Types

As noted above, the Company's Risk Framework is designed around five primary risk types which are more fully described below.

REGULATORY RISK

Regulatory Risk is the failure to meet the Company's obligations under the Financial Services and Market's Act (FSMA), the Consumer Credit Act and the Data Protection Act and to meet the expectations of our regulators.

The Company has a minimal appetite for Regulatory Risk and maintains a control framework to comply with regulatory requirements.

The Chief Risk Officer, and his direct report, the Head of Regulatory Risk, together with a dedicated Regulatory Risk team are responsible for regulatory risk management policies and processes and the oversight of regulatory risk and compliance across the Company.

Regulatory Risk provides oversight and support to the business to ensure regulatory rules and requirements are adhered to and that regulatory risks are identified and managed appropriately. Regulatory Risk's scope includes FSA, Consumer Credit and Data Protection Act requirements as well as internal regulatory risk management policies.

The activities undertaken by the Regulatory Risk team include:

- regular and ad-hoc compliance monitoring, with regular monitoring captured and agreed through the Risk Assurance process and plan;
- regulatory risk reporting internally and externally, including to the FSA;
- supporting the business in identifying and responding to the impact of regulatory change or managing the compliance requirements brought about by internal change or new products;
- review and sign off of financial promotions and customer marketing material;
- maintaining a robust framework for the Company's Significant Influence Approved Persons;
- providing day to day compliance consultancy support to the business and change programmes; and supporting the management of the relationship with the FSA.

As part of the Company's Policy Framework, Regulatory Risk is responsible for a number of policies including Data Protection, Marketing Approval, Regulatory Contact and Share Dealing and Market Abuse. In addition, the Compliance Manual sets out the scope of the Company's regulatory responsibilities and its approach to managing regulatory risk across the business. The Compliance Manual is approved through the RMC.

38 RISK MANAGEMENT (continued)

OPERATIONAL RISK

Operational Risk is the risk of loss caused by human error, ineffective or inadequately designed processes, system failure or improper conduct (including criminal activity). The Company's risk appetite is to maintain a low level of operational risk, while accepting in the short term a higher level of risk inherent in the transformation programme to build stand-alone systems and capability independent of the Royal Bank of Scotland Group (RBS).

The Chief Risk Officer, and his direct report, the Head of Operational Risk, are responsible for developing and overseeing the implementation of the framework, policies and standards for the identification, management and mitigation of operational risk across the business.

In addition, the Head of Operational Risk also has responsibility for fraud risk management (internal and external to the business) and anti money laundering.

The Company maintains appropriate and effective internal control systems to monitor and manage operational and related risks, as well as to ensure that it meets its statutory, regulatory and supervisory responsibilities, including the following:

- a risk and control assessment process is used by the business to identify, assess, manage, monitor and report its operational risks. This information enables the business to assess its residual risk exposure and determine its approach to managing risk;
- a formal escalation process to manage events which have or could have an adverse impact on the Company's customers, staff, operational effectiveness, finances or reputation. This process enables the event to be managed effectively with the root cause established and addressed to reduce the likelihood of a recurrence;
- loss data management process to capture, classify, record and analyse the business's operational risk losses;
- a change management process to ensure that all new products and all material variations to existing products are subject to a thorough risk assessment prior to launch;
- policies and processes to minimise our exposure to financial crime, including fraud and money laundering;
- control assurance testing to monitor the effectiveness of internal controls, and
- information security policy and procedures.

CREDIT RISK

Credit Risk arises from the potential that the business incurs losses from the failure of a customer or any other counterparty to meet its financial obligations. Credit risk arises principally from the Company's retail lending activities but also from placement of surplus funds with other banks and money market funds, investments in transferable securities, interest rate derivatives and foreign exchange. Credit risk may also arise when an adverse change in an entity's credit rating causes a fall in the fair value of the Company's investment in that entity's financial instrument. The Company has a low appetite for credit risk seeking to lend responsibly and maintain a credit risk profile better than the industry average.

The Chief Risk Officer and his direct report, the Head of Credit Risk, are responsible for the development and oversight of the credit risk management framework within the Company, in line with credit risk appetite, as well as supporting the business in the implementation of policies and processes.

The scope of the Company's credit risk policies includes Credit Risk and Minimum Standards, Treasury & Corporate Counterparties, Model Development, Problem Debt Management and Provisioning. All credit risk policies are subject to annual review by the RMC.

Polices are supported through limits and standards, including decisioning parameters, and detailed process manuals governing key credit risk activities. These are tracked through a suite of key indicators reported through the RMC and to the Board.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

Retail Credit Risk

The Company's credit policy is defined via the credit risk policy framework. Through this standards and limits are defined at all stages of the customer lifecycle, including new account sanctioning, customer management and collections and recoveries activity. Customer credit decisions are managed principally through the deployment of bespoke credit scorecard models and credit policy rules, which exclude specific areas of lending, and an affordability assessment which determines a customer's ability to repay an outstanding credit amount. Credit management policy is governed by and agreed through the RMC.

A dedicated credit risk management team have the day to day responsibility for managing the credit quality of the lending portfolio. As at 28 February 2011, the deployment and execution of credit strategies sat within RBS infrastructure, managed through the relevant Commercial Services Agreement; however, the Company has full ownership of its credit risk appetite and its credit policy. Responsibility for setting scorecard parameters, and the process for dealing with exceptions, lies with the Head of Credit Risk, reporting to the Chief Risk Officer. Regular reporting to the RMC, Executive Committee, BRC and the Board ensures that the Company has adequate oversight of this activity and sufficient insight to the performance of the portfolio.

In managing credit risk provisioning and impairment the Company apply IFRS, specifically International Accounting Standard 39: Financial Instruments (IAS 39) which requires that financial assets are assessed for impairment. The Company applies a collective impairment provisioning model that segments provisions into the latent (good) book and the bad book based upon the approved definition of default operated on both the credit card and loans portfolio.

Wholesale Credit Risk

Counterparty credit risk may be defined as the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. Such transactions relate to contracts for financial derivative instruments, securities financing transactions and long settlement transactions. The Company in its ordinary course of business uses over the counter (OTC) derivatives and forward foreign exchange transactions to hedge exposures to market risk, e.g. interest rate and foreign exchange risk. Further details of the Company's exposure to counterparty credit risk for OTC derivative contracts and foreign exchange are provided in note 18.

The Company operates a control framework relating to the placement of funds with approved counterparty and instrument types. Approved counterparties generally include investment grade financial institutions, sovereigns and multilateral development banks with approved instrument types including cash, certificates of deposit, bonds, treasury bills, gilts, repurchase agreements, money market funds and asset backed securities.

Credit Risk is responsible for setting wholesale counterparty credit risk limits. These limits are set out in the Credit Risk policy and approved by the RMC. The Treasurer is responsible for ensuring that Treasury complies with counterparty credit risk limits, with Credit Risk providing independent oversight that these limits are adhered to.

The framework sets limits on the amounts that can be lent, relative to the capital base, based on counterparty credit-worthiness and instrument type. As part of the credit assessment process for Treasury credit risk exposures, the Company continues to use Fitch, Moody's and Standard & Poor's as External Credit Assessment Institutions. All limits are approved via the RMC and any exceptions or overrides to the Company's policy must be explicitly agreed by the RMC.

The Company has not recognised any impairment losses in connection with its financial assets classified as available for sale as at 28 February 2011 (2010: £nil).

The Treasury & Corporate Counterparty Credit Risk Policy provides for the use of credit risk mitigation procedures to reduce credit risk exposure. Industry standard ISDA Master Agreements are in place with all derivative counterparties. Use is also made of Delivery Versus Payment arrangements when settling transactions.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

Credit Risk Exposures

Credit risk exposures relating to on-balance sheet assets are as follows:

	Maximum exposure	
	2011	2010
	£'000	£'000
Cash and balances with central banks	136,808	181,855
Loans and advances to banks	323,136	61,937
Loans and advances to customers	4,679,184	4,297,217
Derivative financial instruments	16,378	1,547
Investment securities:		
- Available for sale	849,831	604,262
- Loans and receivables	292,931	258,500
Other assets	200,891	142,874
Prepayments and accrued income	111,676	91,000
	6,610,835	**5,639,192**

Credit risk exposures relating to undrawn credit card commitments are as follows:

	Maximum exposure	
	2011	2010
	£'000	£'000
Undrawn credit card commitments	**7,127,334**	**6,464,509**

The above table represents a worse-case scenario of credit risk exposure to the Company at 28 February 2011. For on-balance-sheet assets, the exposures set out above are based on net carrying amounts as reported in the statement of financial position.

As shown above, 76% of the total maximum exposure is derived from loans and advances to banks and customers (2010: 77%); 12.9% represents investments in financial assets classified as available for sale (2010: 10.7%).

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

CREDIT RISK: ANALYSIS BY GEOGRAPHY

The table detailed below provides the geographic distribution of the Company's exposures by material asset class. The Company is primarily focused on providing financial services and products to UK personal customers although there is limited exposure in the Republic of Ireland.

The Company sells credit cards into the Republic of Ireland where it is an authorised 'credit institution' under Irish law and is directly regulated by the Irish Financial Regulator in respect of this activity.

2011	**UK** £'000	**Europe (ex. UK)** £'000	**Total** £'000
On balance sheet			
Cash and balances with central banks	136,808	-	136,808
Loans and advances to banks	323,136	-	323,136
Loans and advances to customers	4,646,501	32,683	4,679,184
Derivative financial instruments	16,378	-	16,378
Investment securities:			
- Available for sale	511,600	338,231	849,831
- Loans and receivables	292,931	-	292,931
Other assets	199,119	1,772	200,891
Prepayments and accrued income	107,496	4,180	111,676
	6,233,969	**376,866**	**6,610,835**
Undrawn loan commitments	7,084,999	42,335	7,127,334
	13,318,968	**419,201**	**13,738,169**

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

2010	UK £'000	Europe (ex. UK) £'000	Total £'000
On balance sheet			
Cash and balances with central banks	181,855	-	181,855
Loans and advances to banks	11,937	50,000	61,937
Loans and advances to customers	4,264,784	32,433	4,297,217
Derivative financial instruments	1,547	-	1,547
Investment securities:			
- Available for sale	409,495	194,767	604,262
- Loans and receivables	258,500	-	258,500
Other assets	142,874	-	142,874
Prepayments and accrued income	88,928	2,072	91,000
	5,359,920	**279,272**	**5,639,192**
Undrawn loan commitments	6,417,946	46,563	6,464,509
	11,777,866	**325,835**	**12,103,701**

CREDIT RISK: ANALYSIS BY INDUSTRY TYPE

The distribution of exposures by industry type is provided below. The Company is primarily focused on providing financial services and products to UK personal customers although it also has exposure to wholesale counterparties as detailed below.

2011	Financial institutions £'000	Government £'000	Individuals £'000	Wholesale and retail trade £'000	Total £'000
On balance sheet					
Cash and balances with central banks	7,869	124,777	-	4,162	136,808
Loans and advances to banks	323,136	-	-	-	323,136
Loans and advances to customers	-	-	4,674,813	4,371	4,679,184
Derivative financial instruments	16,378	-	-	-	16,378
Investment securities:					
- Available for sale	468,854	380,977	-	-	849,831
- Loans and receivables	292,931	-	-	-	292,931
Other assets	96,368	-	99,737	4,786	200,891
Prepayments and accrued income	85,708	6,609	19,214	145	111,676
	1,291,244	**512,363**	**4,793,764**	**13,464**	**6,610,835**
Undrawn loan commitments	-	-	7,111,892	15,442	7,127,334
	1,291,244	**512,363**	**11,905,656**	**28,906**	**13,738,169**

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

2010	Financial institutions	Government	Individuals	Wholesale and retail trade	Total
	£'000	£'000	£'000	£'000	£'000
On balance sheet					
Cash and balances with central banks	181,855	-	-	-	181,855
Loans and advances to banks	61,937	-	-	-	61,937
Loans and advances to customers	-	-	4,297,217	-	4,297,217
Derivative financial instruments	1,547	-	-	-	1,547
Investment securities:					
- Available for sale	604,262	-	-	-	604,262
- Loans and receivables	258,500	-	-	-	258,500
Other assets	127,215	-	-	15,659	142,874
Prepayments and accrued income	3,274	-	87,726	-	91,000
	1,238,590	**-**	**4,384,943**	**15,659**	**5,639,192**
Undrawn loan commitments	-	-	6,464,509	-	6,464,509
	1,238,590	**-**	**10,849,452**	**15,659**	**12,103,701**

INSURANCE RISK

The Company is exposed to Insurance Risks through its historic distribution arrangement with RBS and indirectly through it's ownership of 49.9% of Tesco Underwriting Limited (TU), an authorised insurance company.

The legacy arrangement with RBS is now in run off and the primary risk that the Company remains exposed to is reserving risk – the risk that claims reserves will be insufficient to cover the ultimate cost of insurance claims arising from this activity. This is particularly relevant to Motor Insurance claims where the ultimate cost of large bodily injury claims is uncertain and the time taken to settle such claims can vary significantly depending on the severity of the injury. This risk is, in part, mitigated by the use of reinsurance to limit the Company's exposure to the cost of individual claims above certain pre determined limits. However, the nature of this exposure results in the process of estimating the ultimate cost of these claims carrying a degree of uncertainty.

Since October 2010 the majority of new business policies for Home and Motor Insurance product sold by the Company have been underwritten by TU. Customers renewing their Motor or Home insurance policies have been underwritten by TU since November 2010. The key Insurance Risks within TU relate to underwriting risk and specifically the potential for a major weather event to generate significant claims on Home Insurance or the cost of settling bodily injury claims for Motor Insurance. Exposure to this risk is actively managed within TU with close monitoring of performance metrics and the use of reinsurance to limit TU's exposure above pre-determined limits.

Since October 2010 Pet, Travel and Breakdown insurance have all been distributed by the Company on a 'white label' basis. The Company does not carry the insurance risk associated with these products.

The Company's insurance risk framework seeks to:

- Provide an effective and consistent approach to insurance risk management in areas including Actuarial & Pricing, Commercial & Marketing, Insurance Operations and with counterparties, including TU, RBS and white label providers;
- Use the understanding of aggregate risk exposures (including those under the oversight of Regulatory, Operational, Credit and Treasury Risk functions) to:
  - Better understand and manage the potential volatility of the insurance results;
  - Take action, where required, to manage or mitigate risk;
  - Inform strategic development decisions;

- Learn from experience, and develop and improve the quality of the risk assessment.

38 RISK MANAGEMENT (continued)

- Measure the extent to which the insurance business within the Company is being conducted in accordance with the Company's risk appetite and policies.
- Provide subject matter expert support to the business in identifying, assessing and managing risk in accordance with the Company's Risk Management Policy.

The Company's Risk function has a dedicated Insurance Risk team that operates as the primary risk contact across all risk disciplines for the insurance business. However, the insurance business is also subject to second line of defence oversight by the other Risk functions.

In addition, TU operates a separate risk framework with dedicated risk and compliance teams and a suite of TU risk policies. TU is working to implement Solvency II which aims to establish an enhanced set of capital and risk management standards across the European insurance industry. The Company's Risk engagement policy has been developed to provide assurance that risk is being managed effectively within TU.

TREASURY RISK

Treasury is responsible for leading the approaches to the management of the capital and liquidity resources of the Company. This includes responsibility for co-ordinating the Internal Capital Adequacy Assessment Process (ICAAP), the Individual Liquidity Adequacy Assessment (ILAA) and stress testing processes. The specific risks managed by the team include liquidity, interest rate risk in the banking book, foreign exchange risk, large exposures and intra group limits. Capital management activities are discussed in note 45.

The Company has a low risk appetite for all treasury risks and activities.

MARKET RISK

Market risk is the risk that changes in interest rates, foreign exchange rates, equity prices and other rates, prices, volatilities, correlations or other market conditions, such as liquidity, will have an adverse impact on the Company's financial condition or results. The Company does not undertake traded market risk and its principal exposure is to Interest Rate Risk in the Banking Book (IRRBB).

INTEREST RATE RISK IN THE BANKING BOOK

IRRBB arises where there is potential for changes in benchmark interest rates (that embed little or no credit risk) to result in a movement in the Banking Book net interest income.

IRRBB may arise from a number of sources, for example:

- risks related to the mismatch of repricing of assets and liabilities and off balance sheet short and long-term positions;
- risks arising from hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions;
- risk related to the uncertainties of occurrence of transactions e.g. when expected future transactions do not equal the actual transactions; and
- risks arising from consumers redeeming fixed rate products when market rates change.

38 RISK MANAGEMENT (continued)

The Company has established limits that describe its risk appetite in this area and stress tests are performed using sensitivity to fluctuations in underlying interest rates in order to monitor this risk. The Treasurer is responsible for ensuring that IRRBB is managed within limits approved by ALCo. The IRRBB policy is owned and monitored by Treasury and approved by ALCo. The main policy objectives are to:

Manage the overall IRRBB of the Company by:

- identifying, assessing, controlling and reporting the Company's interest rate risk exposure within risk appetite parameters;
- minimising the sensitivity at product, balance or business level of net interest income to changes in benchmark interest rates; and
- ensuring that IRRBB arising in the Company is transferred to the market or managed efficiently by Treasury within approved limits.
- ensuring that compliance with evolving regulatory IRRBB requirements is maintained within each jurisdiction in which the Company operates, including requirements set out as part of the ICAAP process.

The main hedging instrument used is interest rate swaps and the residual exposure is reported to ALCo monthly using two key risk measures:

- 1 day VAR (Value at Risk) to a 95% confidence level; and
- net interest income sensitivity to an instantaneous 1% parallel movement measures.

The different methodologies can be summarised as:

VaR – is a technique that produces estimates of the potential negative change in the value of a portfolio over a specified time horizon at given confidence levels. For internal risk management purposes, the Company use a time horizon of one trading day and a confidence level of 95%.

The Company use historical interest rate models in computing VaR. The model uses the previous 500 trading days of market data. This approach assumes that risk factor changes observed in the past are a good estimate of those likely to occur in the future and is, therefore, limited by the relevance of the historical data used.

NII Sensitivity – This measures the effect of a 1.0% interest rate shock on the next 12 months net interest income, based on the re-pricing gaps in the existing portfolio.

	2011 £'000	2010 £'000
Interest Rate VaR	35	74

	2011	2010
NII Sensitivity	(0.62%)	(0.93%)

In addition to the two key measures outlined above the Company also monitors the contractual interest rate sensitivity gap.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

The following table summarises the contractual interest rate sensitivity gap for the Company as at 28 February 2011. It is not necessarily indicative of the positions at other times. A liability (or negative) gap position exists when liabilities reprice more quickly or in greater proportion than assets during a given period and tends to benefit net interest income in a declining interest rate environment. An asset (or positive) gap position exists when assets reprice more quickly or in greater proportion than liabilities during a given period and tends to benefit net interest income in a rising interest rate environment.

2011	Within 3 months	After 3 months, but within 6 months	After 6 months, but within 1 year	After 1 year, but within 5 years	After 5 years	Non – interest bearing funds	Total
	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Assets:							
Cash and balances with central banks	136,808	-	-	-	-	-	136,808
Loans & advances to banks	323,136	-	-	-	-	-	323,136
Loans & advances to customers	1,687,300	308,470	586,926	1,245,672	101,979	748,837	4,679,184
Investment securities	188,680	165,000	-	294,083	202,068	-	849,831
Other assets	-	-	-	-	-	1,020,232	1,020,232
Total assets	**2,335,924**	**473,470**	**586,926**	**1,539,755**	**304,047**	**1,769,069**	**7,009,191**
Liabilities and equity:							
Deposits from banks	26,200	10,000	-	-	-	-	36,200
Deposits from customers	4,655,009	2,266	225,442	194,747	-	-	5,077,464
Debt securities in issue	224,696	-	-	-	125,559	-	350,255
Other liabilities	42,567	-	-	-	-	252,737	295,304
Subordinated liabilities	190,000	-	-	-	-	-	190,000
Non-controlling interests	-	-	-	-	-	-	-
Shareholders' equity	-	-	-	-	-	1,059,968	1,059,968
Total liabilities and equity	**5,138,472**	**12,266**	**225,442**	**194,747**	**125,559**	**1,312,705**	**7,009,191**
On Balance Sheet Interest rate sensitivity gap	(2,802,548)	461,204	361,484	1,345,008	178,488	456,364	-
Notional value of derivatives	1,579,725	149,000	(280,000)	(1,339,477)	(109,248)	-	-
Cumulative Interest rate sensitivity gap	**(1,222,823)**	**(612,619)**	**(531,135)**	**(525,604)**	**456,364**	**-**	**-**

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

2010	Within 3 months £'000	After 3 months, but within 6 months £'000	After 6 months, but within 1 year £'000	After 1 year, but within 5 years £'000	After 5 years £'000	Non – interest bearing funds £'000	Total £'000
Assets:							
Cash and balances at central banks	178,913	-	-	(495)	-	3,437	181,855
Loans & advances to banks	61,937	-	-	-	-	-	61,937
Loans & advances to customers	1,687,500	291,286	507,409	1,074,031	60,629	676,362	4,297,217
Investment securities	371,262	75,000	-	158,000	-	-	604,262
Other assets	-	-	-	-	-	641,612	641,612
Total assets	**2,299,612**	**366,286**	**507,409**	**1,231,536**	**60,629**	**1,321,411**	**5,786,883**
Liabilities and equity:							
Deposits from banks	29,856	-	-	-	-	-	29,856
Deposits from customers	4,343,850	4,727	4,330	17,318	-	-	4,370,225
Other liabilities	64,285	6,971	13,942	111,515	-	100,000	296,713
Debt securities in issue	224,390	-	-	-	-	-	224,390
Subordinated liabilities	190,000	-	-	-	-	-	190,000
Non-controlling interests							
Shareholders' equity	45,000	-	-	-	-	630,699	675,699
Total liabilities and equity	**4,897,381**	**11,698**	**18,272**	**128,833**	**-**	**730,699**	**5,786,883**
On Balance Sheet Interest rate sensitivity gap	(2,597,769)	354,588	489,137	1,102,703	60,629	590,712	-
Notional value of derivatives	1,189,702	511,500	(450,000)	(1,197,202)	(54,000)	-	-
Cumulative Interest rate sensitivity gap	**(1,408,067)**	**(541,979)**	**(502,842)**	**(597,341)**	**(590,712)**	**-**	**-**

LIQUIDITY RISK

Liquidity risk is the risk that the Company is unable to meet its payment obligations as they fall due. The Board approves the Liquidity Risk Management policy framework and delegates the day to day responsibility for complying with the framework to the Treasurer.

The Company monitors a number of liquidity and balance sheet ratios on a daily basis. The Treasurer is responsible for ensuring that all liquidity and funding measures are respected. Liquidity management information is provided on a regular basis to ALCo and the Board with any exceptions highlighted. Stress testing and reverse stress testing of current and forecast balance sheets is carried out to inform the Company of required liquidity resources and the circumstances that would result in liquidity resources being exhausted.

To ensure ongoing completeness and accuracy there is a periodic balance sheet reconciliation of the liquidity balance sheet to the general ledger.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

As part of the FSA new liquidity framework the Company regularly completes an ILAA. This is submitted to the FSA and is approved by ALCo and the Board before submission.

In December 2008 the Company participated in the Bank of England Special Liquidity Scheme. This involved the Company gaining access to Treasury Bills which can be used to support the Company's liquidity position. Under the current arrangement this scheme will terminate in January 2012. The Company has followed a robust funding plan, allowing it to withdraw from the Scheme ahead of legal termination in 2012.

The following table shows cash flows payable up to a period of 20 years on an undiscounted basis. These differ from the statement of financial position values due to the effects of discounting on certain statement of financial position items and due to the inclusion of contractual future interest flows.

Derivatives designated in a hedging relationship are included according to their contractual maturity.

2011	Within 1 year £'000	Between 1 and 2 years £'000	Between 2 and 3 years £'000	Between 3 and 4 years £'000	Between 4 and 5 years £'000	Beyond 5 years £'000	Total £'000
Financial assets:							
Cash and balances at central banks	136,808	-	-	-	-	-	136,808
Derivative financial instruments	(1,287)	4,426	5,243	4,302	2,580	2,459	17,723
Loans and advances to banks	323,136	-	-	-	-	-	323,136
Loans and advances to customers	3,238,749	655,568	502,488	337,721	169,574	177,982	5,082,082
Investment securities	229,560	202,097	64,447	134,110	80,078	225,119	935,411
Investment Loans	1,568	260,407	2,352	2,517	2,628	89,075	358,547
Trade and other receivables	210,145	-	-	-	-	-	210,145
	4,138,679	**1,122,498**	**574,530**	**478,650**	**254,860**	**494,635**	**7,063,852**
Financial liabilities:							
Deposits from banks	36,200	-	-	-	-	-	36,200
Deposits from customers	4,897,752	173,121	3,438	-	-	-	5,074,311
Debt securities in issue	225,000	-	-	-	-	125,000	350,000
Net settled derivative contracts	25,491	11,690	674	595	(367)	(869)	37,214
Gross settled derivative contracts	210	66	-	-	-	-	276
Accruals & deferred income	183,439	-	-	-	-	-	183,439
Interest payment on borrowings	20,883	23,984	14,852	15,949	16,499	70,197	162,364
Other liabilities	7,850	-	-	-	-	-	7,850
Subordinated liabilities	-	-	-	-	-	190,000	190,000
	5,396,825	**208,861**	**18,964**	**16,544**	**16,132**	**384,328**	**6,041,654**
Gap analysis	**(1,258,146)**	**913,637**	**555,566**	**462,106**	**238,728**	**110,307**	**1,022,198**

38 RISK MANAGEMENT (continued)

2010	Within 1 year £'000	Between 1 and 2 years £'000	Between 2 and 3 years £'000	Between 3 and 4 years £'000	Between 4 and 5 years £'000	Beyond 5 years £'000	Total £'000
Financial assets:							
Cash and balances at central banks	181,855	-	-	-	-	-	181,855
Derivative financial instruments	-	-	-	-	-	-	-
Loans and advances to banks	61,937	-	-	-	-	-	61,937
Loans and advances to customers	3,061,061	513,174	413,260	287,098	165,211	166,410	4,606,214
Investment securities	462,249	73,705	197,306	17,320	111,626	7,776	869,982
Investment Loans						258,500	258,500
Trade and other receivables	224,497	-	-	-	-	-	224,497
	3,991,599	**586,879**	**610,566**	**304,418**	**276,837**	**432,686**	**6,202,985**
Financial liabilities:							
Deposits from banks	29,856	-	-	-	-	-	29,856
Deposits from customers	4,370,225	-	-	-	-	-	4,370,225
Debt securities in issue	-	224,390	-	-	-	-	224,390
Net settled derivative contracts	40,988	17,328	3,153	(1,059)	381	(358)	60,433
Gross settled derivative contracts	876	(179)	1,624	-	-	-	2,321
Accruals & deferred income	119,118	-	-	-	-	-	119,118
Interest payment on borrowings	8,107	11,437	8,169	9,328	10,118	67,806	114,965
Other liabilities	12,837	-	-	-	-	-	12,837
Subordinated liabilities	-	-	-	-	-	190,000	190,000
	4,582,007	**252,976**	**12,946**	**8,269**	**10,499**	**257,448**	**5,124,145**
Gap analysis	**(590,408)**	**333,903**	**597,620**	**296,149**	**266,338**	**175,238**	**1,078,840**

Expected maturity dates do not differ significantly from the contract dates, except for deposits from customers which are all retail in nature These deposits are repayable on demand on a contractual basis. However historical trends show that these deposits have tended to be very stable with actual maturities being significantly longer than the contracted maturity. The Company continuously monitors retail deposit activity to ensure that it understands expected maturity flows. These instruments form a stable funding base for the Company's operations because of the broad customer base and the historical behaviours exhibited.

FOREIGN EXCHANGE RISK

Whilst the large majority of the Company's balance sheet is denominated in the accounting reference currency of sterling, non sterling exposures exist in the form of Euro denominated credit cards, euro and US Dollar denominated treasury investment assets, travel money foreign exchange exposures and some limited accounts payable. The Treasurer is responsible for ensuring these are managed in accordance with the Non-trading Foreign Exchange Risk policy approved by ALCo.

38 RISK MANAGEMENT (continued)

The Company is exposed to limited foreign exchange risk as the majority of this risk has been eliminated through the use of a series of foreign exchange swaps and cross currency swaps.

The table below summarises the Company's exposure to foreign currency exchange rate risk at 28 February 2011. Included in the table are the Company's financial instruments at carrying amounts, categorised by currency.

Maximum exposure 2011	EUR £'000	USD £'000	GBP £'000	Other £'000	Total £'000
Assets:					
Cash and balances with central banks	1,540	1,023	133,489	756	136,808
Loans and advances to banks	-	-	323,136	-	323,136
Loans and advances to customers	32,683	-	4,646,501	-	4,679,184
Derivative financial instruments	-	-	16,378	-	16,378
Investment securities					
- Available for sale	101,050	7,068	741,713	-	849,831
- Loans and receivables	-	-	292,931	-	292,931
Other assets	1,772	-	199,119	-	200,891
Investment in associate	-	-	71,708	-	71,708
Prepayments and accrued income	1,300	-	110,376	-	111,676
Total assets	**138,345**	**8,091**	**6,535,351**	**756**	**6,682,543**
Liabilities:					
Deposits by banks	-	-	36,200	-	36,200
Deposits by customers	78	-	5,077,386	-	5,077,464
Debt securities in issue	-	-	350,255	-	350,255
Derivative financial instruments	-	-	37,369	-	37,369
Accruals and deferred income	6,430	1,058	176,902	761	185,151
Other liabilities	659	-	15,749	123	16,531
Current income tax liability	-	-	3,366		3,366
Deferred income tax liability	-	-	5,022		5,022
Subordinated liabilities	-	-	190,000	-	190,000
Total liabilities	**7,167**	**1,058**	**5,892,249**	**884**	**5,901,358**

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

Maximum exposure 2010	EUR £'000	USD £'000	GBP £'000	Other £'000	Total £'000
Assets:					
Cash and balances with central banks	-	-	181,855	-	181,855
Loans and advances to banks	-	-	61,937	-	61,937
Loans and advances to customers	32,433	-	4,264,784	-	4,297,217
Derivative financial instruments	951	-	596	-	1,547
Investment securities					
- Available for sale	113,457	18,115	472,690	-	604,262
- Loans and receivables	-	-	258,500	-	258,500
Other assets	-	-	119,493	-	119,493
Current income tax asset	-	-	18,451	-	18,451
Deferred income tax asset	-	-	4,930	-	4,930
Prepayments and accrued income	1,124	5	89,871	-	91,000
Total assets	147,965	18,120	5,473,107	-	5,639,192
Liabilities:					
Deposits by banks	-	-	29,856	-	29,856
Deposits by customers	-	-	4,370,225	-	4,370,225
Debt securities in issue	-	-	224,390	-	224,390
Derivative financial instruments	5,596	750	58,413	-	64,759
Accruals and deferred income	-	4,474	114,644	-	119,118
Other liabilities	-	-	12,836	-	12,836
Subordinated liabilities	-	-	190,000	-	190,000
Total liabilities	5,596	5,224	5,000,364	-	5,011,184

LARGE EXPOSURES AND INTRA GROUP LIMITS

The Treasurer is responsible for ensuring that the Company respects the FSA's Large Exposures limits on a daily basis and reports against those limits to the FSA as required.

The Company is also responsible for ensuring that it maintains control over intra group limits.

Both of these policies are approved by ALCo.

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

OTHER PRICE RISK

Other price risk is the risk that the fair value of a financial instrument will fluctuate because of changes in market prices. The Company has available for sale investment securities that are held at fair value on the statement of financial position.

The table below demonstrates the Company's exposure to this other price risk as at 28 February 2011. Included in the table is the impact of a 10 percent shock in market prices on the Company's available for sale investment securities.

2011 **Impact of 10 % shock in market prices**	**Fair value 2011 £'000**	**Impact of 10% shock 2011 £'000**	**Value after 10% shock 2011 £'000**
Available for sale:			
Government-backed investment securities	80,223	(8,023)	72,200
Gilts	188,059	(18,806)	169,253
Supranational investment securities	225,535	(22,553)	202,982
Other investment securities	112,696	(11,270)	101,426
Certificates of deposit	170,057	(68)	169,989
Asset-backed securities	73,261	(7,326)	65,935
	849,831	**(68,046)**	**781,785**

NOTES TO THE FINANCIAL STATEMENTS

38 RISK MANAGEMENT (continued)

2010 Impact of 10 % shock in market prices	Fair value 2010 £'000	Impact of 10% shock 2010 £'000	Value after 10% shock 2010 £'000
Available for sale:			
Government-backed investment securities	244,743	(24,474)	220,269
Gilts	-	-	-
Supranational investment securities	-	-	-
Other investment securities	97,685	(9,768)	87,917
Certificates of deposit	165,006	(32)	164,974
Asset-backed securities	96,828	(9,690)	87,138
	604,262	**(43,964)**	**560,298**

39 FINANCIAL INSTRUMENTS

The following tables analyse the financial assets and financial liabilities in accordance with the categories of financial instruments in IAS 39. Non financial assets and liabilities are shown separately.

2011	**Loans and receivables**	**Other (amortised cost)**	**Derivatives used for hedging**	**Available for sale**	**Non financial assets/liabilities**	**Total**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Assets:						
Cash and balances at central banks	136,808	-	-	-	-	136,808
Loans and advances to banks	323,136	-	-	-	-	323,136
Loans and advances to customers	4,679,184	-	-	-	-	4,679,184
Derivative financial instruments	-	-	16,378	-	-	16,378
Investment securities classified as available for sale	-	-	-	849,831	-	849,831
Investment securities classified as loans and receivables	292,931	-	-	-	-	292,931
Prepayments and accrued income	111,676	-	-	-	-	111,676
Investment in Associate		-	-	-	71,708	71,708
Other assets	200,891	-	-	-		200,891
Intangible assets	-	-	-	-	215,275	215,275
Property, plant and equipment	-	-	-	-	111,373	111,373
	5,744,626	**-**	**16,378**	**849,831**	**398,356**	**7,009,191**
Liabilities and equity:						
Deposits from banks	-	36,200	-	-	-	36,200
Deposits from customers	-	5,077,464	-	-	-	5,077,464
Provisions for liabilities and charges	-	-	-	-	39,477	39,477
Other liabilities	-	24,919	-	-	-	24,919
Tax liabilities	-	8,388	-	-	-	8,388
Debt securities in issue	-	350,255	-	-	-	350,255
Accruals and deferred income	-	185,151	-	-	-	185,151
Subordinated liabilities	-	190,000	-	-	-	190,000
Derivative financial instruments	-	-	37,369	-	-	37,369
	-	**5,872,377**	**37,369**	**-**	**39,477**	**5,949,223**
Equity						1,059,968
						7,009,191

NOTES TO THE FINANCIAL STATEMENTS

39 FINANCIAL INSTRUMENTS (continued)

2010	Loans and receivables £'000	Other (amortised cost) £'000	Derivatives used for hedging £'000	Available for sale £'000	Non financial assets/liabilities £'000	Total £'000
Assets:						
Cash and balances at central banks	181,855	-	-	-	-	181,855
Loans and advances to banks	61,937	-	-	-	-	61,937
Loans and advances to customers	4,297,217	-	-	-	-	4,297,217
Derivative financial instruments	-	-	1,547	-	-	1,547
Investment securities classified as available for sale	-	-	-	604,262	-	604,262
Investment securities classified as loans and receivables	258,500	-	-	-	-	258,500
Prepayments and accrued income	91,000	-	-	-	-	91,000
Investment in associate	-	-	-	-	2,857	2,857
Other assets	142,874	-	-	-	23,381	166,255
Intangible assets	-	-	-	-	60,328	60,328
Property, plant and equipment	-	-	-	-	61,125	61,125
	5,033,383	**-**	**1,547**	**604,262**	**147,691**	**5,786,883**
Liabilities and equity:						
Deposits from banks	-	29,856	-	-	-	29,856
Deposits from customers	-	4,370,225	-	-	-	4,370,225
Other liabilities	-	12,836	-	-	-	12,836
Provisions for liabilities and charges	-	-	-	-	100,000	100,000
Debt securities in issue	-	224,390	-	-	-	224,390
Accruals and deferred income	-	119,118	-	-	-	119,118
Subordinated liabilities	-	190,000	-	-	-	190,000
Derivative financial instruments	-	-	64,759	-	-	64,759
	-	**4,946,425**	**64,759**	**-**	**100,000**	**5,111,184**
Equity						675,699
						5,786,883

NOTES TO THE FINANCIAL STATEMENTS

39 FINANCIAL INSTRUMENTS (continued)

Fair values

The following table shows the carrying values and the fair values of financial instruments.

	2011		2010	
	Carrying value £'000	Fair value £'000	Carrying value £'000	Fair value £'000
Financial assets:				
Cash and balances with central banks	136,808	136,808	181,855	181,855
Loans and advances to banks	323,136	323,136	61,937	61,937
Loans and advances to customers	4,679,184	4,674,972	4,297,217	4,325,096
Investment securities – Available for sale	849,831	849,831	604,262	604,262
Investment securities - Loans and receivables	292,931	289,423	258,500	243,500
Derivative financial instruments	16,378	16,378	1,547	1,547
Financial liabilities:				
Debt securities in issue	350,255	358,637	224,390	223,427
Deposits from banks	36,200	36,200	29,856	29,856
Deposits from customers	5,077,464	5,084,161	4,370,225	4,370,225
Derivative financial instruments	37,369	37,369	64,759	64,759
Subordinated liabilities	190,000	190,978	190,000	207,319

a) Cash and balances with central banks and loans and advances to banks

The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money-market interest rates for debts with similar credit risk and remaining maturity.

b) Loans and advances to customers

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

c) Financial assets classified as available-for-sale investment securities

Financial assets classified as available-for-sale investment securities are carried at fair value based on market prices or broker/dealer price quotations.

d) Investment securities held as loans and receivables

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

e) Derivative financial instruments

Fair values are obtained from valuation techniques (for example for swaps and currency transactions) including discounted cash flow models using observable market data.

NOTES TO THE FINANCIAL STATEMENTS

39 FINANCIAL INSTRUMENTS (continued)

f) Customer accounts and deposits from banks
The estimated fair value of customer accounts and deposits from banks represents the discounted amount of estimated future cash flows expected to be paid. Expected cash flows are discounted at current market rates to determine fair value.

g) Debt securities in issue and subordinated liabilities
The estimated fair value of debt securities in issue and subordinated liabilities is calculated using a discounted cash flow model based on a current yield curve appropriate for the remaining term to maturity.

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

i) Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities. This level includes listed equity securities and debt instruments on exchanges (for example, London Stock Exchange, Frankfurt Stock Exchange, New York Stock Exchange) and exchange traded derivatives like futures (for example, Nasdaq, S&P 500).

ii) Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). This level includes the majority of the OTC derivative contracts, traded loans and issued structured debt. The sources of input parameters like LIBOR yield curve or counterparty credit risk are Bloomberg and Reuters.

iii) Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes equity investments and debt instruments with significant unobservable components.

This hierarchy requires the use of observable market data when available. The Company considers relevant and observable market prices in its valuations where possible.

2011	**Level 1 £'000**	**Level 2 £'000**	**Level 3 £'000**	**Total £'000**
Financial assets classified as available for sale	188,059	661,772	-	849,831
Derivative financial instruments	-	16,378	-	16,378
Total assets	**188,059**	**678,150**	**-**	**866,209**
Derivative financial instruments	-	(37,369)	-	(37,369)
Total liabilities	**-**	**(37,369)**	**-**	**(37,369)**

2010	**Level 1 £'000**	**Level 2 £'000**	**Level 3 £'000**	**Total £'000**
Financial assets classified as available for sale	-	604,262	-	604,262
Derivative financial instruments	-	1,547	-	1,547
Total assets	**-**	**605,809**	**-**	**605,809**
Derivative financial instruments	-	(64,759)	-	(64,759)
Total liabilities	**-**	**(64,759)**	**-**	**(64,759)**

NOTES TO THE FINANCIAL STATEMENTS

40 ASSET QUALITY

Internal reporting and oversight of risk assets is principally differentiated by credit ratings. Internal ratings are used to assess the credit quality of borrowers. Customers are assigned credit ratings, based on various credit grading models that reflect the probability of default.

Expressed as an annual probability of default, the upper and lower boundaries and the midpoint for each of the asset quality grades are as follows:

Asset Quality Grade	Annual probability of default Minimum %	Midpoint %	Maximum %
AQ1	0.00	0.10	0.20
AQ2	0.21	0.40	0.60
AQ3	0.61	1.05	1.50
AQ4	1.51	3.25	5.00
AQ5	5.01	52.50	100.00

2011	**AQ1**	**AQ2**	**AQ3**	**AQ4**	**AQ5**	**Accruing past due**	**Non-accrual**	**Impairment provision**	**Total**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Assets:									
Cash and balances at central banks	136,808	-		-	-	-	-	-	136,808
Loans and advances to banks	323,136	-		-	-	-	-	-	323,136
Loans and advances to customers	604,554	469,898	932,307	1,676,732	892,616	72,779	212,119	(181,821)	4,679,184
Investment securities - available for sale	849,831	-		-	-	-	-	-	849,831
Loans and receivables	292,931	-		-	-	-	-	-	292,931
	2,207,260	**469,898**	**932,307**	**1,676,732**	**892,616**	**72,779**	**212,119**	**(181,821)**	**6,281,890**
Commitments	4,254,414	1,600,981	645,146	444,288	182,505	-	-	-	7,127,334

Refer to note 41 for further details of non-accrual loans.

NOTES TO THE FINANCIAL STATEMENTS

40 ASSET QUALITY (continued)

2010	AQ1 £'000	AQ2 £'000	AQ3 £'000	AQ4 £'000	AQ5 £'000	Accruing past due £'000	Non-accrual £'000	Impairment provision £'000	Total £'000
Assets:									
Cash and balances at central banks	181,748	-	-	-	-	-	-	-	181,748
Loans and advances to banks	61,937	-	-	-	-	-	-	-	61,937
Loans and advances to customers	523,946	398,468	797,128	1,563,144	876,877	78,470	373,175	(313,991)	4,297,217
Investment securities classified as available for sale	604,262	-	-	-	-	-	-	-	604,262
Loans and receivables	258,500	-	-	-	-	-	-	-	258,500
	1,630,393	**398,468**	**797,128**	**1,563,144**	**876,877**	**78,740**	**373,175**	**(313,991)**	**5,403,664**
Commitments	3,926,169	1,328,772	572,768	452,360	184,440	-	-	-	6,464,509

41 PAST DUE AND IMPAIRED FINANCIAL ASSETS

At 28 February 2011, the Company's non-accrual loans amounted to £212,119,000 (2010: £373,175,000). Loan impairment provisions of £181,821,000 (2010: £313,991,000) were held against these loans. Refer to note 17 for details of a change in methodology in the current year which has impacted this balance.

	2011 £'000	2010 £'000
Gross income not recognised but which would have been recognised under the original terms of non-accrual loans	**8,002**	8,524

The following assets were past due at the balance sheet date but not considered impaired:

2011	Past due 1-29 days £'000	Past due 30-59 days £'000	Past due 60-89 days £'000	Past due more than 90 days £'000	Total £'000
Loans & advances to customers	53,642	12,663	6,474	-	72,779

2010	Past due 1-29 days £'000	Past due 30-59 days £'000	Past due 60-89 days £'000	Past due more than 90 days £'000	Total £'000
Loans & advances to customers	57,140	13,872	7,458	-	78,470

NOTES TO THE FINANCIAL STATEMENTS

42 COMMITMENTS

a) Undrawn credit card commitments
The amounts shown below are intended to provide an indication of the volume of business transacted and not of the underlying credit or other risks.

	2011 £'000	2010 £'000
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than one year	**7,127,334**	6,464,509

Under an undrawn credit card commitment the Company agrees to make funds available to a customer in the future. Undrawn credit card commitments, which are usually for a specified term may be unconditionally cancellable or may persist, providing all facility conditions are satisfied or waived.

b) Capital commitments
At 28 February 2011 the Company had capital commitments of £1,907,000 (2010: £39,224,000). This is in respect of IT software development and building fit-out purchases. The Company's management is confident that future net revenues and funding will be sufficient to cover this commitment.

c) Operating lease commitments
The future minimum lease payments under non-cancellable operating leases are as follows:

	2011 £'000	2010 £'000
No later than one year	3,146	743
Later than one year and no later than five years	20,306	18,234
Later than five years	69,632	74,750
	93,084	93,727

43 CASH AND CASH EQUIVALENTS

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances with less than three months maturity from the date of acquisition:

	2011 £'000	2010 £'000
Cash and balances with central banks	132,568	178,525
Loans and advances to banks	323,136	61,937
Certificates of deposit	170,057	165,006
	625,761	405,468

NOTES TO THE FINANCIAL STATEMENTS

44 CASH INFLOW FROM OPERATING ACTIVITIES

	2011 £'000	2010 £'000
Loan impairment charges	(137,310)	58,239
Depreciation and amortisation	19,391	6,346
Loss on disposal of property, plant and equipment	-	258
Profit on disposal of investment securities	(564)	(139)
Provision for customer redress	(50,000)	100,000
Interest on subordinated liabilities	3,193	3,218
Fair value movements	(8,991)	(3,531)
Non cash items included in operating profit before taxation	**(174,281)**	**164,391**
Net movement in mandatory balances with central banks	(910)	(577)
Net movement in loans and advances to customers	(256,916)	(647,437)
Net movement in prepayments and accrued income	(20,676)	(8,283)
Net movement in other assets	(58,016)	10,461
Net movement in deposits from banks	6,344	5,836
Net movement in deposits from customers	707,239	(177,091)
Net movement in accruals and deferred income	47,869	21,317
Provisions utilised	(10,523)	-
Net movement in other liabilities	12,082	(24,158)
Changes in operating assets and liabilities	**426,493**	**(819,932)**

NOTES TO THE FINANCIAL STATEMENTS

45 CAPITAL RESOURCES

The following table analyses the Company's regulatory capital resources:

	2011	2010
	£'000	£'000
Movement in tier 1 capital		
At the beginning of the year	570,524	521,234
Ordinary shares issued	445,500	230,000
Profit attributable to shareholders	61,824	31,406
Ordinary dividends	(162,150)	(152,800)
Intangible assets	(154,947)	(59,316)
At the end of the year	**760,751**	**570,524**
Composition of regulatory capital		
Tier 1 capital:		
Shareholders funds and non-controlling interests	760,751	570,524
Tier 2 capital:		
Qualifying subordinated debt	235,000	235,000
Other interests in tier 2 capital	17,626	20,650
	252,626	255,650
Supervisory deductions:		
Other deductions*	(364,863)	(262,721)
Total regulatory capital	**648,514**	563,453
Total Risk Weighted Assets (unaudited)	**4,787,753**	**4,410,000**
Tier 1 Ratio	**15.89%**	**12.94%**
Risk Asset Ratio	**13.55%**	**12.78%**

*Other deductions relate to capital deducted loans and the investment in associate.

It is the Company's policy to maintain a strong capital base, to expand it as appropriate and to utilise it efficiently throughout its activities to optimise the return to shareholders while maintaining a prudent relationship between the capital base and the underlying risks of the business. In carrying out this policy, the Company has regard to the supervisory requirements of the FSA. The Company carried regulatory capital resources in excess of its capital requirements during the year.

Capital Management
Regulatory capital is reported monthly to ALCo and the Board. Capital adequacy is monitored daily by the Treasury department.

Internal Capital Adequacy Assessment Process
The Company undertakes an Internal Capital Adequacy Assessment Process (ICAAP) which is an internal assessment of its capital needs. The ICAAP is performed annually and is supplemented by a program of capital and liquidity stress testing. The ICAAP and stress testing scenarios are presented to ALCo, RMC and the Board for challenge and approval.

The outcome of the ICAAP covers all material risks to determine the capital requirement over a twelve month horizon and includes stressed scenarios over a three to five year period. Where capital is deemed as not being able to mitigate a particular risk, such as liquidity risk, alternative management actions are identified and described in the ICAAP document.

NOTES TO THE FINANCIAL STATEMENTS

46 RELATED PARTY TRANSACTIONS

During the year the Company had the following transactions with related parties:

a) Transactions involving Directors and other key connected persons
For the purposes of IAS 24 "Related Party Disclosures", key management comprise Directors of the Company. The captions in the Company's primary financial statements include the following amounts attributable, in aggregate to key connected persons.

	2011 £'000	2010 £'000
Loans and advances to customers		
At the beginning of the year	45	15
Loans issued during the year	28	33
Loan repayments during the year	(32)	(3)
Loans outstanding at the end of the year	**41**	**45**
Interest income earned	1	4
Deposits from customers		
Deposits at the beginning of the year	489	412
Deposits received during the year	75	128
Deposits repaid during the year	(171)	(51)
Deposits at the end of the year	**393**	**489**
Interest expense on deposits	4	8

No provisions have been recognised in respect of loans and advances to related parties (2010: nil).

b) Remuneration of key management personnel
The amount of remuneration recharged to the Company in relation to the Directors and other key management personnel is set out below in aggregate. Further information about the remuneration of Directors is provided in note 11.

	2011 £'000	2010 £'000
Total emoluments	3,338	3,477
	3,338	**3,477**

NOTES TO THE FINANCIAL STATEMENTS

47 RELATED PARTY TRANSACTIONS (continued)

c) Trading transactions
During the year, the Company entered into the following transactions with related parties:

	2011 Tesco plc and subsidiaries £'000	2011 Tesco Underwriting Limited £'000	2010 Tesco plc and subsidiaries £'000
Interest received and other income	1,203	662	3,118
Dividend income	3,726	-	28,216
Interest paid	(3,203)	-	(3,248)
Provision of services	(78,952)	-	(76,647)

Balances owing to/from related parties are identified in notes 21,32 and 31

d) Ultimate parent undertaking
The Company's ultimate parent undertaking and controlling party is Tesco plc which is incorporated in England. The financial statements for Tesco plc can be obtained from its registered office at Tesco House, Delamare Road, Cheshunt, Hertforshire EN8 9SL.

48 IMMEDIATE PARENT UNDERTAKING

The Company's immediate parent company is Tesco Personal Finance Group Limited which is incorporated in Scotland. Financial statements for Tesco Personal Finance Group Limited can be obtained from its registered office at 22 Haymarket Yards, Edinburgh EH12 5BH. The smallest group into which the Company is consolidated is Tesco Personal Finance Group Limited and the largest group is Tesco plc.

49 CONTINGENT LIABILITIES

The Financial Services Compensation Scheme
The Financial Services Compensation Scheme is the UK statutory fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS has borrowed from HM Treasury to fund these compensation costs associated with institutions that failed in 2008 and will receive receipts from asset sales, surplus cash flow and other recoveries from these institutions in the future.

The FSCS meets its obligations by raising management expense levies. These include amounts to cover the interest on its borrowings and compensation levies on the industry. Each deposit-taking institution contributes in proportion to its share of total protected deposits.

As at 28 February 2011 the Company has accrued £3,384,000 (2010: £5,106,000) in respect of its current obligation to meet expenses levies.

If the FSCS does not receive sufficient funds from the failed institutions to repay HM Treasury in full it will raise compensation levies. At this time it is not possible to estimate the amount or timing of any shortfall resulting from the cash flows received from the failed institutions and, accordingly, no provision for compensation levies, which could be significant, has been made in these financial statements.

50 SHARE BASED PAYMENTS

The Company charge for the year recognised in respect of share-based payments is £6,162,000 (2010: £4,261,000), which is made up of share option schemes and share bonus payments. Of this amount £2,104,000 (2010: £2,851,000) will be equity settled and £4,058,000 (2010: £1,410,000) cash settled.

NOTES TO THE FINANCIAL STATEMENTS

50 SHARE BASED PAYMENTS (continued)

a) Share Option Schemes
The Company had two option schemes in operation during the year, both of which are equity-settled schemes using Tesco plc shares:

i) The Discretionary Share Option Plan (2004) was adopted by Tesco plc on 5 July 2004. This scheme permits the grant of approved, unapproved and international options in respect of ordinary shares to selected executives. Options are normally exercisable between three and ten years from date of grant at a price not less than the middle-market quotation or average middle-market quotations of an ordinary share for the dealing day or three dealing days preceding the date of grant. The exercise of options will normally be conditional on the achievement of a specified performance target related to the annual percentage growth in earnings per share over a three year period. There will be no discounted options under this scheme.

ii) The Savings-related Share Option Scheme (1981) permits the grant to employees of options in respect of ordinary shares linked to a building society/bank save-as-you-earn contract for a term of three or five years with contributions from employees of an amount between £5 and £250 per four-weekly pay period. Options are capable of being exercised at the end of the three or five-year period at a subscription price not less than 80% of the average of the middle-market quotations of an ordinary share over the three dealing days immediately preceding the offer date.

The following table reconciles the number of share options outstanding and the weighted average exercise price (WAEP):

	Savings-related share option scheme	Savings-related share option scheme	Approved share option scheme	Approved share option scheme	Unapproved share options scheme	Unapproved share options scheme
	Options	WAEP (pence)	Options	WAEP (pence)	Options	WAEP (pence)
Outstanding at 28 February 2009	**-**	**-**	**7,025**	**427.00**	**39,813**	**427.00**
Granted	85,133	328.00	481,420	338.40	522,474	338.40
Forfeited	-	-	(35,460)	338.40	(68,442)	338.40
Exercised	-	-	-	-	-	-
Outstanding as at 28 February 2010	**85,133**	**328.00**	**452,985**	**339.77**	**493,845**	**345.54**
Granted	78,188	386.00	518,822	419.80	964,321	419.80
Forfeited	(16,561)	328.82	(114,307)	389.29	(128,583)	409.94
Exercised	(198)	328.00	-	-	(8,540)	338.40
Outstanding as at 28 February 2011	**146,562**	**358.81**	**857,500**	**381.59**	**1,321,043**	**393.17**

None of the above share options were exercisable as at 28 February 2011 (2010: nil).

Share options were exercised during the financial year by employees who left the business. The average Tesco plc share price during the year ended 28 February 2011 was 417.80p.

The fair value of share options is estimated at the date of grant using the Black-Scholes option pricing model. The following table gives the assumptions applied to the options granted in the respective periods shown. No assumption has been made to incorporate the effects of expected early exercise.

NOTES TO THE FINANCIAL STATEMENTS

50 SHARE BASED PAYMENTS (continued)

	2011 Savings-related share option scheme	2011 Executive Share Option Schemes	2010 Savings-related share option scheme	2010 Executive Share Option Schemes
Expected Dividend Yield (%)	3.50%	3.50%	3.60%	3.90%
Expected Volatility (%)	26 – 30%	25%	26 - 31%	25%
Risk free interest rate (%)	1.6 – 2.2%	3.20%	2.0 - 2.8%	3.30%
Expected life of option (years)	3 or 5	6	3 or 5	6
Weighted average fair value of options granted (pence)	93.49	77.88	86.69	64.23
Probability of forfeiture (%)	14 – 15%	10%	14 - 15%	10%
Share price (pence)	436.00	419.80	378.00	345.10
Weighted average exercise price (pence)	386.00	419.80	328.00	338.40

Volatility is a measure of the amount by which a price is expected to fluctuate in the period. The measure of volatility used in Tesco plc option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. In estimating the future volatility of Tesco plc's share price, the Tesco plc Board considers the historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option, taking into account the remaining contractual life of the option.

b) Share Bonus Schemes
Eligible UK employees are able to participate in Shares in Success, an all-employee profit sharing scheme. Each year, Tesco plc shares are awarded as a percentage of earnings up to a statutory maximum of £3,000.

Senior management also participates in performance-related bonus schemes. The amount paid to employees is based on a percentage of salary and is paid partly in cash and partly in Tesco plc shares. Bonuses are awarded to eligible employees who have completed a required service period and depend on the achievement of corporate targets. The accrued cash element of the bonus at the balance sheet date is £3,440,000 (2010: £990,000).

Selected senior management participate in the senior management Performance Share Plan. Awards made under this plan will normally vest three years after the date of the award for nil consideration. Vesting will normally be conditional on the achievement of specified performance targets related to the return on capital employed over a three year performance period.

The fair value of shares awarded under these schemes is their market value on the date of the award. Expected dividends are not incorporated into the fair value.

The number of Tesco plc shares and weighted average fair value (WAFV) of share bonuses awarded during the year were:

NOTES TO THE FINANCIAL STATEMENTS

50 SHARE BASED PAYMENTS (continued)

	2011 Shares number	2011 WAFV (pence)	2010 Shares number	2010 WAFV (pence)
Shares in Success	99,935	416.23	78,441	349.66
Executive Incentive Scheme	415,253	398.93	64,893	356.05
Performance Share Plan	297,431	402.86	93,958	374.00

c) Long Term Incentive Scheme
Certain members of the Company's senior management participate in a long term incentive scheme which may reward eligible members based on long term sustainable profit growth and annual corporate objectives encompassing certain customer, operational, people and financial metrics. Part of the award is a cash bonus based on a range of profitability targets for the year ending 28 February 2015, with the extent of the award being scaled between a minimum and maximum profitability targets. If the minimum profitability target is achieved, members can also become eligible for an award based on the achievement of the corporate objectives. The corporate objectives are annual targets and their achievement will be approved by the Remuneration Committee on an annual basis. The corporate objective award will be made in the form of "notional" shares linked to the share price of Tesco plc and as such is classified as a cash settled share based payment award. The fair value of the corporate objectives award is based on the quoted price of Tesco plc shares. Any award paid in 2015 will be made net of the cumulative amounts paid to eligible members under other bonus and share based payment arrangements.

There is no charge recognised in the income statement in respect of this long term incentive scheme for the year ended 28 February 2011 (2010: £nil). This reflects the significant uncertainty at year end as to whether or not the minimum qualifying criteria will be met in 2015. Progress against these criteria will be monitored on an ongoing basis and the Company will commence accruing the relevant charge in the income statement if in future it becomes more likely than not that the relevant criteria will be met.