BANK OF SCOTLAND

SC327000

Annual Report and Accounts 2008

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Introduction

Bank of Scotland plc (BoS plc) is the banking subsidiary of the HBOS Group. The BoS plc 2008 Results contained in this report cover the results of the BoS plc Group (the Group) for the year ended 31 December 2008. Unless otherwise stated, the analysis throughout this document compares the year to 31 December 2008 with the year to 31 December 2007.

Background

The continuing global dislocation in financial markets in 2008 has resulted in exceptional instability and volatility, leading to falling market, investor and customer confidence. This has had a profound effect on the banking sector generally and on HBOS specifically. Since the summer of 2007, it had become increasingly difficult for HBOS to raise funds in wholesale markets. Pressures on the banking and financial services sectors were evident through increases in the cost of insurance against bank defaults, deteriorating economic conditions, increased concerns about credit risk and sustained tight conditions in wholesale money markets, despite measures taken by central banks to increase liquidity. The board of HBOS sought to restore confidence and stability through an agreement to be acquired by Lloyds TSB, as announced on 18 September 2008.

However turbulence in the markets continued, fuelled by concerns about credit risk and worsening economic conditions. Measures by national authorities and central banks failed to stem this turbulence and restore inter-bank confidence. The UK Government decided that it would be appropriate for the UK banking sector to increase its level of capitalisation. This led to the UK Government announcing, on 8 October 2008, specific and comprehensive measures to ensure the stability of the UK financial system. This included a significant recapitalisation of the UK banking sector together with the introduction of a guarantee by HM Treasury in respect of future short and medium terms debt issuance. On 13 October 2008, the terms of the acquisition by Lloyds TSB were amended and, as part of the UK Government's co-ordinated package of measures, HBOS announced a Placing and Open Offer to raise £11.5bn of new capital (consisting of £8.5bn in ordinary shares and £3.0bn in preference shares). The capital raising, underwritten by the UK Government, was made available to HBOS on condition that the acquisition by Lloyds TSB completed. On 16 January 2009, the acquisition of HBOS by Lloyds TSB completed and the name of the combined group was changed to Lloyds Banking Group plc (LBG).

Basis of Presentation

In order to provide a clearer representation of the Group's underlying business performance the Group presents its results on a basis referred to as 'underlying' which incorporates the following adjustments:

- Excluding regulatory provisions, the loss on sale of BankWest and St. Andrews; the impact of the change in corporation tax rates and goodwill impairment;
- Operating lease depreciation and impairment on investment securities are netted against income; and
- Share of (losses)/profits of associates and jointly controlled entities are included within underlying non-interest income.

A reconciliation of underlying (loss)/profit before tax to the statutory profit before tax is shown on page 3.

During 2008, certain businesses were transferred between the Retail, Corporate and Treasury divisions. The 2008 Preliminary Results are reported in line with this new structure and the 2007 divisional comparatives have been restated. There is no impact on the 2007 Group Consolidated Balance Sheet and Income Statement previously published.

Prospects

The prospects for the Group should now be considered in the context of the combined LBG and reference should be made to the LBG Annual Report and Accounts for further information.

The UK banking sector is expected to see continued pressure on earnings from the ongoing dislocation in financial markets and the deteriorating global economic environment. The continuing dislocation in global financial markets is expected to perpetuate the ongoing scarcity of wholesale funding for the banking sector leading to higher funding costs. Valuation for the sector's debt securities and other structured products are expected to continue to come under pressure as the economic slowdown impacts on asset values generally. The reduced supply, and increased cost, of credit in the global economy is putting further strain on consumers, small and medium enterprises (SMEs) and large corporate businesses and is a significant factor in driving the deteriorating economic conditions. Rising UK unemployment is expected to result in higher UK sector impairment losses for mortgage and consumer lending. This is in addition to higher impairment losses expected from property based lending as the reduced availability of credit continues to push residential and commercial property prices lower.

Key Performance Indicators

	2008	2007
Statutory (loss)/profit before tax (£m)	**(10,635)**	4,952
Underlying (loss)/profit before tax (£m)	**(9,448)**	5,084
Core Tier 1 capital ratio	**4.7%**	6.4%(1)
Tier 1 capital ratio	**5.3%**	7.0%(1)
Core Tier 1 capital ratio	**7.3%(2)**	
Tier 1 capital ratio	**7.9%(2)**	

(1) On 1 January 2008, BoS Group implemented Basel II rules for capital adequacy and the capital ratios shown are therefore on a Basel II basis.

(2) Includes the down-streaming from HBOS plc to BoS plc of the net proceeds of £8.4bn of ordinary shares from the UK Government's recapitalisation. This was approved by the board on 26 February 2009.

Financial Review

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Underlying net interest income	**8,293**	7,626
Underlying non-interest income	**(3,569)**	3,796
Underlying net operating income	**4,724**	11,422
Underlying operating expenses	**(4,417)**	(4,413)
Underlying operating profit before provisions	**307**	7,009
Impairment losses on loans and advances	**(9,857)**	(2,012)
Non-operating income	**102**	87
Underlying (loss)/profit before tax	**(9,448)**	5,084
Adjusted for:		
Regulatory provisions charge	**(200)**	(122)
Goodwill impairment	**(142)**	
Loss on sale of BankWest and St. Andrews	**(845)**	
Impact of the 2008 change in corporation tax rate on the value of leasing assets		(10)
(Loss)/profit before tax - statutory	**(10,635)**	4,952

Overview of Results

The Group operated in difficult market conditions during 2008. The results were affected by a significant deterioration in credit quality, particularly in the second half of 2008 as the UK economy deteriorated and residential and commercial property prices declined. They were also affected by the continuing dislocation in financial markets which led to further sharp falls in the values of our Treasury debt securities portfolio. Statutory loss before tax was £10,635m (2007 profit before tax of £4,952m).

The income statement commentary that follows is presented on an underlying basis (see 'Basis of Presentation' on page 2). Underlying loss before tax for the year to 31 December 2008 was £9,448m (2007 profit of £5,084m).

Net interest income

Underlying net interest income increased to £8,293m (2007 £7,626m), mainly due to growth in Retail, which benefited from improved margins, and to growth in International and Corporate reflecting increased advances.

Non-interest Income

Underlying non-interest income decreased to negative £3,569m (2007 income of £3,796m). Excluding the negative £4,044m (2007 negative £227m) impact of Market Dislocation, underlying non-interest income decreased to £475m (2007 £4,023m). The significant decline is due to Corporate and reflects significant impairment losses on property related investments made by the Joint Venture business and private equity fund investments made by the Integrated Finance business, together with a material decline in the trading performance generated by jointly controlled entities, particularly in the housebuilding and property sectors.

Operating Expenses

Underlying operating expenses were broadly stable at £4,417m (2007 £4,413m). The slight increase includes additional costs arising from planned investments in International, partially offset by reduced staff costs in Corporate, benefits from cost reduction initiatives in Retail and lower bonus costs across the Group.

Credit Quality

Impairment losses on loans and advances were £9,857m (2007 £2,012m). While increases were seen in all three banking divisions, the most significant increase was in Corporate. This increase reflects the worsening economic conditions, which specifically deteriorated in the last quarter of 2008. The higher impairment losses in Corporate were also the result of applying a provisioning methodology more consistent with that used by Lloyds TSB. In Retail, the increase in impairment losses mainly related to secured lending as the difficult economic conditions *resulted in higher mortgage arrears, particularly in the specialist* book. This, together with a material decline in house prices, resulted in increased provisioning requirements. Similar trends to the UK were evident in our International division, reflecting the deteriorating economies.

Items excluded from underlying (loss)/*profit before tax*

Regulatory Provisions charge - The regulatory provisions charge of £200m is in respect of the Financial Services Compensation Scheme (FSCS) relating to HBOS's share of expenses, primarily the interest payable on the loan taken out by FSCS to pay compensation to depositors. In 2007 the charge relates to ex gratia refunds of current account service fees, together with the associated administration costs.

Loss on sale of BankWest and St. Andrews - On 19 December 2008, BankWest and St. Andrew's Australia were sold to Commonwealth Bank of Australia for a total consideration of A$2.4bn. The sale generated a loss of £845m, including the write off of £240m of goodwill.

Goodwill impairment - Goodwill impairment principally comprises £72m in respect of the full write down of goodwill *held in respect* of the acquisition of the ICC business banking division in Ireland and £50m being the write down of goodwill relating to a specialist area of the UK credit card business to a recoverable amount of £20m.

Balance Sheet Analysis

Loans and advances to customers were £473.0bn (2007 £460.3bn). On a like-for-like basis, excluding BankWest and St. Andrews which were sold in December 2008, loans and advances to customers increased by 8% primarily reflecting growth in Corporate resulting from growth in the first half of 2008 and by foreign currency movements.

Customer deposits decreased to £262.2bn (2007 £272.7bn) reflecting net outflows in September and October, partially offset by the increased use of repos in Treasury. Deposit flows have improved following the announcement of the LBG acquisition.

Financial Review continued

Taxation

The tax credit for the year was £2,448m (2007 tax charge of £1,318m). The 2007 tax charge of £1,318m includes a credit of £76m in respect of the change in the rate of UK corporation tax. Excluding these and other items stripped out of underlying (loss)/profit (ie, regulatory provision s, loss on sale of BankWest and St. Andrews, and goodwill impairment) results in an effective tax rate of 28% (2007 25%).

Liquidity and Funding

Following speculation on HBOS's future in mid-September, the HBOS Group suffered deposit outflows, further increasing the HBOS Group's reliance on wholesale funding markets. The majority of these deposit outflows were non-bank financial institutions and large corporates, rather than personal account customers. In recent months this position has stabilised with net inflows evident following the announcement of the proposed transaction with Lloyds TSB. Further information on the HBOS Group's funding is included in the Risk Management Report on page 24.

Segmental Analysis

A review of the financial and operating performance of the divisions is included on pages 6 to 10. The following table summarises the divisional results for the Group.

Income Statement Year ended 31 December 2008	Retail £m	Corporate £m	International £m	Treasury £m	Other Activities[3] £m	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Underlying net interest income[1]	4,242	2,298	1,477	270[1]	6	**8,293**[1]	7,626
Underlying non-interest income[1]	1,263	(1,475)	230	(3,764)[1]	177	**(3,569)**[1]	3,796[1]
Underlying net operating income[1]	5,505	823	1,707	(3,494)[1]	183	**4,724**[1]	11,422[1]
Underlying operating expenses	(2,011)	(939)	(745)	(170)	(552)	**(4,417)**	(4,413)
Underlying operating profit/(loss) before provisions[1]	**3,494**	**(116)**	**962**	**(3,664)**[1]	**(369)**	**307**[1]	7,009[1]
Impairment losses on loans and advances	(2,230)	(6,669)	(958)			**(9,857)**	(2,012)
Underlying operating profit/(loss)[1]	**1,264**	**(6,785)**	**4**	**(3,664)**[1]	**(369)**	**(9,550)**[1]	4,997[1]
Non-operating income	102					**102**	87
Underlying profit/(loss) before tax	**1,366**	**(6,785)**	4	(3,664)[1]	(369)	(9,448)[1]	5,084[1]
Year ended 31 December 2007[2]							
Underlying profit/(loss) before tax	2,139	2,460	630	201	(346)		5,084

(1) Including £(3,948)m (2007 £(227)m) impact of Market Dislocation in Treasury, comprising £96m in net interest income and £(4,044)m (2007 £(227)m) in underlying non-interest income.
(2) Retail, Corporate and Treasury have been restated to reflect the divisional reorganisation.
(3) Other Activities combine the activities of the Insurance & Investment and Group Items divisions of the HBOS Group which are not individually material to the Group. HBOS Group's Insurance & Investment operations are primarily transacted in entities outside the Group, with operations within the Group limited to sales activities in the banking network. Group Items carries out the head office and central activities of the Group.

Regulatory Capital

On 1 January 2008 BoS Group implemented the Basel II rules for capital adequacy and the capital ratios below are therefore shown on a Basel II basis only.

The Tier 1 capital ratio at 31 December 2008 is 5.3% (1 January 2008 7.0%) and the Core Tier 1 ratio is 4.7% (1 January 2008 6.4%). Including the net capital injection of £8.4bn from HBOS plc in February 2009 from the Government recapitalisation, the Tier 1 Capital ratio would be 7.9% and the Core Tier 1 ratio 7.3% at 31 December 2008.

Risk Weighted Assets (RWAs)

RWAs increased by 6% to £326.7bn (1 January 2008 £307.5bn) driven by the following factors:

- Retail RWAs increased by 10% due to economic conditions increasing average risk weights.
- Corporate RWAs increased by 5% initially due to Loans & Advances growth in the first quarter of the year. Corporate asset growth subsequently slowed, with the RWAs reducing in the second half of the year as a result of asset reduction and impairment provisions offsetting the impact of currency retranslations and deteriorating economic conditions.
- In International RWAs decreased by 5% with the impact of the sale of BankWest reducing RWAs, offset by currency retranslations.
- In Treasury & Asset Management, RWA growth was 49% primarily due to increased liquidity holdings and increase in average risk weights due to rating downgrades on asset portfolios.

Tier 1 Capital

Tier 1 capital decreased by £4.2bn during the year reflecting the loss attributable to shareholders and the payment of the 2007 final dividend in May 2008. These reductions were partially offset by the issue of £5.5bn of ordinary share capital in the year. Tier 1 capital was strengthened in February 2009 as a result of the down-streaming from HBOS plc to BoS plc of the net proceeds of £8.4bn ordinary shares from the UK Government sponsored recapitalisation of HBOS plc.

Tier 2 capital

The increase in Tier 2 capital during the year is due to subordinated debt issues totalling £3bn. At 31 December 2008 there was a regulatory restriction on the value of Lower Tier 2 capital however including the capital injection from HBOS plc the full benefit of Lower Tier 2 is recognised.

Capital Structure Basel II	*As at* 31.12.2008 (including capital injection)* £m	*As at* 31.12.2008 £m	As at 01.01.2008 £m
Risk Weighted Assets	**326,703**	**326,703**	307,482
Capital Resources			
Core Tier 1	**26,012**	**17,661**	22,164
Perpetual non-cumulative preference shares	**1,200**	**1,200**	1,200
Innovative Tier 1	**698**	**698**	698
Deductions from Tier 1	**(2,231)**	**(2,231)**	(2,570)
Total Tier 1 Capital	**25,679**	**17,328**	21,492
Upper Tier 2	**7,005**	**7,005**	4,033
Lower Tier 2	**9,339**	**9,094**	9,695
Deductions from Tier 2	**(861)**	**(861)**	(960)
Total Tier 2 Capital	**15,483**	**15,238**	12,768
Total supervisory deductions	**(919)**	**(919)**	(734)
Total Capital Resources	**40,243**	**31,647**	33,526
Core Tier 1 ratio (%)	**7.3%**	**4.7%**	6.4%
Tier 1 capital ratio (%)	**7.9%**	**5.3%**	7.0%
Total capital ratio (%)	**12.3%**	**9.7%**	10.9%

* Includes the down-streaming from HBOS plc to BoS plc of the net proceeds of £8.4bn of ordinary shares from the UK Government's recapitalisation. This was approved by the board on 26 February 2009. There is no impact on Risk Weighted Assets.

Retail

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 (restated) £m
Net interest income	**4,242**	4,113
Underlying non-interest income	**1,263**	1,239
Underlying net operating income	**5,505**	5,352
Underlying operating expenses	**(2,011)**	(2,023)
Underlying operating profit before provisions	**3,494**	3,329
Impairment losses on loans and advances	**(2,230)**	(1,277)
Underlying operating profit	**1,264**	2,052
Non-operating income	**102**	87
Underlying profit before tax	**1,366**	2,139
Cost:income ratio	**36.5%**	37.8%

Financial Performance

Underlying profit before tax in Retail decreased to £1,366m (2007 £2,139m) as a result of increased impairment losses on loans and advances.

Total net operating income increased to £5,505m (2007 £5,352m). Net interest income was the main driver, increasing to £4,242m (2007 £4,113m). Net interest margin increased despite the cost of both wholesale and retail funding increasing as a consequence of the dislocation in financial markets and a more competitive retail savings market. The margin improvement mainly reflects the beneficial impact of higher mortgage acquisition and retention spreads.

Underlying operating expenses decreased to £2,011m (2007 £2,023m) and reflect the continued benefit from cost reduction initiatives in prior years together with further cost reduction measures taken during 2008.

Impairment losses increased to £2,230m (2007 £1,277m). Secured impairment losses were £1,125m (2007 £28m) with the charge for unsecured lending at £1,105m (2007 £1,249m).

Operational Performance

Mortgages

Given the slowing market and the increased cost of borrowing, price and criteria changes have been made to focus asset growth selectively, both to manage the overall risk profile and improve risk adjusted returns on capital. As a result, the proportion of high loan to value (LTV) business has been reduced, delivering new business LTV of 67% for the full year (2007 65%), against a backdrop where equity for both home purchasers and remortgage customers has been eroded by negative house price inflation. Gross lending for 2008 was £50bn (2007 £73bn), representing a market share of 20% (2007 20%). Principal repaid was £47bn (2007 £58bn), representing a market share of 22% (2007 23%). As a consequence, net lending was £3bn (2007 £15bn), representing a 9% (2007 15%) market share.

Unsecured lending

In the current economic environment the cautious approach to unsecured lending continues with the acquisition strategy being to target the existing customer base with an appropriate and increased focus on credit risk relative to the current economic conditions and proactively tighten credit availability to existing credit card customers.

Savings and Banking

2008 has been characterised by far greater volatility of flows. Despite these difficult market conditions, Bank of Scotland retains its market leading position of Household Sector Liquid assets with a market share of 13.2% (2007 15.6%) and this position, combined with the brand and distribution strength together with innovative products, provides an excellent platform from which to attract future inflows.

The competitiveness of the range of current accounts has continued to drive the sales momentum. New bank accounts acquired totalled 960,000 (2007 one million) and of these 75% (2007 75%) were full facility current accounts.

Corporate

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 (restated) £m
Underlying net interest income	**2,298**	2,272
Underlying non-interest income	**(1,475)**	1,805
Underlying net operating income	823	4,077
Underlying operating expenses	**(939)**	(998)
Underlying operating (loss)/profit before provisions	**(116)**	3,079
Impairment losses on loans and advances	**(6,669)**	(619)
Underlying (loss)/profit before tax	(6,785)	2,460
Cost:income ratio	**114.1%**	24.5%

Financial Performance
A significant deterioration in corporate credit conditions, particularly in the second half of 2008, led to very substantial impairment losses of £6,669m (2007 £619m), primarily as a result of exposure to property-related sectors. Underlying loss before tax was £6,785m (2007 £2,460m profit).

Underlying net interest income increased to £2,298m (2007 £2,272m) due to growth in the loan book. This was offset by lower margins reflecting slowing of back book churn, which has impacted the timing of fee recognition, and increased cost of deposits and higher wholesale funding costs.

Underlying non-interest income decreased to a loss of £1,475m (2007 £1,805m profit). Pronounced falls in estimated values of property and other investments resulted in substantial losses from the investment portfolio, primarily in the private equity and joint ventures businesses.

Underlying operating expenses decreased to £939m (2007 £998m) reflecting lower levels of performance based remuneration and lower headcount.

The level of impairment losses experienced, especially in the last quarter, was principally a reflection of the acceleration in the deterioration in the economy and as a result of applying a provisioning methodology more consistent with that used by Lloyds TSB. The shape of the Corporate book, and in particular its exposure to housebuilders, risk capital (loan stock, preference shares and ordinary shares) and large single credit exposures, exacerbated the impact.

Operational Performance
In Real Estate, as UK property values have fallen, increases in advances has been restricted to a small number of existing customers drawing down existing commitments.

In Commercial the focus was on existing lending customers and new, primarily deposit led, full banking relationships.

In Asset Solutions the vehicle finance businesses have been materially impacted in 2008 by residual value and impairment losses on assets.

Specialised Industry Finance (SIF) businesses performed well in 2008 in a difficult market environment.

The Joint Ventures business has seen an extremely challenging 2008 across all sectors in the UK, with housebuilding suffering from falling volume sales and the negative impact on land values. Commercial property has also been adversely impacted by the rapid deterioration in credit markets and the underlying economy significantly reducing values.

Integrated, Structured & Acquisition Finance has been materially impacted by the reduced deal volumes and falling asset values experienced across the private equity sector in the UK and continental Europe. The drawn LBO portfolio debt totalled £6.7bn (2007 £6.0bn) with undrawn facilities totalling £1.3bn (2007 £1.3bn).

International

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Net interest income	**1,477**	1,105
Underlying non-interest income	**230**	294
Underlying net operating income	**1,707**	1,399
Underlying operating expenses	**(745)**	(653)
Underlying operating profit before provisions	**962**	746
Impairment losses on loans and advances	**(958)**	(116)
Underlying profit before tax	**4**	630
Cost:income ratio	**43.6%**	46.7%

Financial Performance
Underlying profit before tax was £4m (2007 £630m) reflecting an increase in impairment losses, as a result of the deteriorating economic environment. Operating profit before provisions increased to £962m (2007 £746m), reflecting strong income growth across the division. The income statement includes 2008 results for the BankWest and St. Andrews businesses up until their disposal on 19 December 2008 to Commonwealth Bank of Australia (CBA), and the full year results for all other HBOS Australia businesses.

Operating Income and Margins
Underlying net operating income increased to £1,707m (2007 £1,399m). Net interest income increased to £1,477m (2007 £1,105m) driven by growth in lending balances, moderated by a decline in margin. The margin decline was driven by Ireland where higher funding costs, slower churn in the back book impacting the timing of fee recognition and a changing asset mix resulted in a lower margin. Whilst significant price increases have been introduced on new lending across the International banking businesses, these have not yet fully materialised in the overall margin.

Operating Expenses
Underlying operating expenses increased to £745m (2007 £653m). This increase was primarily due to investment in Australia in physical distribution, new products, brand recognition, customer facing staff and back office infrastructure in BankWest and St. Andrews prior to their sale to CBA and in Europe and North America (ENA) due to continued investment in the US infrastructure, establishment of the new corporate business in Canada and a major strategic investment designed to increase the deposit taking capability in Europe.

Credit Quality and Provisions
Impairment losses increased from £116m in 2007 to £958m in 2008. The extremely challenging economic and market conditions led to rising arrears and falling asset values. In Europe and North America deteriorating economic conditions across key markets saw impairment losses increase primarily reflecting two credit exposures in the US.

Lending and Deposit Growth
Loans and advances declined during 2008, reflecting the £27.0bn reduction in balances in Australia following the sale of BankWest and St. Andrews. This was offset by the effect of currency translation and underlying growth in Ireland, ENA and the continuing businesses in Australia.

Treasury

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 (restated) £m
Net interest income	**270**	136
Underlying non-interest income	**(3,764)**	252
Underlying net operating income	**(3,494)**	388
Underlying operating expenses	**(170)**	(187)
Underlying (loss)/profit before tax	**(3,664)**	201

Financial Performance
Underlying (loss)/profit before tax decreased to £(3,664)m (2007 £201m). This result included the impact of Market Dislocation of £(3,948)m (2007 £(227)m) comprising £96m in net interest income and £(4,044)m (2007 £(227)m) in underlying non-interest income.

Operating Income
Underlying sales of Treasury products to customers remained robust but operating income was adversely affected by the impact of dislocated financial markets on trading revenues.

Operating Expenses
Underlying operating expenses decreased to £170m (2007 £187m) primarily reflecting a reduction in performance related staff costs.

Treasury Debt Securities
As part of its investment credit activities Treasury holds a portfolio of debt securities which are analysed on the following page. The investment credit business has two functions: firstly it manages part of the Group's prudential liquidity portfolio and secondly it takes investment positions principally through the Grampian conduit.

Following the International Accounting Standards Board's (IASB) decision to permit the reclassification of Financial Assets, Treasury reclassified certain securities from assets held for trading into the Available for Sale (AFS) portfolio and, subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS, to Loans and Receivables.

ABS and FRNs with book values (as at 31 December 2008) of £10.1bn and £3.4bn respectively were transferred out of Trading into the AFS portfolio with effect from 1 July 2008. Subsequently, ABS with book values (as at 31 December 2008) of £37.2bn were transferred out of the AFS portfolio and into Loans and Receivables with effect from 1 November 2008. If these assets had not been reclassified during the year additional negative fair value adjustments (NFVA) of £981m would have been recognised in the income statement and the AFS reserve movement would have been reduced by £68m (post tax).

The decrease in ABS was due to paydowns of £4.3bn and NFVA and impairment losses of £8.6bn, partially offset by the effects of foreign currency movements which resulted in an increase of £11.3bn. The holding of bank CDs have reduced through maturities being replaced with Government backed bonds.

Market Dislocation losses
For the year to 31 December 2008, losses taken to the income statement due to the impact of Market Dislocation on the Treasury debt securities portfolio totalled £3,948m (2007 £227m), after reclassification, as follows:

	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Negative fair value adjustments	**(2,527)**	(227)
Impairment losses	**(1,421)**	
Total impact of Market Dislocation	**(3,948)**	(227)

During the second half of the year a significant deterioration in market sentiment and liquidity has affected the fair value of the ABS portfolio and in particular certain asset classes including Alt-A bonds and CDOs. In addition the adverse trends on credit quality which commenced in the first half of 2008 have intensified in the second half of 2008 and early 2009, and as a result impairment losses of £0.8bn have been incurred, primarily relating to Alt-A, £0.6bn and ABS CDOs, £0.1bn. As a result of these developments, certain asset classes have been written down significantly at year end, resulting in the Alt-A portfolio with an average carrying mark of 59%, ABS CDOs of 20% and other CBO positions of 53%.

In addition following the failure of a number of financial institutions in the second half of 2008 impairment losses have been incurred of £0.6bn on the FRN book relating to the exposures to Lehman Brothers, Washington Mutual and Icelandic Banks.

Treasury

Treasury debt securities

Treasury's total debt securities portfolio as at 31 December 2008, net of negative fair value adjustments (NFVA) and impairment provisions, is summarised in the following table:

Asset Class	Loans & Receivables £bn	Available for Sale £bn	Fair Value through P&L £bn	Total as at 31.12.2008 £bn	Total as at 31.12.2007 £bn
Asset Backed Securities					
Direct	20.5		3.0	**23.5**	23.3
Grampian conduit	16.7			**16.7**	18.6
Total ABS	37.2		3.0	**40.2**	41.9
Covered Bonds		4.1		**4.1**	3.2
Bank/Financial Institution Floating Rate Notes (FRNs)		16.0	1.9	**17.9**	17.4(1)
Bank Certificates of Deposit (CDs)		2.9	3.1	**6.0**	15.3(1)
Other(2)		1.8	6.0	**7.8**	2.8
Total Treasury Assets	**37.2**	**24.8**	**14.0**	**76.0**	80.6
Landale		0.7		**0.7**	0.6
Total (net of NFVA and impairment provisions)	**37.2**	**25.5**	**14.0**	**76.7**	81.2

(1) £1.6bn reclassified between CDs and FRNs.
(2) Principally Governments and Supra-nationals.

Exposure to Asset Backed Securities (ABS)

Asset Class	Net Exposure as at 31.12.2008 £bn	Average Mark as at 31.12.2008 %	Net Exposure as at 31.12.2007 £bn	Average Mark as at 31.12.2007 %
Mortgage Backed Securities				
US RMBS(1)	**6.9**	**64**	9.3	98
Non-US RMBS	**7.9**	**93**	7.9	99
CMBS(1)	**3.3**	**95**	3.3	99
	18.1	**79**	20.5	99
Collateralised Debt Obligations				
CBO(1)	**2.1**	**49**	3.3	98
CLO(1)	**3.5**	**91**	3.2	99
	5.6	**68**	6.5	99
Personal Sector				
Auto Loans	**1.6**	**98**	1.5	100
Credit Cards	**3.5**	**96**	2.8	99
Personal Loans	**1.1**	**95**	1.0	98
	6.2	**96**	5.3	99
FFELP Students Loans(1)	**7.0**	**94**	5.6	98
Other ABS	**0.6**	**89**	0.7	99
Total Uncovered ABS	**37.5**	**82**	38.6	99
Negative Basis(2)	**2.7**	**70**	3.3	99
Total ABS(3)(4)	**40.2**	**81**	41.9	99

(1) RMBS means Residential Mortgage Backed Securities; CMBS means Commercial Mortgage Backed Securities; CBO means Collateralised Bond Obligations; CLO means Collateralised Loan Obligations; FFELP means Federal Family Education Loan Programme.
(2) Negative basis means bonds held with separate matching credit default swap (CDS) protection.
(3) The total comprises US securities of £24.3bn and Non-US securities of £15.9bn.
(4) There has been no increase in net exposure as a result of the purchase of ABS during the year. Any increase in net exposure is the result of exchange rate movements in excess of paydowns, NFVAs and impairments.

Risk Management

Introduction

During 2008, the global dislocation in financial markets has resulted in exceptional instability and volatility, impacting upon market and investor confidence which has been characterised by a marked reduction in liquidity in the international money markets. This crisis which started in 2007 and has impacted upon financial markets since, led the UK Government to inject liquidity into the financial system and to require (and participate in) recapitalisation of the banking sector to restore confidence to the market.

On 13 October 2008, as part of the co-ordinated package of capital and funding measures for the UK banking sector, implemented by HM Treasury, the Group participated in the Government Funding Package and thereby facilitated access to the UK Government backed provision of liquidity.

Global market and economic conditions continue to pressurise the Group. However, through the injection of capital and liquidity facilitated by the UK Government, both currently and going forward, HBOS remains confident it will navigate through this difficult period, as it becomes part of the Lloyds Banking Group (LBG).

As a wholly owned subsidiary, HBOS is dependent on LBG for funding.

The key dependencies on successfully funding the enlarged Group's balance sheet include the continued functioning of the money and capital market at their current levels; the continued access of the Group to central bank and Government sponsored liquidity facilities, including issuance under HMT's credit guarantee scheme (CGS) and access to the Bank of England's various facilities, limited further deterioration in the Group's credit ratings and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or Government support schemes.

The Lloyds Banking Group was created on 16 January 2009. Subsequently, HBOS has adopted LBG Risk practices. This report discusses Risk practices in effect in HBOS during 2008.

Key risks and uncertainties facing the Group

This section describes the risk factors which are considered to be material in relation to the Group.

These risks should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. Additional risks and uncertainties that are not presently known, or which are currently deemed immaterial, may also have an adverse effect on the Group's operating results, financial condition and prospects.

Each of the Divisions faces key risks and uncertainties in the execution of their strategy. These are set out in the divisional sections of the Business Review, where they can be read in conjunction with the Division's strategy, and financial and operating performance.

Credit Risk: The financial performance of the Group is affected by borrowers ability and willingness to repay *amounts lent by the Group*

Credit risk arises in the Retail, Corporate and International divisions and the Treasury function, reflecting the risks inherent in the Group's lending activities. Over the last year the banking crisis has impacted the financial services industry resulting in high profile losses and writedowns.

The deteriorating economic outlook, both in the UK and overseas, is also leading to significant increases in impairments. The Group is impacted by the economic downturn and a further worsening of the business environment could impact earnings adversely. This poses a major risk to the Group and its lending businesses in:

- Retail, where rising unemployment impacts the ability of customers to meet repayment dates on unsecured and secured lending and leads to a consequent increase in arrears. Additionally, the downturn in the housing market reduces collateral values for residential property and this impacts upon the profitability of secured lending.
- Corporate, where companies are facing increasingly difficult conditions, resulting in corporate default levels rising and leading to increases in corporate impairments.

Liquidity Risk: The Group may be unable to meet its financial obligations as they fall due or is unable to raise sufficient funds to take full advantage of growth opportunities

This is known as liquidity risk and arises from mismatches in the maturities and the timing of cashflows relating to assets, liabilities and off-balance sheet instruments. HBOS relies and intends to rely increasingly on customer savings and transmission balances, as well as ongoing access to the wholesale lending markets, central bank liquidity facilities such as the Special Liquidity Scheme and the Extended Open Market Operations operated by the Bank of England, and support from HM Treasury's guarantee scheme.

Further information about the approach to managing liquidity risk is explained on pages 23 to 26.

Risk Management
continued

Market Risk: Changes in interest rates, credit spreads, foreign exchange rates and commodity and equity prices and other market risks affect the HBOS Group's business and financial results
This is referred to as market risk and is defined as the potential loss in value or earnings of the HBOS Group, arising from changes in external market factors such as interest rates, credit spreads, foreign exchange rates, commodity and equity prices and the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions. Changes in interest rate levels, yield curves and credit spreads may affect the interest rate margin realised between lending and borrowing costs.

Further information about the management of, and exposure to, market risk is set out on pages 20 to 23.

Capital: The Group may have insufficient capital resources to meet the regulatory minimum requirements, to finance growth, or to support its credit rating
Capital discipline is a key element of the Group's strategy. Capital is a scarce resource and the task is to deploy it to achieve sustainable returns and add value for shareholders. To strengthen the Group's capital position, HBOS launched a wholly underwritten £4bn Rights Issue in May 2008. However further market pressures, the failure of Lehman Brothers in the US and S&P downgrading of HBOS had a severe impact on the Group, ultimately resulting in the recommended acquisition of HBOS plc by Lloyds TSB Group plc.

Based upon projections by management, assuming the availability of the existing and announced Government Funding Package, the Group believes it has adequate resources to continue in business for the foreseeable future.

The Group's approach to the management of capital is set out on pages 27 to 28.

Operational Risk: Operational risks exist in the normal course of the Group's business
In a large organisation with many different processes, IT systems and colleagues, there is a risk that operational losses can result. Examples of the sources of such risks include fraud, systems reliability, human error, failure of key suppliers, IT security, change management, operational outsourcing or failure to comply with legislation or regulation.

Further information about the management of operational risk is set out on page 26.

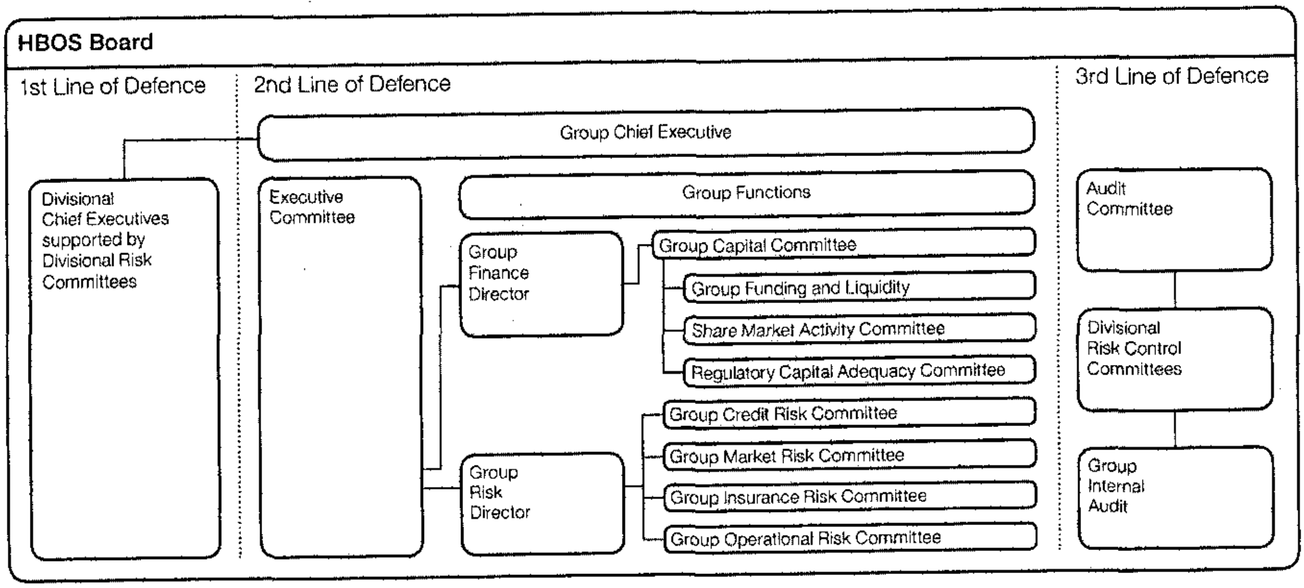
Regulatory Risk: The Group's business and earnings can be affected by changes in financial services laws and regulations in each of the locations in which it operates
Any significant regulatory changes could affect how the Group conducts business and its financial performance.

Regulatory risk is explained in detail on page 26.

Management and Controls

Governance

The governance model comprises a well established and embedded committee structure and associated control environment across the Group. The framework discussed describes that in effect in Bank of Scotland for the financial year.



The Risk Management Framework

HBOS allocates specific roles in the management of risk to executives and senior managers and to the Board and Executive Committees. This is undertaken within an overall framework and strategy established by the Board. The model is based on the concept of 'three lines of defence'.

1st Line of Defence	RISK MANAGEMENT	• *Divisional CEOs* • Divisional Risk Specialists • Divisional Risk Committees	• *Strategy* • Performance • Risk control
2nd Line of Defence	RISK OVERSIGHT	• Group Chief Executive • Executive Committee • Group Functions (inc. Group Risk and Group Finance) • Executive Risk Committees	• Centralised policy management • Independent oversight of risk
3rd Line of Defence	RISK ASSURANCE	• Audit Committee • Divisional Risk Control Committees • Group Internal Audit	• Independent assurance

Risk Management continued

Divisional management has primary responsibility for identifying and evaluating significant risks to the business and for designing and operating suitable controls. Internal and external risks are assessed, including economic factors, control breakdowns, disruption of information systems, competition and regulatory requirements.

The four Group Executive Risk Committees - Group Credit Risk Committee, Group Market Risk Committee, Group Insurance Risk Committee and Group Operational Risk Committee develop the policies and parameters within which Divisions are required to manage risk. The Committees provide central oversight by reviewing and challenging the work of the Divisions' own risk committees and considering the application of appropriate risk management techniques.

The specialist Group Risk function, reporting to the Group Risk Director, supports these Committees. Its responsibilities are:

- to recommend Group policies, standards and limits;
- to monitor compliance with those policies, standards and limits;
- to provide leadership in the development and implementation of risk management techniques; and
- to aggregate risks arising in the Divisions and to monitor the overall Group position independently from the Divisions' own analysis.

Consideration of capital, liquidity and balance sheet management is undertaken on an integrated basis. All capital and funding related activities are the responsibility of the Group Capital Committee, supported by three sub-committees, which focus on the core aspects of overall Group requirements. The Group Capital Committee is chaired by the Group Finance Director and operates under delegated authority from the Board to oversee and manage the Group's Balance Sheet and Capital in accordance with the Board approved Group Business Plan and within regulatory ratios.

In judging the effectiveness of the Group's controls, the Board reviews the reports of the Audit Committee and management.

Certain responsibilities are delegated to the Audit Committee including ensuring that there is regular review of the adequacy and efficiency of internal control procedures. This role provides independent assurance that there is an appropriate control structure throughout the Group.

The Audit Committee, supported by Divisional Risk Control Committees, obtains assurance about the internal control and risk management environment through regular reports from Group Functions (including Group Risk and Group Finance) and Group Internal Audit. It also considers external auditors' reports.

Management of Key Risks

(The information set out below, up to and including the section entitled 'Market Risk' on page 20 forms an integral part of the audited financial statements as described in the Financial Statements section in the Accounting Policies on page 40).

Credit Risk

Credit Risk is the risk of financial loss from counterparty's failure to settle financial obligations as they fall due.

Credit Risk Performance

During the second half of 2008 the pressures being experienced in wholesale and liquidity markets spread to become severe economic deterioration in the UK. This pressure accelerated significantly in quarter four 2008 and saw substantial issues arising in Corporate lending and Treasury investments.

The Corporate Division's Credit Risk Management was unable to react quickly enough to contain the deterioration, exacerbated by HBOS historic levels of exposure concentration within property and property related sectors, giving little room for manoeuvre in a deteriorating market and resulting in impairment losses increasing dramatically.

In addition, Treasury has been materially impacted by the reduction in fair value of the ABS portfolio as a result of credit concerns, poor market sentiment and liquidity pressures. This has been exacerbated following a strategic decision of moving away from using Government bonds to provide liquidity, instead relying on AAA rated Asset Backed Securities and investment grade bank FRNs, which whilst effective in liquidity terms, significantly increased the credit risk profile of the Group.

The credit risk risk profile within HBOS is susceptible to further increases in impairments if the UK economy continues to deteriorate. Additional pressure will also be evident in Treasury's ABS portfolio if US real estate values fall further, resulting in increasing fair value and impairment losses.

Management of Credit Risk

The Group Credit Risk Committee (GCRC), one of the Executive Risk Committees, is chaired by the Group Risk Director and comprises senior executives from across the business Divisions, Group Risk and Group Finance functions. It meets monthly and reviews the Group's lending portfolio, approves Group credit standards, limits and divisional credit risk policies. The Group Credit Risk Policy Statement is approved by the Board on an annual basis. The GCRC also assists the Board in formulating the Group's credit risk appetite in respect of key products and sectors.

Group Credit, a specialist support function within Group Risk, provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance and forward looking risks of each divisional portfolio to the GCRC (and other senior HBOS committees), Group Credit exercises independent oversight over the effectiveness of credit risk management practices and adherence to approved policies, standards and limits.

Day to day management of credit risk is undertaken by specialist credit teams working within each Division in compliance with policies approved by divisional committees, under lending authorities delegated by the Board (via GCRC). Typically, functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts and credit risk model build and governance.

To manage credit risk, a wide range of policies and techniques are used across the Group:

- For retail portfolios, extensive use is made of credit scoring in the assessment of new applications for credit. In addition, behavioural scoring is used to provide an assessment of the conduct of a customer's accounts in granting extensions to, and setting limits for, existing facilities and in identifying customers at risk of default. Affordability is a vitally important measure and is reviewed in combination with either application and/or behavioural scores. HBOS has been involved in data sharing initiatives within the industry and makes extensive use of credit bureau files to inform the assessment of customer risk and affordability and to aid responsible lending. Small business customers are assessed for their credit-worthiness in a similar manner to retail customers.

- For corporate portfolios, a full credit assessment of the financial strength of each potential transaction and/or customer is undertaken, including a stress test of key financial aspects of the transaction, awarding an internal risk rating which is reviewed regularly. The same approach is also used for larger SME (small to medium enterprise) customers.

- Within Treasury Division (Treasury), which handles the Group's banking and sovereign related exposures, as well as the Group's structured credit bond (ABS) portfolio held for liquidity and proprietary purposes, focused credit risk policies are established and reviewed by the Group Wholesale Credit Committee (GWCC), a sub-committee of the GCRC. Basel II Advanced IRB compliant models are used to rate banking and sovereign counterparties. Structured credit bonds are reviewed individually by an independent credit function prior to purchase and an internal rating is applied to all exposures. Additional thresholds and limits are applied by rating and by asset class in line with the business strategy. As part of an ongoing portfolio review process, monitoring is performed covering each bond holding, supplemented by stress analyses conducted on a periodic basis.

An additional measure within the credit risk framework is the establishment of product, risk profile, industrial sector and country limits to manage excessive concentrations of risk. Material portfolios, such as mortgages, have approved sub-sector limits to ensure that they remain within plan and tolerance for risk. All such limits are set and monitored by the GCRC.

Standards have been established across the Group for the management of credit risk. All Divisions are independently rated against these internal standards by the Group Credit function (on an annual basis) and work together to continuously improve credit risk management capability. There continues to be significant levels of investment in the development of credit risk rating tools, including enhancements to the portfolio risk measurement systems and in governance arrangements to support operations within the terms of the Basel II Accord. These include principles for development, validation and performance monitoring of credit risk models. The approval process for credit models is dependant upon the materiality of the model, with all models impacting the regulatory capital calculation requiring approval by the Group Model Governance Committee (GMGC), which is a sub-committee of the GCRC, and those deemed material to the Group being approved by the Group Capital Committee (GCC).

Internal reporting has developed in response to the introduction of improved rating tools. Senior Management across the Group are now provided with reports assessing the risk profile in terms of Probability of Default and Expected Loss and will continue to do so under the Basel II environment going forward.

Standard Technical Definitions

- PD – Probability of Default. The probability that an obligor enters default in the next 12 months.

- EAD – Exposure At Default. The obligor's credit exposure at the point of default, assuming default occurs within the next 12 months.

- LGD – Loss Given Default. The proportion of an obligor's exposure at default that the lender loses as a result of default, assuming that default occurs within the next 12 months. This is a percentage.

- EL – Expected Loss. The monetary amount expected to lose from an obligor, arising from a default in the next 12 months.

Derived by the formula EL = PD x EAD x LGD.

Scope of HBOS IRB Permission

In the period to 31 December 2007, HBOS operated under what is commonly know as the Basel I regulatory capital regime. Under Basel I the FSA required each bank and banking group to maintain an individually prescribed ratio of total capital to risk-weighted assets, taking into account both balance sheet assets and off-balance sheet transactions. From 1 January 2008 HBOS, in common with UK peers, adopted the Basel II framework through application of the FSA BIPRU rules.

Basel II seeks to augment arrangements and introduces a risk sensitive framework. Basel II is structured to provide a choice of methodologies to determine credit risk regulatory capital requirements, with different levels of complexity. HBOS makes use of the Standardised and Advanced Internal Ratings Based (AIRB) approaches with no portfolios using the Foundation Internal Ratings Based approach.

Risk Management continued

- Standardised approach. This is an extension of Basel I and requires banks to use external credit ratings to determine risk weightings for rated counterparties. Like Basel I, it groups other counterparties into broad categories and applies regulatory determined risk weightings to these categories.
- Advanced Internal Ratings Based approach. This is the most sophisticated approach. Banks use their own internal assessment of PD, EAD and LGD to determine risk weight asset values.

HBOS is approved by the FSA to use the Advanced Internal Ratings Based approach (AIRB) for regulatory capital purposes.

The scope of permission covers all Basel II asset classes, however, HBOS has a model roll-out schedule to complete, predominately in relation to International and Corporate businesses. The roll-out plan and mandatory parallel run will run until the end of 2010.

Beside these, HBOS has a number of small portfolios where, for economic reasons, it is not commercially viable to construct AIRB models. These are typically products which are no longer sold and effectively in run off mode or new products where the critical mass of data necessary to construct AIRB models has yet to be established. In such cases the Standardised approach is applied.

The models that are used in the regulatory capital calculation also underpin the credit risk measurement framework used by HBOS. It is a regulatory requirement that the models deployed in the capital calculations are used to inform credit related decisions.

Internal Ratings Process
For each IRB asset class the approach has been to build internal models to generate PD's, LGD's and EAD's for products within the asset class. This is summarised below.

Retail Assets
Retail assets include residential mortgages, overdrafts, credit cards and unsecured personal lending exposures. The methodology for Retail assets is transaction based with a foundation in the scorecards used for application decision and account management. The regulatory EL is mapped to a Lifetime Expected Loss (LEL) which is used in wider business processes, including assessment of risk appetite and pricing.

Corporate Assets
Corporate assets include exposures to corporate and SME entities. The methodology for non specialised lending Corporate assets considers individually, the obligor PD, the transaction EAD and LGD then combines these to produce the transaction EL. The approach within HBOS to estimating PD has been to undertake a statistical analysis of the obligor's financial statements with a supplementary qualitative but standardised overlay. This is then calibrated to the historically identified (and where necessary appropriately adjusted) default rate for the portfolio in hand. EAD estimates are based on current exposures plus an additional proportion of the undrawn positions. The LGD component is estimated, taking account of the EAD less any recognisable collateral.

Specialised Lending Assets
This asset class predominantly comprises property investment and property development transactions but also includes major asset financing deals, such as shipping and aircraft. This is a transaction based approach. Where full models are in place, the methodology has been to stochastically assess the transaction's cash flows over its lifetime and use this to calculate the 12 month EL.

Financial Institutions and Sovereign Assets
This comprises exposures to governments together with exposures to bank counterparties. Given the historical limited default data for such portfolios the methodology for these assets has been to predict what rating would be provided by an External Credit Assessment Institution (ECAI) should the obligor have sought one. This rating is then related to a PD value based upon the long run historic information associated with such ECAI ratings. A transaction EAD is estimated based on the product characteristics while LGD is directly associated with the standing of the obligor. These components are then combined to produce the transaction EL.

Within HBOS, all models have been developed internally and there is no use of external models (although there may be reliance on external feeds such as bureau data, PD ratings for external third parties such as tenants, and feeds to Treasury's Bank rating models). Minimum Standards for the development and monitoring of Credit Risk Models are in force across the Group.

In accordance with the HBOS federal structure, credit risk control units have been established within each divisional risk function. Divisional credit teams are independent from business generation teams and are responsible for:

- development, validation, implementation and recalibration of credit risk models;
- monitoring of the ongoing performance of the credit risk models; and
- securing annual approval of all credit risk models from the appropriate body.

The most material internal rating models are approved for use by the Group Capital Committee with the remainder at the Group Model Governance Committee, which is a sub-committee of GCRC. Group Credit Risk undertake independent technical review of divisional credit risk models in accordance with the Group's standards. These reviews take place annually or when a model is materially changed and result in a recommendation to the GMGC or Group Capital Committee where the model is approved for use.

Use of Internal Estimates
The Group has introduced IRB models on a phased basis, ensuring that full confidence in the outputs is built up within the credit areas before moving to full use in decisioning.

IRB parameters are being widely used in the Divisions, particularly in those that will experience the most material benefit under Basel II and for the most material requirements.

Credit approval
Credit assessment and approval within HBOS is mainly conducted at the divisional level in line with the Group Credit Risk Policy Statement (GCRPS) and divisional credit policy statements. The GCRPS requires adherence to the canons of lending appropriate for a financial institution of HBOS's size and sophistication, and in relation to IRB inputs it specifically requires that:

- each borrower must be assigned a credit rating or score, or directly, a probability of default (PD) which is updated at least annually; and
- PD and EL should be considered as part of a credit assessment.

The divisional processes can be broken down into two main categories:

Portfolio level credit approval (defined as low value, high volume automated credit processes and used primarily for assessing retail portfolios). Typically, LEL and EL estimates generated from/by IRB models are used to set application scorecard cut-offs. Therefore, the level of business accepted via automated decision making processes is directly influenced by IRB outputs. Decisioning and pricing are linked and LEL outputs are also fed into profitability models that are used to make pricing decisions.

Transaction level credit approval (defined as high value, low volume exposures which are addressed directly by credit analysts - used for corporate, corporate SME, financial institution and sovereign asset classes).

In general, the process operates as follows:

- the relationship manager inputs the appropriate information into the models which return PD/EL outputs; and
- an independent credit risk management unit checks the inputs to the model calculations for accuracy and plausibility (and for outputs); and verifies that the correct model has been used.

Credit Limits
The governance process for limits approval is:

- at Group level, limits for products, sectors and countries are set under the authority of GCRC; and
- within the divisions, sanctioning is conducted under a set of agreed delegated lending authorities granted to individuals or credit committees. These delegated authorities have been revised substantially in response to the deteriorating credit conditions.

Divisional risk committees do not make individual credit decisions but are responsible for putting in place appropriate governance arrangements, approving policies and standards and credit risk rating systems and monitoring all aspects of credit risk within their respective Divisions.

Pricing
Transaction/portfolio level pricing is set by the Divisions who are increasingly basing these decisions on the outputs of the IRB models.

For Retail, pricing and decisioning are intrinsically linked. The lifetime expected losses are fed into the profit model, along with other costs, to allow a price to be set that generates the required return. All pricing decisions have been assessed using the Basel lifetime expected loss to ensure that current pricing passes the required hurdle rates dependent on the risk involved.

For Corporate, the pricing model facilitates the incorporation of appropriate pricing information into the credit approval process.

For Treasury, the major activities are funding, liquidity and hedging in external markets on behalf of the wider HBOS group. Treasury is not normally a market maker in the markets within which it operates and is therefore dependent on prices quoted to it by the market.

Portfolio Reporting
Credit risk reporting is conducted at both Group and divisional levels, embedding IRB parameters into management information. This includes analysing PD, LGD, EAD and EL measures. Model performance and parameter assessment are also presented.

Factors Impacting Loss Experience
The deterioration in the loss experience generally reflects the increasing economic pressures over the year, characterised by declining economic activity, rising unemployment, the contraction of the mortgage market, reduced availability of credit and the fall in house and commercial property values.

The increase in mortgage losses was driven predominantly by increased affordability pressures and reduced attrition from higher risk customers as well as the rise in Loan to Value ratios due to reduced housing values.

The Corporate credit environment has suffered significant deterioration, with an increasing number of customers operating under stressed conditions. In particular, the exposure to the construction and real estate sectors, where HBOS has had historically large concentrations of lending, have been impacted more severely than other sectors. In addition, HBOS strategy was to support relatively high levels of exposure to a small number of long term customer relationships, these single name concentrations have placed the Group at risk of significant loss, should default occur. The general deterioration of the credit environment and associated market dislocation has limited the options available to Corporate to restructure or dispose of distressed assets. As a result, not only has HBOS been impacted earlier and more significantly than most of its peers, it has been very difficult to materially reduce the balance sheet risk profile in reaction to the environment.

Likewise, the loss experience within the International businesses reflects the deteriorating economies within which it operates.

Risk Management continued

Losses experienced in Treasury are due to both the fair value impact of the market dislocation on the Asset Backed Securities portfolio, including Alt A bonds and CDOs and the well publicised failure of certain bank counterparties resulting in credit impairments. The fall in value has been driven largely by credit concerns, poor market sentiment and liquidity requirements.

Credit Risk Mitigation

Collateral is the pledging of assets which in the event of default can be sold in order to realise some, or all, of the outstanding monies. HBOS has documented policies in respect of the criteria for recognition of collateral taken as credit risk mitigation.

HBOS employs a variety of credit risk mitigation techniques in order to mitigate the credit risk faced. These techniques include netting, collateral, guarantees and credit derivatives.

The Retail mortgage portfolios are formally secured on residential properties. Corporate exposures utilise a broad range of collateral types, serving to reduce the loss in event of default. Financial collateral is predominantly cash. Other eligible collateral includes first charges on commercial and residential real estate and other physical assets such as aircraft, shipping, commercial vehicles and car fleets.

On-balance sheet netting is recognised where the agreement is legally effective and enforceable, and there is an intention and ability to settle on a net or simultaneous basis, in all jurisdictions. In recognising the netting agreements, HBOS ensures it can determine at any time those assets and liabilities that are subject to the netting agreement.

On-balance sheet netting is recognised in respect of mutual claims between HBOS and its counterparty. This is limited to reciprocal cash balances between HBOS and the counterparty.

For master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions to be recognised for the purposes of the calculation of regulatory capital, they shall:

- be legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counterparty;.
- give the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon the event of default, including in the event of the bankruptcy or insolvency of the counterparty; and
- provide for the netting of gains and losses on transactions closed out under a master agreement, so that a single net amount is owed by one party to the other.

HBOS policy is to calculate the market value of collateral taken and periodically reassess it. Notwithstanding, revaluation is undertaken whenever HBOS has reason to believe that a significant decrease in market value has occurred.

Where the collateral is held by a third party, HBOS takes reasonable steps to try to ensure that the third party segregates the collateral from its own assets.

Where real estate is pledged as collateral the value of the property is periodically reassessed. More frequent assessment is carried out where the market is subject to significant changes in conditions.

Statistical methods are used to monitor the value of the property and to identify property that requires to be revalued. The property valuation is reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices.

The value of other physical forms of collateral is assessed on a frequent basis and at a minimum once every year. More frequent assessment is required where the market is subject to significant changes in conditions.

HBOS policy is to try to ensure it has the ability to liquidate the collateral, the ability to establish objectively, a price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility or a proxy of the volatility of the value of the collateral. Both initial valuation and revaluation take into account any deterioration or obsolescence of the collateral. Particular attention is paid in valuation and revaluation to the effects of the passage of time on fashion/date-sensitive collateral.

HBOS policy in recognising collateral is that there is the right to physically inspect the collateral, ensuring also that the collateral taken as protection is adequately insured against damage.

Guarantees exist when one entity commits to paying the outstanding monies in event of default of another entity, which has entered into a transaction with HBOS. The Group receives a variety of guarantee types, however, capital calculation recognition is only taken through the use of PD substitution for guarantees provided by appropriate sovereigns and institutions.

Credit derivatives are an investment banking product whereby HBOS pays a premium to a credit protection provider in order to receive the full amount of monies owed should a specific counterparty default on their obligations. In effect, this is a form of insurance policy and is used in Treasury to mitigate Credit Risk.

Counterparty Credit Risk

Internal capital and credit limits

Bank and Sovereign AIRB rating predictor models are used to produce an internal rating for each counterparty within the portfolio. These ratings are mapped across to statistically derived (based upon Moody's history of default data) PD and LGD tables. When combined with EAD, these values determine EL. To determine EAD exposure, values for derivative products are calculated by using the mark-to-market methodology for regulatory purposes and internally developed models for limit management. EL is then used to calculate the minimum capital from which the Risk Weighted Asset (RWA) is derived. Treasury does not use economic capital models, thus RWAs are used to determine regulatory capital.

Securing collateral and establishing credit reserves

Treasury makes active use of collateral and risk mitigation techniques to reduce credit risks in its portfolio. These include the use of collateral (cash, government securities and guarantees), break clauses and netting. In addition, a gross notional control for repo and stock borrowing exists.

To recognise the effects of credit risk mitigation, the mitigation agreements must be valid, enforceable, unconditional and irrevocable. In addition, collateral must be transferred to Bank of Scotland through the passing of title and should be netable on a portfolio basis. Once these and other conditions specified by the credit sanctioner are met, the effect of collateral received is reflected in reductions to all applicable credit exposures and in capital adequacy calculations.

Treasury Collateral Operations are required to actively monitor collateral using established best risk management practices.

Correlation risk

Under the repo framework, the issuer of collateral held and the counterparty the trade is transacted with should be neither the same nor connected. The same rule applies for derivatives under collateral assets standards. Treasury Credit has the discretion to extend the rule to other cases where there is significant correlation.

Financial instruments subject to credit risk

The table below sets out the Group's exposure to credit risk relating to financial instruments before taking account of collateral and other security. Policyholder assets are excluded from the analysis in the table as the underlying credit risks are for the account of the policyholders and have no direct impact on the Group's results. A full reconciliation between the Group's consolidated balance sheet and financial instruments subject to credit risk is set out in Note 36 on page 95.

	Financial instruments subject to credit risk As at 31.12.2008 £m	Financial instruments subject to credit risk As at 31.12.2007 £m
Loans and advances to customers	**473,015**	460,267
Financial assets held for trading	**22,571**	54,681
Debt securities	**65,219**	48,094
Other financial assets	**66,271**	22,335
	627,076	585,377
Contingent liabilities and commitments	**88,355**	106,318
Total	**715,431**	691,695

Loans and advances to customers

Loans and advances to customers are managed on a divisional basis. Information about the credit quality of loans and advances to customers is set out in Note 36 on page 95.

Financial assets held for trading

As described above, full credit analysis is undertaken and, based upon that, an internal rating is derived which helps to establish a credit appetite for the issuer or asset intended to be acquired.

As Treasury manages the liquidity of the HBOS Group, its mandate is to maintain a high quality credit portfolio and actively uses portfolio techniques to manage and monitor the quality of its portfolios. This includes the use of rating based thresholds, established portfolio level thresholds, asset class limits and sub-limits. There are also rules governing the types of assets that can be held within Treasury's Liquidity portfolios, Trading and Banking books and for individual Asset Backed Security (ABS) tranche sizes. There are also limits controlling the maximum weighted average life of assets.

Financial assets held for trading are predominantly investment grade investments with 99% (2007 99%) of inter-bank and structured investment portfolios rated 'A' or above based on an internal credit ratings scale that is, in general, aligned with the ratings scales of the major credit ratings agencies (Moody's, S&P and Fitch).

During the course of 2008 £12.2bn of ABS and FRN assets were transferred from the Trading Book to the AFS Book. Subsequently, £35.4bn of ABS was transferred from the AFS Book into the Loans & Receivables Book.

	As at 31.12.2008 %	As at 31.12.2007 %
AAA	**67.4**	51.5
AA	**19.3**	34.2
A	**12.1**	13.7
Below A	**1.2**	0.6

Risk Management continued

Debt securities

Debt securities are primarily held within Treasury and are predominantly invested in investment grade counterparties with 92.2% (2007 96.5%) of debt securities rated 'A' or above, again based on the internal rating scale.

	As at 31.12.2008 %	As at 31.12.2007 %
AAA	**52.3**	60.4
AA	**22.9**	23.6
A	**17.0**	12.5
Below A	**7.8**	3.5

Other financial assets

Other financial assets include cash and balances at central banks, items in the course of collection, derivative assets, loans and advances to banks and sundry financial assets.

Market Risk

Market risk is defined as the potential loss in value or earnings of the organisation arising from:

- **changes in external market factors such as interest rates (interest rate risk), foreign exchange rates (foreign exchange risk), credit spread, commodities and equities; and**
- **the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions.**

(Market risk information is collated at divisional and entity levels for submission into the consolidated HBOS Group position. This consolidated information is used to manage market risk at the HBOS Group level. Although the Bank forms a significant part of the HBOS Group, management of market risk is not undertaken at group sub-consolidation level. Additionally as HBOS plc, the holding company, is an important funding vehicle for the HBOS Group its exclusion from any funding information presents a distorted view of the overall Group funding position. Accordingly, the information presented below is based on an extract from the HBOS Group Risk Report).

The objectives of the Group's market risk framework are to ensure that:

- market risk is taken only in accordance with the Board's appetite for such risk;
- such risk is within the Group's financial capability, management understanding and staff competence;
- the Group complies with all regulatory requirements relating to the taking of market risk; and
- the quality of the Group's profits is appropriately managed and its reputation safeguarded.

Risk appetite is set by the Board which allocates responsibility for oversight and management of market risk to the Group Market Risk Committee, an Executive Risk Committee chaired by the Group Risk Director.

The Group devotes considerable resources to ensuring that market risk is captured, modelled and reported, and managed. Trading and non-trading portfolios are managed at various organisational levels, from the HBOS Group overall, down to specific business areas.

Market risk measurement and management methods are designed to meet or exceed industry standards, and the tools used facilitate internal market risk management and reporting.

Market risk is controlled across the Group by setting limits using a range of measurement methodologies. The principal methodologies are Net Interest Income (NII) sensitivity and Market Value (MV) sensitivity for banking books and Value-at-Risk (VaR) for trading books. All are supplemented by scenario analysis which is performed in order to estimate the potential economic loss that could arise from extreme, but plausible stress events.

Detailed market risk framework documents and limit structures have been developed for each Division. These are tailored to the specific market risk characteristics and business objectives of each Division. Each divisional policy requires appropriate divisional sanction, and is then forwarded to the Group Market Risk Committee for approval on at least an annual basis.

Market risk within the insurance and investment businesses arises in a number of ways and, depending upon the product; some risks are borne directly by the customer and some by the insurance and investment companies. Risk to customers is controlled by adherence to and regular monitoring of investment mandates and, if appropriate, unit pricing systems and controls. In the case of the risk to the companies, individual Boards approve overall risk appetites and policies against which exposure is monitored.

Market risk – principally interest rate, inflation and equity – also arises from the Group's defined benefit pensions obligations. These sensitivities are regularly measured and are reported to the Group Market Risk Committee every month.

Interest Rate Risk (Non-Trading)

A key market risk faced by the Group in its non-trading book is interest rate risk. This arises where the Group's financial assets and liabilities have interest rates set under different bases or reset at different times.

The principal Board limit for structural interest rate risk is expressed in terms of potential volatility of net interest income in adverse market conditions. Risk exposure is monitored using the following measures:

- Net Interest Income sensitivity - This methodology comprises an analysis of the Group's current interest rate risk position overlaid with behavioural assessment and re-pricing assumptions of planned future activity. The change to forecast NII is calculated with reference to a set of defined parallel interest rate shocks which measure how much current projections would alter over a 12 month period.
- Market Value sensitivity – This methodology considers all re-pricing mismatches in the current balance sheet including those beyond the time horizon of the NII measure. It is also calculated with reference to a set of defined interest rate shocks.

The Board has delegated authority to the Group Market Risk Committee to allocate limits to divisions as appropriate within the overall risk appetite approved by the Board each year. In turn, the Group Market Risk Committee has granted limits which constitute the risk tolerance for each Division.

Banking divisions are required to hedge all significant open interest rate mismatch positions with Treasury and are not permitted to take positions of a speculative nature. A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly as assets; or when, if rates rise, assets cannot be re-priced as quickly as liabilities.

Net Interest Income Sensitivity

The following table shows, split by major currency, the Group's sensitivities as at 31 December 2008 to an immediate up and down 25 basis points change to all interest rates.

	As at 31.12.2008	
Impact of interest rate shift	**+ 25 bps £m**	**– 25 bps £m**
Currency		
Sterling	**82.4**	**(119.6)**
US Dollar	**(2.9)**	**2.7**
Euro	**(8.0)**	**8.1**
AU Dollar	**(1.5)**	**1.5**
Other	**(0.3)**	**0.3**
Total	**69.7**	**(107.0)**

	As at 31.12.2007	
Impact of interest rate shift	+ 25 bps £m	– 25 bps £m
Currency		
Sterling	(21.2)	21.6
US Dollar	(0.6)	0.5
Euro	(4.3)	4.3
AU Dollar	0.1	(0.1)
Other	0.1	(0.1)
Total	(25.9)	26.2

Base case projected NII is calculated on the basis of the Group's current balance sheet, forward rate paths implied by current market rates, and contractual re-pricing dates (adjusted according to behavioural assumptions for some products); it also incorporates business planning assumptions about future balance sheet volumes and the level of early redemption fees. The above sensitivities show how this projected NII would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

The principal driver of the risk is re-pricing mismatch but the methodology also recognises that behavioural re-pricing assumptions – for example, prepayment rates - are themselves a function of the level of interest rates.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount. Also, it does not incorporate the impact of management actions that, in the event of an adverse rate movement, could reduce the impact on NII.

Basis Risk

Major structural interest rate exposure will largely be addressed by quantifying re-pricing risk, however, there is potentially a material risk relating to basis ie, the exposure relating to the Group's (net) asset position repricing off a different index than the (net) liability position.

The primary source of basis risk exposure within the Group is in the UK, where HBOS has a net asset position referenced to Bank Rate and a net liability position referenced to short term LIBOR rates. Analogous Bank Rate/LIBOR positions also exist in Ireland.

The following table shows net assets for the Banking Divisions (excluding Treasury) by pricing basis and reflects the major components of the Group's balance sheet as it relates to basis risk.

	2008	2007
Bank Rate	**97.9**	113.0
Variable Market Rates	**(79.5)**	(58.6)
Administered Rates	**(29.4)**	(62.3)
Fixed (including capital and low/ non-interest bearing)	**11.0**	(7.9)

Reserve Sensitivity

The following table shows the market value sensitivity, for a 25 basis point shift, of those items in respect of which a change in market value is reflected in the equity of the Group – principally 'available for sale' assets and cash flow hedges.

	As at 31.12.2008	
Impact of interest rate shift	**+ 25 bps £m**	**– 25 bps £m**
Available for sale reserve	**(14.5)**	**14.5**
Cash flow hedge reserve	**84.9**	**(84.9)**
Total	**70.4**	**(70.4)**

	As at 31.12.2007	
Impact of interest rate shift	+ 25 bps £m	– 25 bps £m
Available for sale reserve	(15.7)	15.7
Cash flow hedge reserve	116.1	(116.1)
Total	100.4	(100.4)

Foreign Exchange Risk (Non-Trading)

The Group Funding & Liquidity Committee is responsible for the framework within which structural foreign currency risk is managed. The Group Funding & Liquidity Committee manages foreign currency exposures based on forecast currency information provided by the Divisions, and mandates Treasury to execute transactions and undertake currency programmes to manage structural currency risk. The actual risk position is monitored monthly by the Group Market Risk Committee.

Risk Management continued

Transaction exposures arise primarily from profits generated in the overseas operations, which will be remitted back to the UK and then converted into sterling.

Translation exposures arise due to earnings that are retained within the overseas operations and reinvested within their own balance sheet.

Structural currency exposures arise from the Group's investments in overseas subsidiaries, branches and other investments and are noted in the table below.

Functional currency of the operation	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	2008 Remaining structural currency exposure £m
AU Dollar	**2,015**	**2,015**	
Euro	**3,011**	**3,011**	
US Dollar	**191**	**181**	**10**
Other	**(23)**		**(23)**
Total	**5,194**	**5,207**	**(13)**

Functional currency of the operation	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	2007 Remaining structural currency exposure £m
AU Dollar	2,023	2,023	
Euro	1,888	1,613	275
US Dollar	97	97	
Other	4		4
Total	4,012	3,733	279

As at 31 December 2008 and 31 December 2007 there are no material net currency exposures in the non–trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses.

Trading

The Group's market risk trading activities are principally conducted by Treasury Division. This Group activity is subject to a Trading Book Policy Statement, which is approved by the Board, and limits set by the Group Market Risk Committee.

Treasury trading primarily centres around two activities: proprietary trading and trading on the back of business flows. Both activities incur market risk, the majority being interest rate and foreign exchange rate exposure. In addition, a number of marketable assets held as part of the liquidity risk management framework are also held in trading books. Such activity gives rise to market risk as a result of movements in credit spread.

The Group employs several complementary techniques to measure and control trading activities including: Value at Risk (VaR), sensitivity analysis, stress testing and position limits.

The VaR model, used as part of the Group's management of trading activity, expresses market risk to 99% confidence using a one day holding period. The number provides an indication of the maximum mark-to-market loss which, to this level of confidence, might be incurred on a single day given the size of current trading positions. It is computed using a historical simulation approach and a one year history of price data.

The underlying assumption of VaR is that future price volatility and correlation will not differ significantly from that previously observed. It also implicitly assumes that all positions are sufficiently liquid to be realisable within the chosen one day holding period.

VaR gives no indication of the size of any loss that could occur from extreme adverse prices changes (ie, outside the chosen confidence level). For these reasons, stress testing is employed to simulate the effect of selected adverse market movements. Three different types of stress tests are conducted:

- historical scenarios;
- defined scenarios tailored to key vulnerabilities; and
- extreme shocks to single risk factors.

Such measures are particularly relevant when market conditions are abnormal and daily price movements are difficult to source.

The Group's trading market risk exposure for the year ended 31 December 2008 is analysed below.

Owing to the unprecedented level of volatility in the credit markets, VaR has been suspended as a measure for the credit trading portfolio. Positions are now managed using sensitivity measures. The large increase in VaR, relative to 31 December 2007, is due principally to higher price volatility in wholesale markets – the size of underlying trading positions has not changed materially.

The regulatory capital charge for market risk trading exposures represents only 0.85% (2007 1.87%) of the Group's capital base.

For all significant exposures VaR is calculated on a daily basis and is used by senior management to manage market risk. On a more detailed desk and trader level, to increase transparency interest rate risk relating to the trading book is principally managed using sensitivity methodology to measure exposure and set limits. This methodology calculates the present value

Exposure	As at 31 Dec 2008 £m	As at 31 Dec 2007 £m	Average 2008 £m	2007 £m	Highest 2008 £m	2007 £m	Lowest 2008 £m	2007 £m
Total value at risk	**8.4**	13.2	**12.2**	7.6	**18.3**	13.9	**5.0**	4.0
Included in the above is the Value at risk relating to:								
Interest rates	**8.4**	4.7	**5.5**	3.0	**9.1**	5.9	**2.8**	1.7
Credit spread	**suspended**	8.3	**suspended**	4.3	**suspended**	8.4	**suspended**	1.8
Foreign exchange	**6.1**	1.9	**8.3**	0.6	**16.3**	2.0	**1.3**	0.1
Equity risk factor	**0.1**	0.2	**0.2**	0.2	**1.1**	0.4	**0.0**	0.0

impact of a one basis point movement in interest rates on the outstanding positions. Credit spread risk is managed using position limits based on credit spread sensitivity. Foreign exchange risk is principally managed by the use of position limits. Equity risk is managed through Equity Index VaR and position limits.

The VaR model was granted CAD2 recognition by the FSA in December 2007 for general market risk in London for the following risk factors:

- Interest Rate
- Foreign Exchange
- Equity

It is validated by daily backtesting against observed P&L both at the total (diversified) level and at sub-portfolio levels.

Derivatives
In the normal course of business, the Group uses a limited range of derivative instruments for both trading and non-trading purposes. The principal derivative instruments used are interest rate swaps, interest rate options, cross currency swaps, forward rate agreements, credit derivatives, forward foreign exchange contracts and futures. The Group uses derivatives as a risk management tool for hedging interest rate and foreign exchange rate risk.

The Group's activity in derivatives is controlled within risk management limits set by the Board and overseen by the relevant Group Risk Committees. Details of derivative contracts outstanding at the year end are included in Note 14 to the Accounts on pages 60 to 62.

Liquidity Risk
The risk that the Group does not have sufficient financial resources to meet its obligations when they are due or will have to do so at excessive cost.
(Liquidity and funding risk information is collated at divisional and entity levels for submission into the consolidated HBOS Group position. This consolidated information is used to manage liquidity and funding risk at the HBOS Group level. Although the Bank forms a significant part of the HBOS Group, management of liquidity and funding risk is not undertaken at group sub-consolidation level. Additionally, as HBOS plc, the holding company, is an important funding vehicle for the HBOS Group its exclusion from any funding information presents a distorted view of the overall Group funding position. Accordingly, the information presented below is based on an extract from the HBOS Group Risk Report).

Liquidity risk is governed by the Group Liquidity Policy Statement which is approved by the Board and defines the core principles for identifying, measuring, managing and monitoring liquidity risk across the Group. Detailed liquidity risk framework documents and limit structures are in place for the Group's operations, where liquidity is managed on a Group basis, and for overseas banking units subject to specific regulatory requirements. The responsibility for oversight and management of Liquidity risk is delegated to the Group Capital Committee (GCC).

Policy is reviewed at least annually to ensure its continued relevance to the Group's current and planned operations. Operational liquidity management is delegated to Treasury. The authority to set specific limits and guidelines and responsibility for monitoring and controlling liquidity is delegated by the GCC to the Group Funding and Liquidity Committee (GFLC).

The Group's banking operations in the UK should comply with the FSA's Sterling Stock Liquidity approach for sterling liquidity management and regulatory reporting. A key element of the FSA's Sterling Stock Liquidity Policy is that a bank should hold a stock of high quality liquid assets that can be sold or used via repo, quickly and discreetly in order to replace funding that has been withdrawn due to an actual or perceived problem with the bank. The objective is that this stock enables the bank to continue business, whilst providing an opportunity to arrange more permanent funding solutions. Limits on the five day sterling net wholesale outflow and the minimum level of stock liquidity have been agreed with the FSA. HBOS should also adhere to the requirements of other regulatory authorities including the Australian Prudential Regulatory Authority (APRA), the Irish Financial Regulator and the Office of the Comptroller of the Currency in the United States, in whose jurisdictions the Group has branches or subsidiaries.

The internal approach to liquidity management, which has been in place for several years, goes beyond the regulatory requirements. The approach looks at the forecast cash flows across all currencies and at longer timeframes than the regulatory norms. At 31 December 2008, the Group's liquidity portfolio of marketable assets was £77.3bn (2007 £67.0bn), of which £39.5bn (2007 £13.4bn) has been used for repo. The liquidity portfolio is recorded in Treasury and predominantly comprises Treasury debt securities, excluding Grampian and Landale.

Details of the Treasury debt securities portfolio are disclosed on page 9. The assets in the liquidity portfolio are treated in two forms.

Firstly, assets known to be eligible under normal arrangements with the Bank of England, the European Central Bank and the Federal Reserve. Secondly, a substantial pool of high quality assets that allow us to manage through periods of stress taking into account the likely behaviours of depositors and wholesale markets. These approaches are supported by a liquidity framework that includes:

- funding diversity criteria focusing on retail, other customer and wholesale sources;
- sight to one week and sight to one month mismatch limits as a percentage of total wholesale funding for all major currencies and for all currencies in aggregate;
- targets on the appropriate balance of short to medium term wholesale funding; and
- criteria and limits on marketable assets, by asset class for Sterling, US Dollars, Euros, other currencies and for all currencies in aggregate.

Risk Management continued

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components:

- Firstly, HBOS stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both HBOS name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.
- Secondly, the Group has a Liquidity Contingency Plan embedded within the Group Liquidity Policy Statement which has been designed to identify emerging liquidity concerns at an early stage, so that action can be taken to avoid a more serious crisis developing. This is achieved through the use of Early Warning Indicators (EWIs).

Clear guidelines are set out for the management escalation process in the event of EWIs triggering and the actions to be taken (short and medium term), should such an event take place.

In response to the market dislocation that started in the second half of 2007 and intensified in September 2008, the Group has increased vigilance by operating under full contingency arrangements including daily monitoring of funding and liquidity positions with GCC meeting on a weekly basis to monitor and manage the Group balance sheet.

Funding

The wholesale funding capacity of the Group is dependent upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position, as well as market sentiment and perception, most evident in share and debt price volatility.

	As at 31.12.2008 £bn	As at 31.12.2007 £bn
Loans and advances to customers	**435.2**	430.0
Customer accounts	**222.3**	243.2
Customer lending less customer accounts	**212.9**	186.8
Customer accounts as a % of loans and advances to customers	**51.0%**	56.6%

It has been the Group's policy to manage its balance sheet profile to ensure customer deposits sourced outside Treasury represent a significant component of overall funding, and GFLC directs and co-ordinates the activities of the Divisions in raising liabilities from a range of sources.

In order to strengthen the Group's funding position, HBOS has over the last few years diversified its funding sources, and also lengthened the maturity profile of market sensitive funding. This has been achieved through:

- widening the wholesale investor base and product set;
- building and maintaining a term issuance programme - securitisation, covered bonds, Medium Term Note programmes; and
- utilising the geographic diversity of New York and Sydney as funding hubs for the Group.

The ability of the HBOS Group to access wholesale funding sources and raise retail deposits on favourable economic terms is dependent on a variety of factors, including a number outside of its control, such as general market conditions including the state of UK and global finance markets, an increase in competitive behaviour, and confidence in the UK banking system in general or the HBOS Group in particular.

Following speculation on HBOS's future in mid-September, HBOS suffered deposit outflows, further increasing the Group's reliance on wholesale funding markets. The majority of these deposit outflows were non-bank financial institutions and large corporates, rather than personal account customers. In recent months this position has stabilised with net inflows evident following the announcement of the proposed transaction with Lloyds TSB.

In wholesale markets, the HBOS Group has previously looked to achieve a geographically diverse investor base and product set of an appropriate maturity profile to ensure it is not overly exposed to short-term market dislocation.

As a result of the increasingly turbulent conditions in the global financial markets in the second half of 2008, there has been a significant deterioration in the inter-bank and term funding markets and a consequent material reduction in the availability of longer-term funding. As a result, HBOS has had to source more shorter-term and overnight funding, with a consequent increase of refinancing risk.

In recent months, the strain in the financial systems has increased substantially, leading to a significant tightening in market liquidity and the threat of a more marked deterioration in the global economic outlook, with a consequent increase in recourse to liquidity schemes provided by central banks. While various governments, including the UK Government, have taken substantial measures to ease the current crisis in liquidity, such as the measures announced in the UK on 8 October 2008 and 13 October 2008, there can be no assurance that these global measures will succeed in improving the funding and liquidity of the markets in which the major banks, including HBOS, operate.

HBOS, as a wholly owned subsidiary, will be dependent on Lloyds Banking Group for funding and expects reliance for the foreseeable future on the continued availability of central bank liquidity facilities (particularly those with the Bank of England) as well as HM Treasury's guarantee scheme for short and medium-term debt issuance.

The Group's wholesale funding sources are shown in the tables below. Tables are prepared on the basis that "retail" is defined using the current statutory definition, ie, administered rate products. Wholesale funding, when issued in a foreign currency but swapped into Sterling, is included at the swap exchanged amount. Wholesale funding is shown excluding any repo activity and the funding raised in the names of the conduits.

Instrument	As at 31.12.2008 £bn	%	As at 31.12.2007 £bn	%
Bank Deposits	**13.7**	**3.3**	33.1	6.7
Deposits from Customers	**24.0**	**5.7**	27.8	5.6
Debt Securities in issue:				
Certificates of Deposit	**51.0**	**12.2**	63.9	12.9
Medium Term Notes	**45.7**	**10.9**	43.2	8.7
Covered Bonds	**29.1**	**7.0**	24.4	4.9
Commercial Paper	**8.9**	**2.1**	16.8	3.4
Securitisation	**35.8**	**8.6**	45.9	9.3
	170.5	**40.8**	194.2	39.2
Subordinated Debt	**22.2**	**5.3**	18.1	3.7
Other	**7.6**	**1.8**	6.9	1.3
Total Wholesale	**238.0**	**56.9**	280.1	56.5
Retail	**180.1**	**43.1**	215.4	43.5
Total Group Funding	**418.1**	**100.0**	495.5	100.0

Wholesale funding – Currency	As at 31.12.2008 £bn	%	As at 31.12.2007 £bn	%
US dollar	**52.8**	**22.2**	105.2	37.6
Euro	**87.4**	**36.7**	79.6	28.4
Sterling	**80.1**	**33.7**	70.3	25.1
Other	**17.7**	**7.4**	25.0	8.9
Total Wholesale Funding	**238.0**	**100.0**	280.1	100.0

Wholesale funding – Residual Maturity	As at 31.12.2008 £bn	%	As at 31.12.2007 £bn	%
Less than one year	**119.4**	**50.2**	166.2	59.3
One to two years	**25.2**	**10.6**	21.6	7.7
Two to five years	**44.1**	**18.5**	46.3	16.5
More than 5 years	**49.3**	**20.7**	46.0	16.5
Total Wholesale Funding	**238.0**	**100.0**	280.1	100.0

The increased use of repo activity as a funding tool has materially impacted the levels of wholesale funding shown in the tables.

The following tables reconcile wholesale figures reported above with those in the Statutory Balance Sheet.

Accounting Classification - as at 31.12.2008	Risk Report £bn	Repos and Conduits £bn	Interest Accruals and Other Accounting Adjustments £bn	Statutory Balance Sheet £bn
Debt Securities in Issue	**170.5**	**3.0**	**14.9**	**188.4**
Sub Debt and Other	**29.8**		**0.3**	**30.1**
Deposits by Customers	**204.1**	**18.2**		**222.3**
Bank Deposits	**13.7**	**70.9**	**12.6**	**97.2**
Total	**418.1**	**92.1**		

Accounting Classification - as at 31.12.2007	Risk Report £bn	Repos and Conduits £bn	Interest Accruals and Other Accounting Adjustments £bn	Statutory Balance Sheet £bn
Debt Securities in Issue	194.2	12.0	0.3	206.5
Sub Debt and Other	25.0		(0.7)	24.3
Deposits by Customers	243.2			243.2
Bank Deposits	33.1	7.8	0.6	41.5
Total	495.5	19.8		

Risk Management continued

Conduits

HBOS sponsors two conduits, Grampian and Landale, which are special purpose vehicles that invest in highly rated assets and funds via the Asset Backed Commercial Paper (ABCP) market. At 31 December 2008, investments held by Grampian totalled £21.7bn and £0.7bn of assets held by Landale were consolidated. Grampian is a long established, high grade credit investment vehicle that invests in diversified Asset Backed Securities, of which 75.9% are rated AAA by S&P and Aaa by Moody's. Grampian has a liquidity line in place with HBOS which covers all of the assets and programme wide credit enhancement is also provided by HBOS. Grampian has been fully consolidated into the balance sheet. Landale holds both assets originated from the Group balance sheet and third party transactions. Landale has liquidity lines from HBOS and from third party banks, and therefore the former, but not the latter, are consolidated into the balance sheet.

In 2008, there have been occasions when Grampian and Landale (in respect of assets backed by HBOS liquidity lines) have declined to issue Asset Backed Commercial Paper. At these times, HBOS has funded the conduits through the available liquidity lines rather than through the ABCP market. At 31 December 2008, HBOS had provided funding to the Grampian and Landale conduits of £20.4bn.

(End of information that forms an integral part of the audited financial statements).

Operational Risk

Operational risk exists in the normal conduct of business and is the risk of loss resulting from inadequate or failed internal processes or systems or from people related or external events. Examples of potential sources of operational risk include fraud, system reliability, human error, failure of key suppliers, IT security, business continuity, change management, operational outsourcing and failure to comply with legislation or regulation.
The Board has approved an Operational Risk Policy that establishes the framework for managing operational risk. The main components of the Framework include risk and control assessment, internal loss reporting, capture of risk event information, key risk indicator monitoring and evaluation of external events.

The Group Operational Risk Committee is one of the four Executive Risk Committees chaired by the Group Risk Director. It is attended by senior executives from the Divisions and Group specialist areas. The committee considers the management of issues and exposures, recommends the appropriate capital requirement, approves policies and standards and provides oversight of the operational risk communities.

A key enhancement to the infrastructure has been to focus on the explicit risk management of specialist areas that underpin the HBOS Operational Risk Framework. Each specialist risk area is supported by a relevant specialist Group Function. The specialists' role is to ensure that appropriate risk management practice is operating across their 'community'. The key elements of the Group specialists' roles are:

- Set and maintain policy.
- Provide opinion on the effectiveness of risk management for their area of specialism.

The Group Business Risk function designs and maintains Group-wide risk systems and co-ordinates the specialist areas. A specialist portfolio management team undertakes the detailed modelling required to assess risk exposure and appropriate levels of capital using internal and external loss event information. External information is available through HBOS membership of the Operational Risk Data Exchange (ORX). ORX provides anonymous information from a number of international banks which assist in the identification, assessment and modelling of operational risk.

The FSA granted HBOS Advanced status under Basel II and consequently the Group utilises the Advanced Measurement Approach (AMA) for regulatory capital reporting in most of its businesses. HBOS does not currently use insurance or expected losses to offset its regulatory capital requirement.

Regulatory Risk

The Financial Services Authority is the main regulator for HBOS, although the Group's international businesses in the USA, Australia and Ireland are subject to direct scrutiny from the US Federal Reserve and the OCC, APRA and The Financial Regulator respectively.

HBOS understands that consumers have a choice of supplier and product and are more demanding of financial services providers. The Group supports the FSA's Treating Customers Fairly (TCF) initiative and has set clear principles for doing business. This is supported by ongoing maintenance of procedures across the Group, with associated enhancement and development where necessary. The objective is to meet the requirements of shareholders through meeting the needs of customers. The Group's TCF self-assessment was sent to the FSA on 30 December and HBOS awaits feedback comment.

HBOS is alert to the wider, cumulative picture of regulatory change and utilises centralised expertise in the area of regulatory and legal compliance, specifically to:

- Identify and assess the impact of, respond to and where possible influence the direction of regulatory developments on behalf of HBOS;
- Lead the development and monitoring of the application of specific Group-wide policies and standards; and
- Oversee the management, support and co-ordination of the liaison and interaction with HBOS regulatory stakeholders across all its international businesses.

The impact of regulatory change is reported across all Executive Risk Committees with specific reference to the discipline affected and at Group level to Audit Committee and the Board.

(The information set out below ending before the section entitled 'Capital Requirements' on page 28 forms an integral part of the audited financial statements as described in the Financial Statements section in the Accounting Policies on page 40.)

Capital Management
Capital management within HBOS has Board visibility and is managed primarily through the capital planning process, which in turn forms part of the overall Group Business Plan. The capital planning process assists in determining the optimal amount of capital that should be held by the Group and the most appropriate mix between the different components of capital, subject to regulatory limits. The day to day management of the Group's capital is delegated to the Group Capital Committee with support from underlying committees, including the Group Regulatory Capital Adequacy Committee.

The Group Capital Committee is responsible for establishing the strategic and management framework for the assessment and allocation of capital within the parameters set by the Board through the agreed terms of the Group Business Plan and the approved Risk Appetite. The committee monitors compliance with the capital plan, including stress and scenario analysis, contingency planning and capital management strategies.

The Group Capital Committee supports wider business planning and decisions by analysing business levels that are sustainable under internal capital generation, what options are available with regards to the levels of capital generated by the business and also reviews and provides oversight on business cases that are put forward for inorganic activity.

As part of its capital management remit, the Group Capital Committee also ensures compliance with the Group Capital and Funding Policy. This policy is reviewed annually and approved by the Board.

The policy covers the following key areas:

- capital planning management process and responsibilities;
- the type and level of capital required and held by the Group;
- monitoring and controlling capital plans and forecasts; and
- subsidiary regulated entities and capital transferability.

For the latter, the policy governs the transferability of capital around the Group subject to guiding principles which require that all subsidiary regulated entities within the Group must hold sufficient capital to ensure that they continue to meet their individual regulatory capital ratios as imposed by the local regulator. Each regulated entity is required to set out their capital plans for approval by the Group Capital Committee.

Surplus capital held at regulated entity levels may be released up to HBOS plc level in the form of dividends or capital repatriation.

The capital planning process ensures Divisions and regulated legal entity 'owners' commit to and are monitored against key drivers, including:

- Risk Weighted Assets and Expected Losses;
- other deductions from capital;
- non-equity capital and gearing; and
- Surplus capital and agreed utilisation.

The capital plan is monitored on a continuous basis. It is updated formally as part of the annual planning and quarterly reforecasting cycles, in line with the Group Business Plan, with additional revisions made in the intervening periods as necessary.

The capital plan is stressed under demanding economic scenarios with both common and specific univariate sensitivity analysis undertaken.

The Group Capital Committee receives a monthly update and review of the capital position of the Group. Summary management information is also passed to the Executive Committee and the Board. A reconciliation of monthly actual data to forecast is also completed with commentary on variances and submitted to the Group Capital Committee.

Throughout 2008, the Group Capital Committee has met weekly in order to maintain an up to date view of market conditions and key capital ratios and to ensure issues arising are identified and actioned promptly. The Group's on-going capital strength has been a core focus of the Group Capital Committee during the year.

The Group Regulatory Capital Adequacy Committee is responsible for supporting the Group Capital Committee in its capital management role. It achieves this through establishing policies and minimum standards to measure and monitor the financial capital resource requirements of the Group in accordance with the Group's risk profile and appropriate regulatory requirements. The committee relies on input from the specialist executive risk committees (the Group Credit Risk Committee, the Group Market Risk Committee and the Group Operational Risk Committee).

Where capital requires to be raised, it is the Group's policy to issue capital in a range of different forms and also from diverse sources to spread the investor base. HBOS plc raises the non-equity Tier 1 capital and subordinated debt for all the Group's businesses, with the exception of Clerical Medical which is permitted to raise capital separately as part of the overall Group capital plan to spread the investor base for subordinated debt.

The types of capital held by the Group are subject to regulatory limits which have been established to ensure that restrictions are placed on the extent to which certain types of capital, such as innovative Tier 1, are eligible for inclusion within a firm's capital resources.

Risk Management continued

The regulatory limits specify that:

- at least 50 per cent of Tier 1 Capital must be 'core' Tier 1;
- the amount of innovative Tier 1 cannot exceed 15 per cent of overall Tier 1 Capital;
- qualifying Tier 2 Capital cannot exceed Tier 1 Capital; and
- qualifying dated subordinated loan capital may not exceed 50 per cent of Tier 1 Capital.

There are also limitations on the amount of collectively assessed impairment provisions which may be included as part of Tier 2 Capital.

The principal forms of capital are included in the following balances on the consolidated balance sheet: called up share capital, share premium account, other reserves, retained earnings and other borrowed funds.

In July 2008 HBOS raised £4.0bn (net) of capital through a rights issue. Subsequent to the year end a further £11.3bn (net) of capital was raised. This comprised of £8.3bn of ordinary shares raised through a Placing and Open Offer exercise supported by the UK Government and £3.0bn of preference shares subscribed to HM Treasury.

The latter capital raising exercise was made in support of the Proposed Government Funding initiative devised to stabilise the UK banking system and was conditional on the completion of the acquisition of HBOS by Lloyds TSB Group plc.

(End of information that forms an integral part of the audited financial statements.)

Capital Requirements
The FSA requires each bank and banking group to maintain adequate capital resources to meet their total capital requirements (Pillar 1 and Pillar 2) under the Basel II Framework. This includes any additional capital requirements identified through the firm's or group's Individual Capital Guidance.

The FSA supervises HBOS on a regulatory consolidated basis and as such receives information on the capital adequacy of, and sets capital requirements for, HBOS as a whole. A similar function is performed at sub-group levels within the business, including at Bank of Scotland Group level.

Individual banking subsidiaries are directly regulated by either the FSA or their local supervisors, who set their capital adequacy requirements. This includes supervision on a 'solo consolidation' basis.

HBOS must at all times monitor and demonstrate compliance with the relevant regulatory capital requirements of the FSA. The Group has in place, extensive processes and controls to monitor the Group's capital adequacy and frequent reporting of the Group's capital position and associated data and analysis is made to the FSA under the Integrated Regulatory Reporting Regime.

Capital Structure
The capital structure of HBOS is divided into two tiers:

- Tier 1 Capital comprises shareholders' funds, innovative Tier 1 securities and minority interests, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at the Tier 1 Capital position.
- Tier 2 Capital comprises qualifying subordinated loan capital, certain collectively assessed impairment provisions, and unrealised gains arising on the fair valuation of equities held as available for sale.

In addition, the excess of Expected Loss over and above any accounting impairment provisions made is deducted 50% from Tier 1 Capital and 50% from Tier 2 Capital. Other regulatory deductions made on a similar basis relate to securitisation positions held and material holdings.

From the total of Tier 1 and Tier 2 Capital the carrying amounts of unconsolidated investments, investments in the capital of other banks, and certain regulatory items are deducted.

Movements in Tier 1 Capital and the capital structure of the Group are given on page 109.

Pillar 2 Capital Requirements
In order to satisfy the requirements of Pillar 2, HBOS is required to perform an Internal Capital Adequacy Assessment Process (ICAAP).

The HBOS ICAAP is based upon a 'Pillar 1 Plus' approach whereby the 'Pillar 1' regulatory capital requirements for Credit Risk, Operational Risk and Market Risk (Trading Book) are supplemented by consistent assessments of the key risks not captured under Pillar 1, of which the most material are Pension Obligation Risk and Concentration Risk.

The individual risk assessments are aggregated with no allowance for inter-risk diversification, generating a total internal capital assessment which is incrementally greater than the total Pillar 1 amount. The total minimum regulatory capital requirement is set by the FSA taking into account this internal assessment. A strong capital buffer, defined as the amount by which the total capital resources exceed the total capital requirement, is held.

The current capital planning forecasts show a satisfactory capital buffer even in a deteriorating economic scenario, significantly bolstered by the post year end capital injection.

Pillar 3 Disclosures
The HBOS plc Basel II Pillar 3 Disclosures for the year ended 31 December 2008 will be published online during the second quarter of 2009.

These disclosures will represent the first full set of Pillar 3 disclosures to be published by HBOS under the Basel II Framework.

The purpose of Pillar 3 is to communicate the firm's risk management practices, its approach to capital management, its capital resources and Pillar 1 capital requirements and to provide a detailed analysis of its credit risk exposures.

Pillar 3 disclosures build on a number of equivalent disclosures made within the Annual Report and Accounts, providing greater detail and analysis.

Directors' Report

The Directors present the Annual Report and Accounts for the year ended 31 December 2008.

Principal Activities
The principal activity of the Group is the provision of financial services. A list of the main subsidiary undertakings, and the nature of their business, is given in Note 19 on page 69.

Post-Balance Sheet Event
On 16 January 2009, the entire issued share capital of HBOS plc (the parent company of the Bank) was acquired by Lloyds Banking Group plc pursuant to a Scheme of Arrangement under sections 895 to 899 of the Companies Act 2006.

Business Review
The Companies Act 2006 requires the Directors' Report to include a Business Review of the Bank, giving a fair review of the business of the Group and a description of the principal risks and uncertainties facing it. These are reviewed in the Business and Financial Review on pages 2 to 10 and the Risk Management report on pages 11 to 28. The information in both of these sections, which fulfils the requirements of the Business Review, is incorporated into this Directors' Report by reference.

The Annual Report and Accounts, including this Directors' Report, have been prepared solely for the Bank's members as a body. To the extent permitted by law, the Bank, its Directors, employees, agents and advisers disclaim liability to any other persons in respect of information contained in the Annual Report and Accounts. By their nature, statements containing risks and uncertainties facing the Group, and any other forward-looking statements, involve uncertainty, since future events and circumstances can cause results and developments to differ materially from those anticipated. The forward-looking statements reflect the knowledge and information available at the date of preparation of the Annual Report and Accounts and the Bank undertakes no obligation to update these forward-looking statements. Nothing in the Annual Report and Accounts shall be construed as a profit forecast.

Results and Dividends
The loss before taxation for the year ended 31 December 2008 amounted to £10,635m (2007 profit before taxation of £4,952m).

The final dividend of £1,205m in respect of the year ended 31 December 2007 was paid in May 2008. No final dividend is being proposed in respect of the year ended 31 December 2008.

Directors
The Directors in office at the date of this report are W C G Berndt[1], Sir Victor Blank[1], E Brown[1], J E Daniels[1], J Dawson, P A Gore-Randall, P N Green[1], Sir Julian Horn-Smith[1], A G Kane[1], Lord Leitch[1], Sir David Manning[1], C J McCall[1], J P du Plessis[1], M A Scicluna[1], G T Tate[1], T J W Tookey[1], D J Watkins and H A Weir[1].

C W Dunstone stood down from the Board on 29 April 2008. R J Cousins, P J Cummings, M H Ellis, Sir Ron Garrick, A J Hobson, A H Hornby, K E D Jones, J E Mack, C Matthew, C L McConville, K A Nealon and Lord Stevenson all served throughout the year and resigned from the Board on 16 January 2009.

Corporate Governance
The Board met frequently during the year, at which meetings the most important decisions affecting the Company were taken. The Board also oversaw the Company's performance and set the framework for how authority and accountability was delegated throughout the Group.

The Board included, throughout the year, a balance of Executive Directors who managed the business on a day-to-day basis and independent Non-executive Directors. The roles of Chairman and Chief Executive were separate. The Board was also supported by a structure of committees.

Going Concern
As set out in the 'Principles Underlying Going Concern Assumption' of the Basis of Preparation section of the Notes to the Accounts, the Directors are satisfied that the Group has adequate resources to continue in business for the foreseeable future and consequently the going concern basis continues to be appropriate in preparing the accounts.

Employees
The principal employer for UK based employees is HBOS plc. During the year, the HBOS Group's Total Reward strategy sought to align colleagues' reward with personal, Divisional and Group performance. A number of employee share schemes operated throughout the year.

During the year HBOS used a multi-media approach when communicating with colleagues throughout the Group. This included e-mail, electronic and printed magazines, intranets, business television and face-to-face communication. A Group-wide electronic magazine, entitled HBOS Today, was used to update colleagues on key business news. It was issued as required (rather than on a set publishing cycle). In 2008, 37 issues were published.

[1] appointed 16 January 2009.

Directors' Report continued

Topical news stories were also placed on the Company's intranet site. The views of HBOS colleagues were sought on a regular basis, most notably through opinion surveys conducted by MORI and through regular consultation with the recognised trade unions ACCORD and Unite, with whom the Company has entered into a partnership agreement.

The Group is recognised by Jobcentre Plus as a 'two-tick' employer, actively seeking applications for employment from disabled people and guaranteeing an interview where disabled applicants meet the essential criteria for the role being applied for. In the event of an existing colleague becoming disabled, HBOS works with external specialists to ensure that all possible reasonable adjustments are made to allow the colleague to continue in their existing role. If, after making all possible adjustments, a colleague is not able to continue in their current role, HBOS will look at suitable alternative roles within the Group and provide retraining accordingly. Training and career development opportunities are open to all colleagues including disabled colleagues and Group policies are designed with inclusion of disabled colleagues in mind.

Payment Policy
The Bank's suppliers are paid through HBOS plc's centralised Accounts Payable department. For the forthcoming period the Group's policy for the payment of suppliers will be as follows:

- Payment terms will be agreed at the start of the relationship with the supplier and will only be changed by agreement;
- Standard payment terms to suppliers of goods and services will be 30 days from the date of a correct invoice that has been received for satisfactory goods or services which have been ordered and received unless other terms are agreed in a contract;
- Payment will be made in accordance with the agreed terms or in accordance with the law if no agreement has been made; and
- Suppliers will be advised without delay when an invoice is contested and disputes will be settled as quickly as possible.

Trade creditors outstanding at 31 December 2008 represented 19 days of purchase.

HBOS plc complies with the Better Payment Practice Code. Information regarding this Code and its purpose can be obtained from the Better Payment Practice Group's website at www.payontime.co.uk.

Charitable and Other Donations
The Group made no charitable donations during the year.

Properties
The Directors are of the opinion that the current market value of the Group's properties is not significantly different from the amount at which they are included in the balance sheet.

Auditors
A resolution to appoint PricewaterhouseCoopers LLP as auditors of the Company in the place of the outgoing auditors will be put to the 2009 Annual General Meeting.

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware:

- there is no relevant audit information (as defined by section 234ZA of the Companies Act 1985) of which the Company's Auditors are unaware; and
- each Director has taken all the steps that they ought to have taken as a Director to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

On behalf of the Board

Harry F Baines
Company Secretary
26 February 2009

Statement of Directors' responsibilities in respect of the Annual Report and the financial statements

The Directors are responsible for preparing the Annual Report and the Group and parent Company financial statements in accordance with applicable law.

Company law requires the Directors to prepare Group and parent Company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law and have elected to prepare the parent Company financial statements on the same basis.

The Group and parent Company financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the Group and the parent Company and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the Group and parent Company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent Company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent Company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law, the Directors are also responsible for preparing a Directors' Report that complies with that law.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Independent auditors' report to the members of Bank of Scotland plc

We have audited the Consolidated and Bank financial statements (the financial statements) of Bank of Scotland plc for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated and Bank Balance Sheets, the Consolidated and Bank Cash Flow Statements, the Consolidated and Bank Statements of Recognised Income and Expense, and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Bank's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Bank's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The Directors' responsibilities for preparing the Annual Report, Directors' Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 31.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion, the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Annual Report that is cross referred from the Business Review section of the Directors' Report.

In addition we report to you if, in our opinion, the Bank has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Bank's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error.

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the Consolidated financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2008 and of its loss for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- the Bank financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Act 1985, of the state of the Bank's affairs as at 31 December 2008;
- the Bank financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants
Registered Auditor
Edinburgh

26 February 2009

Consolidated Income Statement
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
Interest income		**39,332**	36,354
Interest expense		**(31,039)**	(28,728)
Net interest income	1	**8,293**	7,626
Fees and commission income		**2,208**	2,360
Fees and commission expense		**(382)**	(396)
Net earned premiums on insurance contracts		**215**	245
Net trading (expense)/income	2	**(2,963)**	185
Net investment income related to insurance and investment business		**34**	37
Other operating income		**1,665**	2,292
Net operating income	3	**9,070**	12,349
Change in investment contract liabilities		**17**	(7)
Net claims incurred on insurance contracts		**(76)**	(105)
Net change in insurance contract liabilities		**22**	(21)
Administrative expenses	5	**(4,253)**	(4,187)
Depreciation and amortisation:			
Intangible assets other than goodwill	20	**(153)**	(130)
Property and equipment	21	**(211)**	(218)
Operating lease assets	23	**(1,178)**	(985)
		(1,542)	(1,333)
Goodwill impairment	20	**(142)**	
Operating expenses		**(5,974)**	(5,653)
Impairment losses on loans and advances	10 (a)	**(9,857)**	(2,012)
Impairment losses on investment securities	10 (b)	**(2,193)**	(60)
Operating (loss)/profit		**(8,954)**	4,624
Share of (loss)/profit of jointly controlled entities	18	**(651)**	241
Share of loss of associates	18	**(287)**	
(Loss)/profit on sale of businesses	4	**(743)**	87
(Loss)/profit before taxation	9	**(10,635)**	4,952
Tax on (loss)/profit	11	**2,448**	(1,318)
(Loss)/profit after taxation		**(8,187)**	3,634
Profit of subsidiary acquired with a view to resale			4
(Loss)/profit for the year		**(8,187)**	3,638
Attributable to:			
Parent company shareholders		**(8,238)**	3,608
Minority interests		**51**	30
		(8,187)	3,638

Consolidated Balance Sheet
As at 31 December 2008

	Notes	2008 £m	2007 £m
Assets			
Cash and balances at central banks	41	**2,502**	2,944
Items in course of collection		**445**	945
Financial assets held for trading	13	**22,571**	54,681
Derivative assets	14	**50,517**	13,794
Loans and advances to banks		**12,445**	4,095
Loans and advances to customers	15	**473,015**	460,267
Investment securities	17	**67,772**	51,615
Interests in jointly controlled entities	18	**970**	1,367
Interests in associates	18	**223**	372
Goodwill and other intangible assets	20	**1,148**	1,517
Property and equipment	21	**1,187**	1,291
Investment properties	22	**43**	34
Operating lease assets	23	**3,967**	4,643
Other assets		**2.432**	4,637
Current tax assets		**865**	
Deferred tax assets	24	**3,182**	
Prepayments and accrued income		**694**	1,430
Total Assets		**643,978**	603,632
Liabilities			
Deposits by banks		**97,066**	41,513
Customer accounts		**262,201**	272,687
Financial liabilities held for trading	13	**18,851**	22,705
Derivative liabilities	14	**40,827**	12,160
Notes in circulation		**957**	881
Insurance contract liabilities			24
Investment contract liabilities			98
Current tax liabilities		**23**	728
Deferred tax liabilities	24		965
Other liabilities		**2,250**	2,560
Accruals and deferred income		**2,306**	2,894
Provisions	25	**345**	172
Debt securities in issue	26	**188,448**	206,520
Other borrowed funds	27	**18,779**	17,881
Total Liabilities		**632,053**	581,788
Shareholders' Equity			
Issued share capital	28	**1,324**	499
Share premium	29	**11,018**	6,343
Other reserves	29	**(4,694)**	1,167
Retained earnings	29	**4,013**	13,479
Shareholders' Equity (excluding minority interests)		**11,661**	21,488
Minority interests	29	**264**	356
Total Shareholders' Equity	29	**11,925**	21,844
Total Liabilities and Shareholders' Equity		**643,978**	603,632

Approved by the Board on 26 February 2009 and signed on its behalf by:

Jo Dawson
Director

Philip Gore-Randall
Director

Tim Tookey
Director

Dan Watkins
Director

Consolidated Statement of Recognised Income and Expense
As at 31 December 2008

	2008 £m	2007 £m
Foreign exchange translation	**106**	8
Available for sale investments:		
Net change in fair value (net of tax)	**(5,897)**	(336)
Net gains transferred to the income statement (net of tax)	**(17)**	(201)
Impairment recognised in income statement (net of tax)	**915**	17
Cash flow hedges:		
Effective portion of changes in fair value taken to equity (net of tax)	**(2,801)**	(216)
Net losses/(gains) transferred to the income statement (net of tax)	**1,844**	(292)
Net expense recognised directly in equity	**(5,850)**	(1,020)
(Loss)/profit for the year	**(8,187)**	3,638
Total recognised income and expense	**(14,037)**	2,618
Attributable to:		
Parent company shareholders	**(14,099)**	2,576
Minority interests	**62**	42
	(14,037)	2,618

Consolidated Cash Flow Statement
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
(Loss)/profit before taxation		**(10,635)**	4,952
Adjustments for:			
Impairment losses on loans and advances		**9,857**	2,012
Impairment losses on investment securities		**2,193**	60
Depreciation and amortisation		**1,542**	1,333
Goodwill impairment		**142**	
Interest on other borrowed funds		**1,323**	915
Movement in derivatives held for trading		**1,613**	(2,276)
Exchange differences [1]		**74**	(1,430)
Other non cash items		**2,075**	(914)
Net change in operating assets		**(35,908)**	(80,897)
Net change in operating liabilities		**30,382**	69,111
Net cash flows from operating activities before tax		**2,658**	(7,134)
Income taxes paid		**(1,061)**	(792)
Cash flows from operating activities		**1,597**	(7,926)
Cash flows from investing activities		**735**	(240)
Cash flows from financing activities		**2,743**	4,516
Net increase/(decrease) in cash and cash equivalents		**5,075**	(3,650)
Transfer in under HBOS Group Reorganisation			(27,265)
Opening cash and cash equivalents		**2,911**	33,826
Closing cash and cash equivalents	41	**7,986**	2,911

[1] Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

Investing Activities	2008 £m	2007 £m
Sale of other intangible assets	**397**	33
Purchase of other intangible assets	**(276)**	(242)
Sale of property and equipment	**190**	180
Purchase of property and equipment	**(271)**	(297)
Sale of investment properties		52
Purchase of investment properties	**(18)**	
Investment in subsidiaries		(28)
Disposal of subsidiaries	**1,110**	115
Investment in jointly controlled entities and associates	**(472)**	(371)
Disposal of jointly controlled entities and associates	**57**	176
Dividends received from jointly controlled entities	**8**	132
Dividends received from associates	**10**	10
Cash flows from investing activities	**735**	(240)

Financing Activities	2008 £m	2007 £m
Issue of ordinary shares	**5,500**	2,480
Issue of other borrowed funds	**3,000**	5,156
Repayments of other borrowed funds	**(3,405)**	(598)
Interest on other borrowed funds relating to servicing of finance	**(1,323)**	(905)
Minority interest acquired	**242**	98
Equity dividends paid	**(1,228)**	(1,672)
Dividends paid to minority shareholders in subsidiaries	**(43)**	(43)
Cash flows from financing activities	**2,743**	4,516

Bank Balance Sheet
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
Assets			
Cash and balances at central banks	41	**1,820**	1,667
Items in course of collection		**449**	890
Financial assets held for trading	13	**22,571**	52,169
Derivative assets	14	**46,374**	12,134
Loans and advances to banks		**34,144**	25,458
Loans and advances to customers	15	**570,255**	453,590
Investment securities	17	**107,852**	27,020
Interests in jointly controlled entities	18	**103**	103
Investments in subsidiaries	19	**4,383**	3,273
Goodwill and other intangible fixed assets	20	**770**	783
Property and equipment	21	**1,061**	1,108
Operating lease assets	23	**2**	29
Current tax assets		**1,180**	
Deferred tax assets	24	**2,123**	152
Other assets		**2,661**	4,364
Prepayments and accrued income		**565**	1,292
Total Assets		**796,313**	584,032
Liabilities			
Deposits by banks		**97,091**	47,321
Customer accounts		**458,967**	316,849
Financial liabilities held for trading	13	**18,851**	22,145
Derivative liabilities	14	**39,648**	10,546
Notes in circulation		**957**	881
Current tax liabilities			544
Other liabilities		**2,359**	1,735
Accruals and deferred income		**1,837**	1,654
Provisions	25	**332**	135
Debt securities in issue	26	**143,456**	149,188
Other borrowed funds	27	**18,082**	14,855
Total Liabilities		**781,580**	565,853
Shareholders' Equity			
Issued share capital	28	**1,324**	499
Share premium	29	**11,018**	6,343
Other reserves	29	**(2,125)**	1,296
Retained earnings	29	**4,516**	10,041
Total Shareholders' Equity		**14,733**	18,179
Total Liabilities and Shareholders' Equity		**796,313**	584,032

Approved by the Board on 26 February 2009 and signed on its behalf by:

Jo Dawson
Director

Philip Gore-Randall
Director

PA Gore-Randall

Tim Tookey
Director

Dan Watkins
Director

Bank Statement of Recognised Income and Expense
For the year ended 31 December 2008

	2008 £m	2007 £m
Foreign exchange translation		(7)
Available for sale investments:		
Net change in fair value (net of tax)	**(2,992)**	(248)
Net losses/(gains) transferred to the income statement (net of tax)	**31**	(11)
Impairment recognised in income statement (net of tax)	**466**	
Cash flow hedges:		
Effective portion of changes in fair value taken to equity (net of tax)	**(2,789)**	(209)
Net losses/(gains) transferred to the income statement (net of tax)	**1,863**	(290)
Net expense recognised directly in equity	**(3,421)**	(765)
(Loss)/profit for the year	**(4,320)**	2,420
Total recognised income and expense	**(7,741)**	1,655
Attributable to:		
Parent company shareholders	**(7,741)**	1,655

Bank Cash Flow Statement
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
(Loss)/profit before taxation		**(5,882)**	3,452
Adjustments for:			
Impairment losses on loans and advances		**9,621**	1,867
Impairment losses on investment securities		**1,074**	27
Impairment losses on investment in subsidiaries		**107**	
Depreciation and amortisation		**313**	296
Goodwill impairment		**50**	
Interest on other borrowed funds		**1,057**	784
Dividends received from subsidiaries			(707)
Exchange differences [1]		**923**	(728)
Movements in derivatives held for trading		**(2,430)**	(1,385)
Other non-cash items		**1,100**	(678)
Net change in operating assets		**(185,156)**	(105,225)
Net change in operating liabilities		**192,333**	76,703
Net cash flows from operating activities before tax		**13,110**	(25,594)
Income taxes paid		**(759)**	(588)
Cash flows from operating activities		**12,351**	(26,182)
Cash flows from investing activities		**(100)**	178
Cash flows from financing activities		**5,380**	2,479
Net increase/(decrease) in cash and cash equivalents		**17,631**	(23,525)
Transfer in under HBOS Group Reorganisation			(28,084)
Opening cash and cash equivalents		**1,722**	53,331
Closing cash and cash equivalents	41	**19,353**	1,722

[1] Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

Investing Activities	2008 £m	2007 £m
Sale of other intangible assets	**31**	9
Purchase of other intangible assets	**(186)**	(160)
Sale of property and equipment	**99**	116
Purchase of property and equipment	**(44)**	(255)
Investment in subsidiaries		(210)
Investment in jointly controlled entities and associates		(36)
Disposal of jointly controlled entities and associates		7
Dividends received from subsidiaries		707
Cash flows from investing activities	**(100)**	178

Financing Activities	2008 £m	2007 £m
Issue of ordinary stock	**5,500**	2,480
Issue of other borrowed funds	**3,000**	3,020
Repayments of other borrowed funds	**(870)**	(565)
Equity dividends paid	**(1,205)**	(1,672)
Interest on other borrowed funds relating to servicing of finance	**(1,045)**	(784)
Cash flows from financing activities	**5,380**	2,479

Notes to the Financial Statements

Accounting Policies

Financial Statements

The financial statements of Bank of Scotland plc comprise the Consolidated Income Statement and the Consolidated and Bank Balance Sheets, Cash Flow Statements and Statements of Recognised Income and Expense together with the related Notes to the financial statements. The notes include information contained in the Risk Management section of the Business Review on pages 11 to 28 that are cross-referenced into the financial statements. These disclosures are required under IAS 1 'Presentation of Financial Statements' relating to the management of capital and IFRS 7 'Financial Instruments: Disclosures' relating to the nature of risks and their management. These disclosures form an integral part of the financial statements and are prefaced as such on the respective pages.

Statement of Compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) as adopted by the European Union. The standards applied by the Group and Bank are those endorsed by the European Union and effective at the date the financial statements are approved by the Board. However, the Group has not utilised the carve-out provisions in respect of full fair value and portfolio hedging of core deposits in IAS 39 'Financial Instruments: Recognition and Measurement' as adopted by the European Union and has implemented IFRIC 12 Service Concession Arrangements although this has an immaterial effect on the financial statements. Consequently, the financial statements comply with International Financial Reporting Standards.

The financial statements also comply with the relevant provisions of Part VII of the Companies Act 1985, as amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004.

Basis of Preparation

a) Principles Underlying Going Concern Assumption

During 2008, global financial markets experienced difficult conditions which have been characterised by a marked reduction in liquidity. As a consequence of this, governments and central banks carried out a series of actions to address the lack of liquidity within their respective banking systems. In the UK these actions have included the introduction by the Bank of England of liquidity support, through schemes (collectively "Bank of England facilities") such as the extended Long-Term Repo open market operations and the Special Liquidity Scheme (SLS) whereby banks and building societies can exchange eligible securities for UK treasury bills; and the creation of a credit guarantee scheme by HM Treasury, providing a government guarantee for certain short and medium term senior debt securities issued by eligible banks. During 2008 HBOS plc has made use of these measures in order to maintain and improve a stable funding position.

In the context of this continued turbulence and uncertainty in the financial markets, combined with a deteriorating global economic outlook, HBOS plc has also taken steps to strengthen its capital position in order to provide a buffer against further shocks arising from the financial systems and to ensure that it remains competitive. On 15 January 2009, in conjunction with the takeover of HBOS plc by Lloyds TSB Group plc (Note 44), HBOS plc raised £11,345m (net after costs) in preference and ordinary share capital (Note 28).

On 16 January 2009, following completion of the acquisition of the Group by Lloyds Banking Group plc, the Group became a wholly owned subsidiary and became dependent upon the ultimate parent and its banking subsidiaries for its capital, liquidity and funding needs.

There is a risk despite the substantial measures taken so far by governments that further deterioration in the markets could occur. In addition the economic conditions in the UK are deteriorating more quickly than previously anticipated placing further strain on the Lloyds Banking Group's capital resources. The key dependencies on successfully funding the Lloyds Banking Group's balance sheet include the continued functioning of the money and capital markets at their current levels; the continued access of the Lloyds Banking Group to central bank and Government sponsored liquidity facilities including access to HM Treasury's credit guarantee scheme and access to the Bank of England's various facilities; limited further deterioration in the Lloyds Banking Group's credit ratings; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or Government support schemes.

Based upon projections prepared by Lloyds Banking Group plc management which take into account the acquisition on 16 January 2009 of HBOS plc and its subsidiaries (Note 44) together with the Lloyds Banking Group's current ability to fund in the market and the assumption that announced government sponsored schemes will continue to be available, the Directors are satisfied that the Bank and the Group have adequate resources to continue in business for the foreseeable future. The Group has received confirmation that it is the current intention of Lloyds Banking Group plc to ensure that the Group's subsidiaries should have at all times for the foreseeable future access to adequate resources to continue to trade and meet their liabilities as they fall due. Accordingly, the financial statements of the Bank and the Group have been prepared on a going concern basis.

b) Basis of Measurement

The financial statements have been prepared under the historical cost basis, except that the following assets and liabilities are stated at their fair values: derivatives, financial instruments held for trading, financial instruments designated at fair value through the income statement, financial instruments classified as available for sale and investment properties.

IFRS Applied in 2008

The following IFRS amendments have been applied in 2008:

Amendments to IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'. In view of the ongoing market dislocation and the deterioration of the world's financial markets, the Group transferred certain asset backed securities (ABS) and floating rate notes (FRNs) from the 'held for trading' classification to the 'available for sale' classification with effect from 1 July 2008 at their fair values at that date. Subsequently, in light of increasing illiquidity in the markets for ABS, the Group changed the classification of ABS from 'available for sale' to 'loans and receivables' with effect from 1 November 2008. There have been no other reclassifications in the year. Thereafter the recognition and measurement principles of IAS 39 are followed. Disclosure of the reclassifications is given in Note 33.

The following IFRIC interpretations have been applied in 2008:

IFRIC 11 IFRS 2 'Group and Treasury Share Transactions'. IFRIC 11 provides guidance on accounting in the separate financial statements of subsidiaries for transactions where a parent grants rights to its equity instruments directly to the employees of subsidiaries and where the subsidiary grants to its employees rights to the equity instruments of the parent. The application of this interpretation has not affected the Bank financial statements as costs are recharged to the subsidiaries on the basis prescribed in the interpretation.

IFRIC 14 'The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'. This precludes recognition of any surplus within a pension scheme from which the Bank could not derive a benefit. This did not impact on these financial statements.

The accounting policies below have been consistently applied to all periods presented in these financial statements. Certain comparative amounts have been reclassified to conform to the current year's presentation.

Basis of Consolidation
The consolidated financial statements include the results of the Bank and its subsidiary undertakings (and, where appropriate, special purpose vehicles), together with the Group's interests in associates and jointly controlled entities.

The financial statements of entities controlled by the Group are consolidated in the Group financial statements commencing on the date control is obtained until the date control ceases. Control is defined as being where the Group has power, directly or indirectly, to govern the financial and operating policies of such entities so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. When assessing whether or not a special purpose entity (SPE) that has been sponsored by the Group should be consolidated or not, the Group considers the indicators of control that are included in the Standing Interpretations Committee (SIC) Interpretation 12 'Consolidation – Special Purpose Entities' and if these are met the SPE is included in the consolidation.

All intra-group balances, transactions, income and expenses are eliminated on consolidation.

Recognition and Derecognition of Financial Assets and Liabilities
The Group recognises loans and advances to customers and banks, deposits by banks, customer accounts, debt securities in issue, other borrowed funds and other financial assets and liabilities upon origination.

The Group derecognises a financial asset when the contractual rights to the cash flows from the asset expire or it transfers the right to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in the transferred financial asset that is created or retained by the Group is recognised as a separate asset.

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled or expired.

Derivatives
Derivatives are measured at fair value and initially recognised on the date the contract is entered into. Where the fair value of a derivative is positive, it is carried as a derivative asset and where negative, as a derivative liability.

The gain or loss from changes in fair value is taken to net trading income, except for interest from derivatives used for economic hedging purposes that do not qualify for hedge accounting treatment which is taken to net interest income, insurance and investment related derivatives which are taken to net investment income related to insurance and investment business or when cash flow hedge accounting is employed.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of the same. At inception of the hedge relationship formal documentation is drawn up specifying the hedging strategy, the component transactions and the methodology that will be used to measure effectiveness.

Monitoring of hedge effectiveness is undertaken continually. A hedge is regarded as effective if the change in fair value or cash flows of the hedge instrument and the hedged item are negatively correlated within a range of 80% to 125%, either for the period since effectiveness was last tested or cumulatively since inception.

The Group uses three hedge accounting methods:

Firstly, fair value hedge accounting offsets the change in the fair value of the hedging instrument against the change in the fair value of the hedged item in respect of the risk being hedged. The hedged item is adjusted for the fair value of the risk being hedged irrespective of its financial instrument classification. These changes in fair value are recognised in the income statement through net trading income. Adjustments made to the carrying amount of the hedged item for fair value hedges will be amortised on an effective interest rate basis over the remaining expected life in line with the presentation of the underlying hedged item. If the hedge is highly effective the net impact on the income statement is minimised.

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

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

Thirdly, hedging of net investments in foreign operations is discussed within the foreign currencies accounting policy.

A derivative may be embedded in another financial instrument, known as the host contract. Where the economic characteristics and risks of an embedded derivative are not closely related to those of the host contract, the embedded derivative is separated from the host and held separately on the balance sheet at fair

Notes to the Financial Statements continued

value, except for those instruments that have been designated at fair value through the income statement, where the derivative is not separated from the host instrument. Changes in fair value are taken to the income statement through net trading income, and the host contract is accounted for in accordance with the policy for that class of financial instrument.

If quoted or market values are not available then derivative fair values are determined using valuation techniques that are consistent with techniques commonly used by market participants to price these instruments. These techniques include discounted cash flow analysis and other pricing models. The fair values calculated from these models are regularly compared with prices obtained in actual market transactions to ensure reliability. In all material instances these techniques use only observable market data.

Loans and Advances

Loans and advances held for trading principally consist of reverse repurchase agreements, are carried at fair value and are classified as financial assets held for trading. Gains, losses and related income are taken to net trading income as they arise.

All other loans and advances are classified as loans and receivables. They are initially recognised at the draw down date at the fair value on the commitment date plus directly attributable incremental transaction costs. They are subsequently carried at amortised cost using the effective interest method less provision for impairment.

The fair value of loans and advances to customers is measured at the commitment date and calculated by discounting anticipated cash flows, including interest, at current market rate of interest. The fair value of floating rate loans and advances and overnight deposits is considered by the Group to be equal to the carrying value as these loans and advances are accounted for at current interest rates and credit risk is assessed in the impairment review. The fair value of fixed interest bearing accounts is based on cash flows discounted using current money market interest rates for debts with similar maturity and credit risk characteristics.

Loans and advances that are performing in accordance with the underlying contract are classified as neither past due nor impaired. If a customer fails to make a payment that is contractually due, or if the loan is in excess of facility limit, the loan is classified as past due.

If subsequently all contractually due payments are made or if the loan continues to operate within limit, the loan reverts to its neither past due nor impaired status.

The Group assesses whether objective evidence of impairment exists individually for financial assets that are individually significant and individually or collectively for assets that are not significant. The estimation involved in these impairment assessments is considered a critical accounting estimate.

Objective evidence that a financial asset is impaired includes significant difficulty of the customer, breach of contract such as interest or principal payments being missed, the loan being in excess of facility limit for a sustained period or the likelihood that the borrower will enter bankruptcy. Objective evidence may also arise from wider economic and financial market indicators including factors that pertain to a particular industry sector or local economy.

The amount of any impairment is calculated by comparing the net present value of estimated future cash flows, discounted at the loan's original effective interest rate, with the carrying value of the loan.

If impaired, the carrying value is adjusted via the provision and the additional provision is charged to the income statement.

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

A write-off is made when it is not possible or economically viable to collect all or part of a claim. Write-offs are offset against the release of a previously established impairment provision or directly through the income statement.

Loans with no identified evidence of individual impairment are subject to collective impairment assessment. This is to quantify impairment losses which exist at the balance sheet date, but which have not yet been individually identified. Collective assessment is carried out for groups of assets that share similar risk characteristics. Collective impairment is assessed using a methodology based on existing risk conditions or events that have a strong correlation with a tendency to default.

Terms and conditions for past due or impaired loans and advances may be renegotiated. When the renegotiated contract becomes effective, the loan is subsequently classified as past due, impaired or neither past due nor impaired according to its performance under the renegotiated terms.

Loans and advances to customers include advances that are subject to non-returnable finance arrangements following securitisation of portfolios of mortgages and other advances. The principal benefits of these advances are acquired by special purpose securitisation entities that fund their purchase primarily through the issue of debt securities in issue.

Syndications

Syndication activity is undertaken as part of the Group's risk management strategy specifically with the intention of transferring credit risk and obtaining financing as distinct from trading.

The Group considers that loan commitments and subsequent draw down form one contract and the loan is therefore recognised at the date of the draw down at the fair value as measured at the commitment date plus directly attributable and incremental transaction costs. Loans pending syndication are classified as loans and receivables and derecognised upon sell down when the risks and rewards are transferred to a third party.

Finance Leases and Operating Leases

Assets leased to customers that transfer substantially all the risks and rewards incidental to ownership to the customer are classified as finance leases. They are recorded at an amount equal to the net investment in the lease, less any provisions for impairment, within loans and advances to customers.

The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income. Lease income is recognised over the term of the lease using the pre-tax net investment method, which reflects a constant periodic rate of return on the net investment.

All other assets leased to customers that do not transfer substantially all the risks and rewards of ownership are classified as operating leases. These assets, less any provision for impairment, are separately disclosed in the balance sheet and are recorded at cost less accumulated depreciation, which is calculated on a straight-line basis over their estimated useful lives.

Operating lease rentals are recognised in operating income on a straight-line basis over the lease term. Finance and operating lease assets are regularly reviewed for impairment.

Leases entered into by the Group as lessee are primarily operating leases. Operating lease rentals payable are recognised as an expense in the income statement on a straight-line basis over the term unless a more systematic basis is more appropriate.

Investment Securities

Investment securities held for trading are classified as financial assets held for trading and are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. Investment securities designated at fair value through the income statement are carried at fair value. Gains, losses and related income are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business.

Debt securities other than those held for trading or designated at fair value and for which there is no active market at inception are classified as loans and receivables. They are initially recognised at fair value plus directly related incremental transaction costs and are subsequently carried on the balance sheet at amortised cost using the effective interest method less provision for impairment.

All other investment securities are classified as available for sale. They are initially recognised at fair value plus directly related incremental transaction costs and are subsequently carried on the balance sheet at fair value. Unrealised gains or losses arise from changes in the fair values and are recognised directly in equity in the available for sale reserve, except for impairment losses or foreign exchange gains or losses related to debt securities, which are recognised immediately in the income statement in impairment on investment securities or other operating income respectively.

Income on debt securities is recognised on an effective interest rate basis and taken to interest income through the income statement. Income from equity shares is credited to other operating income, with income on listed equity shares being credited on the ex-dividend date and income on unlisted equity shares being credited on an equivalent basis. On sale or maturity, previously unrealised gains and losses are recognised in other operating income.

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

Impairment losses on available for sale equity instruments are not reversed through the income statement. Any increase in the fair value of an available for sale equity instrument after an impairment loss has been recognised is treated as a revaluation and recognised directly in equity. An impairment loss on an available for sale debt instrument is reversed through the income statement, if there is evidence that the increase in fair value is due to an event that occurred after the impairment loss was recognised.

The fair values of investment securities trading in active markets are based on market prices or broker/dealer valuations. Where quoted prices on instruments are not readily and regularly available from a recognised broker, dealer or pricing service, or available prices do not represent regular transactions in the market, the fair values are estimated using quoted market prices for securities with similar credit, maturity and yield characteristics or similar valuation models. Investment securities, principally asset backed securities (ABS) not traded in an active market are valued using valuation models that include non-market observable inputs. These models use observed issuance prices in related asset classes, market correlations, prepayment assumptions and external credit ratings.

Additional assessments are then made on possible deterioration in credit risk for each individual security and on additional liquidity considerations for particular asset classes.

The Group uses trade date accounting when recording the purchase and sale of investment securities.

Jointly Controlled Entities and Associates

Jointly controlled entities are entities over which the Group has joint control under a contractual arrangement with other parties.

Associates are entities over which the Group has significant influence, but not control over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity but is not control over those policies.

The venture capital exemption is taken for investments where significant or joint control is present and the investing area operates as a venture capital business. These investments are designated at fair value through the income statement. Otherwise, the Group's share of results of associates and jointly controlled entities, generally based on audited accounts, are included in the consolidated financial statements using the equity method of accounting. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

Goodwill

The excess of the cost of a business combination over the interest in the net fair value of the identifiable assets, liabilities and contingent liabilities at the date of acquisition of a business is capitalised as goodwill. The goodwill is allocated to the cash-generating units or groups of cash-generating units that are expected to benefit from the acquisitions concerned.

In most cases, the cash-generating units represent the business acquired.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Cash generating units to which goodwill is allocated are subject to a semi-annual impairment review at 31 March and 30 September and whenever there is an indication that the unit may be impaired. This compares the recoverable amount, being the higher of the cash generating unit's fair value less costs to sell and its value in use, with its carrying value. When this indicates that the carrying value of goodwill is not recoverable, it is irrevocably written down through the income statement by the amount of any impaired loss identified.

Notes to the Financial Statements continued

Further details of the calculation are given in the critical accounting estimates and in Note 20. IFRS 3 'Business Combinations' has not been applied retrospectively to business combinations that occurred before 1 January 2004.

Software
Costs associated with the development of software for internal use, subject to de minimis limits, are capitalised if the software is technically feasible and the Group has both the intent and sufficient resources to complete the development. Costs are only capitalised if the asset can be reliably measured and will generate future economic benefits to the Group either through sale or use.

Only costs that are directly attributable to bringing the asset into working condition for its intended use are capitalised. These costs include all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in a manner intended by management. Other development expenditure is recognised in the income statement as an expense as incurred.

Capitalised development expenditure and purchased software is stated at cost less accumulated amortisation and impairment losses. Once the software is ready for use, the capitalised costs are amortised over their expected lives, generally four years. Capitalised software is assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The amortisation charge for the asset is then adjusted to reflect the asset's revised carrying amount.

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

Property, Plant and Equipment
Property, plant and equipment is stated at cost less accumulated depreciation and impairment losses.

Freehold land is not depreciated. Freehold and leasehold property, other than freehold investment properties, is stated at cost and depreciated over fifty years or the length of the lease term if shorter. Improvements to leasehold properties are stated at cost and are depreciated in equal instalments over the lesser of the remaining life of the lease or eight years. Premiums are amortised over the period of the lease.

The cost of equipment, which includes fixtures and fittings, vehicles and computer hardware, less estimated residual value, is written off in equal instalments over the expected lives of the assets, generally between three and eight years.

Subsequent costs are included in the asset's carrying amount, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably.

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

Investment Properties
Investment properties comprise freehold and leasehold property that are held, either to earn rental income or for capital appreciation or both. They are initially recognised at cost and are fair valued annually.

Rental income from investment properties is recognised on a straight-line basis over the term of the lease and any gains or losses arising from a change in the fair value are recognised in the income statement in the period that they occur through other operating income, except for those relating to insurance and investment business, which are taken through net investment income related to insurance and investment business.

Investments in Subsidiaries
Investments in subsidiaries are included in the Bank's balance sheet. These comprise equity investments in, and capital contributions to subsidiary entities. These are carried at cost less impairment provisions. At each reporting date an assessment is undertaken to determine if there is any indication of impairment. This assessment can include reviewing factors such as the solvency, profitability and cash flows generated by the subsidiary. If there is an indication of impairment, an estimate of the recoverable amount is made. If the carrying value exceeds the recoverable amount then a provision for impairment is made to reduce the carrying value to the recoverable amount.

Disposal Group
Assets and liabilities of a disposal group are classified as held for sale where the carrying amount will be recovered principally through a sale transaction as opposed to continuing use. This applies where the assets and liabilities are available for sale in their present condition, subject only to the terms that are usual and customary for the sale of such assets and liabilities, and when a sale is highly probable and expected to complete within one year of being classified as a disposal group. Disposal groups are measured at the lower of carrying amount and fair value less costs to sell.

Deposits by Banks and Customer Accounts
Deposits by banks and customer accounts held for trading are classified as financial liabilities held for trading and are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. All other customer accounts and deposits by banks are held at amortised cost using the effective interest method.

The fair value of customer deposits with no stated maturity date is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings with no quoted market price is calculated using a cash flow model discounted using interest rates for debts with similar maturities.

Repurchase Agreements
Securities sold subject to repurchase agreements are retained within the balance sheet where the Group retains substantially all of the risks and rewards of ownership. Funds received under these arrangements are included within deposits by banks, customer accounts or financial liabilities held for trading. Conversely, securities acquired under commitments to resell are not recognised in the balance sheet as debt securities where substantially all the risks and rewards do not pass to the Group. In this case, the purchase price is included within loans and advances to banks, loans and advances to customers, or financial assets held for trading. The difference between sale and repurchase prices for such transactions is reflected in the income statement over the lives of the transactions, within interest payable or interest receivable as appropriate.

Post Retirement Schemes

The Bank is a participating employer in both a defined contribution pension scheme and a defined benefit pension scheme based upon final pensionable pay, operated by HBOS plc, the HBOS Final Salary Pension Scheme (HBOS FSPS). The HBOS FSPS was formed on 3 July 2006 following the merger of the Bank of Scotland 1976 Scheme and the Halifax Retirement Fund (HRF), in both of which the Bank was previously a participating employer, with two other schemes in the HBOS Group.

Because the Bank is unable to identify its share of the scheme assets and liabilities on a consistent and reasonable basis, as permitted by IAS 19 'Employee benefits' the HBOS FSPS has been accounted for, in these financial statements, as if the scheme was a defined contribution scheme.

Taxation

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

The tax charge is analysed between tax that is payable in respect of policyholder returns and tax that is payable on shareholders' equity returns. This allocation is based on an assessment of the effective rate of tax that is applicable to shareholders' equity for the year.

Deferred tax is provided in full using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following differences are not provided: goodwill not deductible for tax purposes, the initial recognition of assets and liabilities that affects neither accounting nor taxable profit, and overseas earnings where both remittance is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, based on tax rates that are enacted or substantially enacted at the balance sheet date.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised.

The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Provisions

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

A constructive obligation is only deemed to exist in respect of restructuring provisions once a detailed restructuring plan has been formally approved and the plan has been announced publicly or work on the restructure has commenced.

Provision is made for undrawn loan commitments which have become onerous.

As explained under critical accounting judgements, if the Group assesses that a constructive obligation for a regulatory provision exists then a provision is established. Where the provisioning criteria are met, the Group makes provision for the estimated cost of making redress payments to customers in respect of past product sales where the sales processes have been deficient. To calculate the provision the Group estimates the number of cases requiring redress and the average cost per case. These are dependent upon, inter alia, the volume of claims, the actions of regulators and, as appropriate, the performance of investments. As progress is made in settling claims, if necessary, the Group revises its judgements and estimates based on the emerging trends.

Debt Securities in Issue

Debt securities in issue held for trading are classified as financial liabilities held for trading and are carried at fair value. Gains, losses and related expense are taken to net trading income as they arise. Debt securities in issue designated at fair value through the income statement are carried at fair value. Gains, losses and related expense are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business. All other debt securities in issue are held at amortised cost. They are initially recognised at fair value plus directly related incremental transaction costs and are subsequently carried on the balance sheet at amortised cost using the effective interest method.

Fair values are calculated based on quoted market prices. Where quoted market prices are not available, a cash flow model is used, discounted using an appropriate current yield curve for the remaining term to maturity.

Other Borrowed Funds

Other borrowed funds comprises preference shares that are classified as debt, preferred securities and subordinated liabilities, all of which are held at amortised cost, using the effective interest method.

Preference shares are classified as debt where they are redeemable on a specific date, or at the option of the shareholders, or if dividend payments are not discretionary. Dividends on preference shares classified as debt are recognised in the income statement through interest expense.

Preferred securities are issued at or close to market values. These are classified as debt where they are redeemable on a specific date, or at the option of the holders, or if interest payments are not discretionary. The interest payable on such securities is recognised in the income statement through interest expense.

Subordinated liabilities consist of dated and undated loan capital. The interest payable is recognised in the income statement through interest expense.

Notes to the Financial Statements continued

Share Capital
Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction from the proceeds.

Netting
Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of offset and there is an intention and ability to settle on a net or simultaneous basis.

Where master netting agreements allow for offset only on default by one of the parties, the Group presents the disclosures on a gross basis.

Foreign Currencies
The consolidated financial statements are presented in sterling which is the Bank's functional and presentation currency.

Foreign currency transactions are translated into sterling at the exchange rate prevailing at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies are translated at balance sheet date exchange rates. Exchange differences arising, including those from changes in the amortised cost of foreign currency monetary available for sale assets, are recognised in the income statement except for differences arising from hedges of net investments in foreign operations and derivatives related to cash flow hedges which are recognised directly in equity.

Non-monetary assets and liabilities carried at historical cost are translated using the historical exchange rate.

Non-monetary assets and liabilities carried at fair value are translated at exchange rates on the date the fair value is determined. Exchange differences arising are recognised in the income statement except those relating to available for sale financial assets (equity investments), which are recognised directly in reserves.

The results and financial position of all Group entities that have a functional currency different from sterling are translated into sterling as follows:

- assets and liabilities for each balance sheet presented are translated at the closing rate at the date of the balance sheet;
- goodwill and fair value adjustments arising on the acquisition of a foreign operation are treated as assets and liabilities of the foreign entity and translated at the closing rate; and
- income and expenses are translated at the average exchange rates for the period (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions).

All resulting exchange differences are recognised as a separate component of other reserves within equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to equity where the hedge is deemed to be effective. When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale. The ineffective portion of any net investment hedge is recognised in the income statement immediately.

Cumulative translation differences for all foreign operations are deemed to be zero at 1 January 2004. Any gain or loss on the subsequent disposal of a foreign operation will exclude translation differences that arose before 1 January 2004, but include later translation differences.

Cash and Cash Equivalents
Cash and cash equivalents consist of cash and balances at central banks that are freely available, and loans and advances to banks with an original maturity of three months or less excluding financial assets that are held for trading purposes.

Effective Interest Rate
Revenue on financial instruments classified as loans and receivables, available for sale and expense on financial liabilities at amortised cost, are recognised on an effective interest rate basis. This calculation takes into account interest received or paid and fees and commissions paid or received that are integral to the yield as well as incremental transaction costs and all other premiums and discounts. The effective interest rate is the rate that discounts the expected future cash flows over the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial instrument at initial recognition. These calculations are undertaken on a portfolio basis other than in respect of significant balances, relating principally to larger corporate customers, which are assessed individually.

In applying the portfolio basis, the Group makes use of various statistical modelling techniques which are specific to different portfolios to estimate redemption profiles and derive the expected cash flows. A number of relevant considerations are taken into account to estimate the cash flows of individually significant corporate balances, including previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions at the date of acquisition. The impact of the assumption related to the expected life of the instruments is considered under critical accounting estimates.

Fees and Commission
Fees and commission income and expense is recognised in the income statement as the related service is provided except those that are integral to the effective interest rate calculations or to investment contract deferred origination costs.

Fees and commission recognised in the income statement include service fees, agency and management fees, transaction fees, guarantee fees, letter of credit fees, asset management fees and non-utilisation fees.

Syndication and underwriting fees are spread over the expected term of the sell down. In the event of the loan not being sold down then no fees are recognised.

Fees and commission included in the effective interest calculation are those that are incremental and directly attributable to the origination of the product and which are integral to the yield of the product. These include arrangement fees, incentives such as cash backs, intermediary fees and commissions, high loan to value fees and procurement fees.

Guarantees
Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

Financial guarantees are initially recognised at fair value on the date the guarantee was given. Subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of the amount determined under the Group's accounting policy on provisions and the amount initially recognised less cumulative amortisation recognised to record any fee income earned in the period.

Intra-group financial guarantee contracts in the Bank financial statements are accounted for as general insurance contracts. This practice also applies to any new intra-group financial guarantees written.

Critical Accounting Judgements and Estimates

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based on amounts which differ from those estimates. Judgements, estimates and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

a) Critical Accounting Judgements

The preparation of the financial statements necessarily requires the exercise of judgement in the application of accounting policies which are set out above. These judgements are continually reviewed and evaluated based on historical experience and other factors. The principal critical accounting judgements made by the Group that have a material financial impact on the financial statements are as follows:

Designation of Financial Instruments

The Group has classified its financial instruments in accordance with IAS 39 'Financial Instruments: Recognition and Measurement'. In some instances the classification is prescribed whilst in others the Group is able to exercise judgement in determining the classification as follows:

- Non-derivative financial assets, other than those held for trading, where there is no active market and which have fixed or determinable payments are classified as 'loans and receivables';

- The Group's 'trading' portfolio is classified as 'held for trading'. The Group exercises judgement in determining which financial instruments form part of its trading book. This is determined at acquisition by the purpose for which the instrument is acquired;

- The Group exercised judgement when determining that the ongoing market dislocation and deterioration of the world's financial markets that occurred during the third quarter of 2008 was a sufficiently rare circumstance to warrant a reclassification of certain financial assets from 'held for trading' to 'available for sale' for which the Group has the intention and ability to hold these assets for the foreseeable future. The Group also subsequently reclassified certain financial assets from 'available for sale' to 'loans and receivables'. In both cases, the Group had the intention and ability to hold the financial assets for the foreseeable future and the financial assets transferred met the classification criteria of loans and receivables;

- Derivative instruments are automatically classified as 'at fair value through the income statement' unless they form part of an effective hedging relationship. The Group's accounting policy for hedge accounting is described under the policy for derivatives;

- Instruments that are deemed by the Group on initial recognition to eliminate a measurement mismatch or where they contain an embedded derivative which is not separated from the host contract are designated on initial recognition as 'at fair value through the income statement'. In addition portfolios of assets, liabilities or both that are managed and the performance evaluated on a fair value basis in accordance with a documented risk or investment management strategy are designated on initial recognition 'at fair value through the income statement';

- In addition the venture capital exemption is taken for investments where significant influence or joint control is present and the investing area operates as a venture capital business. These investments are designated 'at fair value through the income statement'. This policy is applied consistently across the Group's portfolios. Judgement is applied when determining whether or not a business area operates as a venture capital business. The judgement is based on consideration of whether, in particular, the primary business activity is investing for current income, capital appreciation or both; whether the investment activities are clearly and objectively distinct from any other activities of the Group; and whether the investee operates as a separate business autonomous from the Group;

- The Group has chosen not to designate any financial assets as 'held to maturity';

- All other financial assets are classified as 'available for sale'; and

- All other financial liabilities are classified as 'at amortised cost'.

The accounting treatment of these financial instruments is set out in the relevant accounting policy.

Active Markets

Asset backed securities not traded in an active market are valued using models. An active market is one where prices are readily and regularly available from an exchange, broker, pricing service, industry group or regulator and these prices represent actual and regularly occurring transactions on an arm's length basis. Where there are no regular transactions occurring (significant liquid markets) the market is not described as active. A significant increase in the spread between the amount sellers are 'asking' and buyers are 'bidding' or the presence of a relatively small number of 'bidding' parties, are indicators that a market may be inactive. The determination of whether a market is inactive requires judgement.

More details of the models used to value the securities not traded in an active market are given in the 'fair values' section in critical accounting estimates below.

Impairment of Investment Securities

As explained in the accounting policy, investment securities are reviewed at the specific investment level for impairment. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Objective evidence of impairment might include a significant or prolonged decline in market value below the original cost of a financial asset and, in the case of debt securities, including those reclassified as

Notes to the Financial Statements continued

loans and receivables, non-receipt of due interest or principal repayment, a breach of covenant within the security's terms and conditions or a measurable decrease in the estimated future cash flows since their initial recognition.

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

Unarranged Overdraft Charges
The Group's accounting policy in respect of regulatory provisions is given in the section on provisions. In the absence of a legal obligation, judgement is necessary in determining the existence of a constructive obligation. In respect of the claims made for refunds of unarranged overdraft charges, the judgement of the Group is that there is no constructive obligation pending the outcome of the legal case.

Syndications
As explained in the accounting policy on syndications, the Group has elected to treat loans and advances pending syndication as loans and receivables rather than account for them as trading assets. Accordingly these are initially recognised at the draw down date at the fair value as at the commitment date plus directly attributable and incremental transaction costs.

Investment in Subsidiaries
As explained in the accounting policies, investments in subsidiaries are included in the Bank's balance sheet. These comprise equity investments in and capital contributions to subsidiary entities made by the Bank. These are carried at cost less impairment provisions. At each reporting date, an assessment is undertaken to determine if there is an indication of impairment. This assessment can include reviewing factors such as the solvency, profitability and cash flows of the subsidiary.

If impairment indicators are evident, an estimate of recoverable amount is made which requires the exercise of management judgement.

More details of the methodology used to calculate recoverable amount are given in critical accounting estimates below.

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

b) Critical Accounting Estimates
The preparation of the financial statements requires the Group to make estimations where uncertainty exists. The principal critical accounting estimates made by the Group are considered below. Disclosures about estimates and the related assumptions are also included in the appropriate Note to the Financial Statements.

Fair Values
The designation of financial instruments for measurement purposes is set out under the critical accounting judgements above and the valuation methodologies for financial instruments remain as disclosed in this accounting policy section.

Derivatives and other financial instruments classified as at fair value through the income statement or available for sale are recognised at fair value.

Debt securities measured at fair value and not traded in an active market, principally comprising asset backed securities (ABS) in the Treasury division, are valued using valuation models that include non-market observable inputs. These models use observed issuance prices in related asset classes, market correlations, prepayment assumptions and external credit ratings. For each asset class within the ABS portfolio, the implied spread arrived at by using this methodology is applied to the securities within that asset class. Additional assessments are then made on possible deterioration in credit risk for each individual security and on additional liquidity considerations for particular asset classes.

Of the total debt securities carried at fair value on the balance sheet, the fair values of those calculated using models with inputs that are not observable in the market is £3,054m (2007 £17,790m).

For debt securities valuations using non-market observable inputs, the effect of a one hundred basis point move in credit spreads (which based upon experience is the only key sensitivity) would result in a pre-tax movement of £163m (2007 £185m) for assets classified as at fair value through the income statement and a post-tax movement of £nil (2007 £(351)m), recognised in equity reserves, on assets classified as available for sale.

On ABS that were valued using models with non-observable market inputs, a £1,056m (2007 £78m) pre-tax negative fair value adjustment was recognised in the income statement within net trading income and a post-tax negative fair value adjustment of £3,572m (2007 £158m) on ABS classified as available for sale was recognised in equity reserves.

Effective Interest Rate
As described in the accounting policy for effective interest rate, the Group uses statistical and mathematical models to calculate the effective yield for loans and advances. The Group applies judgement when determining the expected life of these loans. The underlying products usually allow the customer to make early repayment before the contractual maturity date. In estimating the expected life of the loan, the Group takes into account a number of relevant considerations when the asset is initially recognised to estimate the cash flows from early redemptions including the type of product, previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions. The cash flows are adjusted in the light of actual experience, however the effective interest rate is not reassessed. As a consequence of the reduced levels of principal repaid in 2008 and the resulting adjustments to estimated future cash flows a £200m credit (2007 £nil) has been taken to the income statement. If the estimated life of the Retail portfolio were to increase or decrease by one month then the carrying value of the Retail portfolio would increase or decrease by £6m (2007 £18m) respectively.

Impairment Losses on Loans and Advances

The Group regularly reviews its loan portfolios carried at amortised cost to assess for impairment. This review is conducted across all asset types and impairment provisions are established to recognise incurred impairment losses within the loan portfolios. As explained in the Group's accounting policy on loans and advances, impairment loss calculations involve the estimation of future cash flows of loans and advances based on observable data at the balance sheet date, historical loss experience for assets with similar credit risk characteristics and other factors including, inter alia, future prospects of the customers, value of collateral held and reliability of information. These calculations may be undertaken on either a portfolio basis or individually for individually significant exposures. In applying the portfolio basis the Group makes use of various statistical modelling techniques which are specific to different portfolio types.

The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment provisions given the range of asset types, number of customers and current economic conditions. This uncertainty is exacerbated in the current economic climate, where the timing of and value realisable from the collateral held in the form of property is particularly uncertain. Consequently these allowances can be subject to variation.

Goodwill

Goodwill arises on the acquisition of a business. As explained in the accounting policy for goodwill it is subject to a six monthly impairment review. This compares the recoverable amount, being the higher of a cash generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment.

The recoverable amount of goodwill carried at 31 December 2008 has been based upon value in use. This calculation uses cash flow projections based upon the five year business plan, where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows thereafter are extrapolated using a growth rate of 2.2% pa, reflecting management's view of the expected future long term trend in growth rate of the respective economies concerned, predominantly being in the UK, and the long term performance of the businesses concerned. The pre-tax discount rate used in discounting the projected cash flows has, in view of current credit conditions, been increased to within a range of 14.4% - 15.3% pa (2007 10.0% - 12.2% pa), reflecting, inter alia, the perceived risks within those businesses.

As at 31 December 2008 the carrying value of goodwill held on the balance sheet is £667m (2007 £1,041m) as shown in Note 20. Goodwill has been impaired by £142m during the year. The unprecedented levels of market turmoil and current economic conditions have adversely impacted the short-term profitability of the cash generating units. The Group has considered the impact upon assumptions used and has conducted sensitivity analysis on the impairment tests. For example, an increase in discount rate to 17% would result in an additional impairment to goodwill of £31m; alternatively if projected cash flows reduced by 20% an impairment of £31m would arise.

Investment in Subsidiaries

As explained in the accounting policies, investments in subsidiaries are included in the Bank's balance sheet. These comprise equity investments in and capital contributions to subsidiary entities made by the Bank and are carried at cost less impairment provisions. If impairment indicators are present, a comparison of the recoverable amount, being the higher of a subsidiary entity's value in use and fair value less costs to sell, is made with the carrying value. When this indicates that the carrying value is not recoverable it is written down by the impairment loss identified.

The recoverable amount of the Group's Australian operation has been based upon value in use. This calculation uses five year projections which are extrapolated thereafter using a growth rate of 2.2%. The pre-tax discount rate used in discounting the projected cash flows is 14.6% pa.

At 31 December 2008, the carrying value of the investment is £1,510m. A sensitivity analysis has been conducted within the following parameters: a discount rate of 13.6% pa and 15.6% pa, variation of future profitability of plus/minus 10% pa against forecast and economic growth of 2.0% pa and 2.5% pa beyond 2013. Within these parameters, the key sensitivity is profitability and were projected profitability found to be 10% pa below forecast, an impairment loss of some £162m would be recorded.

IFRS and IFRIC Not Yet Applied

The following standards and interpretations have been adopted by the European Union but are not effective for the year ended 31 December 2008 and have not been applied in preparing the financial statements:

IFRS 8 'Operating Segments' which is effective for periods commencing on or after 1 January 2009. This standard replaces IAS 14 'Segmental Reporting' and aligns the disclosure of operating segments in the financial statements with the internal reporting of segments to senior management. Following the acquisition of the Group by Lloyds TSB plc, the Group will adopt the segmental structure and measurement basis for segments of the Lloyds Banking Group. These are currently being determined by the new organisation.

Amendments to IAS 1 'Presentation of Financial Statements: A Revised Presentation' which is effective for periods commencing on or after 1 January 2009. The revised standard will affect the presentation of owner changes in equity and of comprehensive income. Adoption will not change the recognition, measurement or disclosure of specific transactions or events as required by other standards.

Amendment to IAS 23 'Borrowing Costs' which is applicable to borrowing costs related to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. The application of this revised standard in 2008 would not have had a material impact on the financial statements.

Amendment to IFRS 2 'Share-based Payment: Vesting Conditions and Cancellations' which is effective for periods commencing on or after 1 January 2009. This defines 'non-vesting' conditions on cancellation and clarifies the accounting. The application of this amendment would not have an impact upon the financial statements as the Group accounting policy accords with the treatment prescribed by the amendment.

Amendments to IAS 32 and IAS 1 'Puttable Financial Instruments and Obligations Arising on Liquidation' which is effective for periods commencing on or after 1 January 2009.

Notes to the Financial Statements continued

This amendment addresses the balance sheet classification of puttable financial instruments and obligations arising only on liquidation. Where these instruments represent a residual interest in the net assets of an entity and meet certain other conditions they should be classified as equity rather than liabilities. The Group has no items currently classified as liabilities that would need to be presented as equity as a result of this amendment because these instruments fail to meet the criteria for such a reclassification.

IFRIC 13 'Customer Loyalty Programmes' which is effective for periods commencing on or after 1 July 2008. The application of this interpretation in 2008 would not have had a material impact on the financial statements.

The following interpretation has not yet been adopted by the European Union but is effective for the year ended 31 December 2008. The Group has implemented the principles of this interpretation in preparing the financial statements:

IFRIC 12 'Service Concession Arrangements' which is effective for periods commencing on or after 1 January 2008. The application of this interpretation would not have affected the financial statements as the Group accounting policy accords with the requirements.

The following standards and interpretations have not yet been adopted by the European Union, are not effective for the year ended 31 December 2008 and have not been applied in preparing the financial statements. Where appropriate disclosures will be revised in the financial statements in the year in which the standard or interpretation becomes applicable.

IFRS 1 'First-time adoption of IFRS' which is effective for periods commencing on or after 1 January 2009. As the Group and Bank reports under IFRS, the application of this amendment in 2008 would not have any effect upon the financial statements.

Amendments to IAS 27 'Consolidated and Separate Financial Statements' which is effective for periods commencing on or after 1 January 2009. This amendment removes the definition of the cost method which requires dividends from pre-acquisition profits to be set off against the cost of an investment in a subsidiary. Application in 2008 would not have had an effect upon the financial statements.

IFRIC 15 'Agreements for the Construction of Real Estate' which is effective for periods commencing on or after 1 January 2009. The application of this interpretation would not have affected the financial statements as the Group accounting policy accords with the requirements.

IFRIC 16 'Hedges of a Net Investment in a Foreign Operation' which is effective for periods commencing on or after 1 October 2008. The application of this interpretation in 2008 would not have affected the financial statements as the Group accounting policy accords with the requirements.

IFRIC 17 'Distributions of Non Cash Assets to Owners' which is effective for periods commencing on or after 1 July 2009. The application of this interpretation would not have affected the financial statements as the Group accounting policy accords with the requirements.

IFRIC 18 'Transfer of assets from customers' which applies to transfers of assets from customers received on or after 1 July 2009. The application of this interpretation in 2008 would not have had a material impact on the financial statements.

Improvements to IFRS 2008 The majority of these improvements are effective for periods commencing on or after 1 January 2009 and their application would not have had a material effect upon the financial statements.

Amendments to IAS 39 'Financial Instruments: Recognition and Measurement: Eligible Hedged Items' which is effective for periods commencing on or after 1 July 2009. This amendment clarifies what can be designated as a hedged item in a hedge accounting relationship and application in 2008 would not have had a material impact upon the financial statements.

Amendments to IAS 39 'Reclassification of Financial Assets': Effective Date and Transition which is effective on or after 1 July 2008. This amendment clarifies the effective date and transition requirements for the change to the standard issued in October 2008 permitting entities to reclassify non derivative financial assets out of the fair value through the income statement category in particular circumstances. The application of this amendment would not have affected the financial statements as the Group accounting policy accords with the requirements.

Revised IFRS 3 'Business Combinations' and amended IAS 27 'Consolidated and Separate Financial Statements'
These changes are effective for periods beginning on or after 1 July 2009 with the main effects being that the cost of investment will comprise the consideration paid to the vendors for equity with acquisition costs being expensed immediately; goodwill will be accounted for only upon the acquisition of a subsidiary as subsequent changes in interest will be recognised in equity and only upon the loss of control will any profit or loss be recognised in income. Further, any pre-existing stake held will, where control is subsequently gained, be revalued with any profit or loss arising being booked to income. These changes will affect the manner in which acquisitions and disposals made by the Group are accounted for after the implementation of the revised Business Combinations standard and related revisions to IAS 27.

1 Net Interest Income

	2008 £m	2007 £m
Interest receivable:		
Loans and advances to customers	**32,000**	27,919
Loans and advances to banks	**693**	2,241
Investment securities	**619**	69
Lease and hire purchase receivables	**299**	321
Interest receivable on loans and receivables	**33,611**	30,550
Available for sale financial assets	**2,108**	2,278
Interest receivable on derivatives	**3,486**	3,332
Other	**127**	194
Total interest receivable	**39,332**	36,354
Interest payable:		
Deposits by banks	**3,955**	2,567
Customer accounts	**12,388**	11,680
Debt securities in issue	**10,191**	10,482
Other borrowed funds	**392**	346
Interest payable on liabilities held at amortised cost	**26,926**	25,075
Interest payable on derivatives	**3,436**	3,381
Other	**677**	272
Total interest payable	**31,039**	28,728
Net interest income	**8,293**	7,626

2 Net Trading (Expense)/Income

	2008 £m	2007 £m
Equity and commodity instruments and related non hedging derivatives	**952**	92
Interest bearing securities and related non hedging derivatives	**(4,174)**	58
Foreign exchange and related non hedging derivatives	**90**	72
Net gains and losses from trading financial instruments and non hedging derivatives	**(3,132)**	222
Gains/(losses) on fair value hedges:		
On hedging instruments	**2,413**	1,180
On the hedged items attributable to the hedged risk	**(2,246)**	(1,216)
	167	(36)
Cash flow hedge ineffectiveness recognised	**2**	(1)
Total net trading (expense)/income	**(2,963)**	185

3 Net Operating Income

	2008 £m	2007 £m
Included within net operating income are the following:		
Cash flow hedges:		
Net (losses)/gains released from equity into income (Note 29)	**(2,561)**	417
Financial instruments at fair value through the income statement:		
Net (losses)/gains from trading financial instruments and non hedging derivatives (Note 2)	**(3,132)**	222
Net (losses)/gains from designated financial instruments	**(261)**	146
Available for sale financial instruments:		
Dividend income	**108**	291
Net realised gains on sale (Note 29)	**24**	281
Financial instruments designated as loans and receivables:		
Net realised gains on sale	**22**	3

Notes to the Financial Statements continued

4 (Loss)/Profit on Sale of Businesses

Non-operating income consists of the following:

	2008 £m	2007 £m
Loss on the sale of Bank of Western Australia Ltd and St. Andrews Australia Pty Ltd	**(845)**	
Profit on the part disposal of Rightmove plc (Note 18)	**56**	59
Distribution from Visa Inc shares listing	**26**	
Profit on the sale and leaseback of certain branch premises	**20**	28
	(743)	87

On 8 October 2008, the HBOS Group agreed the sale of part of its Australian operations, principally Bank of Western Australia Ltd and St. Andrews Australia Pty Ltd, to Commonwealth Bank of Australia Limited. The sale completed on 19 December 2008 and results in a pre-tax loss on disposal of £845m (including goodwill written-off of £240m) which is included as non-operating income within the (loss)/profit on sale of businesses for the year.

Under the share sale agreement HBOS plc has provided certain warranties to Commonwealth Bank of Australia, that all relevant, material circumstances and facts in relation to the sale have been disclosed and described in agreement. The share sale agreement provided for adjustments to the initial purchase price based on the risk weighted assets of Bank of Western Australia Limited and the net assets of St. Andrews Australia Pty Limited. As a result, the loss on sale of these businesses may be subject to adjustment for the contingent element of the commitment receivable.

Following the sale, HBOS retains a presence in Australia through Bank of Scotland International (Australia) Limited and Capital Finance Australia Limited which are engaged in corporate banking and asset finance activities respectively, together with the Bank of Scotland plc Sydney branch and therefore this sale does not constitute a discontinued activity. As such, the performance of the businesses sold and the loss on disposal remains within the profit arising from continuing operations of the Group. These businesses are reported in International division for segmental reporting purposes.

5 Administrative Expenses

	2008 £m	2007 £m
Administrative expenses include:		
Regulatory provisions charge (Note 25):		
Financial Services Compensation Scheme (FSCS) management expenses levy	**200**	
Unauthorised overdraft charges		122
Colleague costs (Note 6)	**2,572**	2,530
Accommodation, repairs and maintenance	**465**	427
Technology	**218**	226
Marketing and communication	**326**	327

6 Colleagues

HBOS refers to its employees as colleagues. Most UK based colleagues are contractually employed by HBOS plc, the ultimate parent company. All expenses related to the employment of colleagues for whom the Bank gains the benefit of their employment are recharged by HBOS to the Bank. Consequently, the Bank has no employees.

	2008 Number	2007 Number
The average number of colleagues recharged during the year was:		
Full time	**48,576**	53,526
Part time	**14,242**	15,521
	62,818	69,047

The aggregate remuneration recharged to the Group is included within administrative expenses and comprises:

	2008 £m	2007 £m
Wages and salaries	**2,024**	2,030
Social security costs	**179**	195
Pension costs	**264**	198
Other post retirement benefits	-	-
Expense arising from share-based payments	**105**	107
	2,572	2,530

The expense arising from share-based payment arrangements does not include £4m credit (2007 charge £12m) in relation to National Insurance and income tax costs that are borne by the Group.

7 Directors' Remuneration

The Directors of the Bank during the year were also Directors of HBOS plc, the parent company of the Bank. No Director received emoluments for qualifying services to the Bank in the year ended 31 December 2008 or for the comparative period. Details of the Directors' remuneration are disclosed in the 2008 HBOS plc Annual Report and Accounts.

8 Auditors' Remuneration

During the year the Group (including its overseas subsidiaries) obtained the following services from the Bank's auditor and its associates:

Group	**2008 £m**	2007 £m
Statutory audit of the Bank and consolidated accounts	**1.7**	1.7
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	**3.3**	2.9
Other services pursuant to legislation	**0.5**	0.7
Total audit and audit related services	**5.5**	5.3
Tax services	**0.5**	0.7
Services relating to information technology	-	0.1
Services relating to corporate finance transactions	**0.1**	0.3
Other services	**0.6**	0.4
Total other services	**1.2**	1.5
Total(1)	**6.7**	6.8

(1) Excludes value added taxes

Other services pursuant to legislation includes reporting accountant services in support of the listing rules and includes the review of the half yearly results.

In respect of the Bank, fees in respect of the statutory audit were £0.2m (2007 £1.6m) and other fees amounted to £0.1m (2007 £0.1m).

Notes to the Financial Statements continued

9 Segmental Analysis

Principal activities of the Bank of Scotland Group are the provision of banking and other financial services in the UK and overseas.

The Group's activities are organised on a divisional basis which reflect the business sector segments below. Information about the main divisions, including their key products and markets, is located in the Business Review. Other activities combine the activities of the Insurance & Investment and Group Items divisions of the HBOS Group which are not individually material to the Group.

Business sector

	Retail £m	Corporate £m	International £m	Treasury £m	Other £m	2008 Total £m
Net interest income - internal	(2,392)	318	(3,703)	5,777		
Net interest income - external	6,634	1,980	5,180	(5,507)	6	8,293
Net fees and commission income - internal	144	62	5	(211)		
Net fees and commission income - external	988	377	188	210	63	1,826
Net trading income - external	48	(652)	(45)	(2,314)		(2,963)
Other operating income - internal	65	3	5	(73)		
Other operating income - external	15	1,594	102	45	158	1,914
Net operating income/(expense)	5,502	3,682	1,732	(2,073)	227	9,070
Administrative expenses - internal	(635)	(245)	3		877	
Administrative expenses - external	(1,321)	(650)	(700)	(165)	(1,417)	(4,253)
Depreciation and amortisation	(55)	(1,215)	(55)	(5)	(212)	(1,542)
Goodwill impairment	(69)		(73)			(142)
Other operating expenses			7		(44)	(37)
Operating expenses	(2,080)	(2,110)	(818)	(170)	(796)	(5,974)
Impairment losses on loans and advances	(2,230)	(6,669)	(958)			(9,857)
Impairment losses on investment securities		(737)	(35)	(1,421)		(2,193)
Operating (loss)/profit	1,192	(5,834)	(79)	(3,664)	(569)	(8,954)
Share of (loss)/profit of jointly controlled entities and associates	3	(951)	10			(938)
(Loss)/profit on sale of businesses	102		(845)			(743)
(Loss)/profit before taxation	1,297	(6,785)	(914)	(3,664)	(569)	(10,635)

Total assets	280,639	145,022	63,463	148,596	6,258	643,978
Included in total assets:						
Interests in jointly controlled entities and associates	68	955	165	5		1,193
Loans and advances to customers	270,971	135,261	62,328	4,455		473,015

Total liabilities	205,328	70,205	17,413	337,642	1,465	632,053
Included in total liabilities:						
Customer accounts	159,710	58,579	7,915	35,967	30	262,201
Capital expenditure on property and equipment and software	91	1	111	9	335	547

9 Segmental Analysis continued

In July 2008 the Group announced a divisional reorganisation under which the Group's Business Banking became part of Corporate division, moving from Retail division. In addition, there was a transfer of Trading Cash Management from Treasury to Corporate division. Accordingly the 2007 comparatives have been restated to reflect these new structures and certain other minor reorganisations. There is no impact on the 2007 Consolidated Balance Sheet and Income Statement as previously published.

Business sector

	Retail £m	Corporate £m	International £m	Treasury £m	Other £m	2007 Total £m
Net interest income - internal	(910)	492	(1,260)	1,678		
Net interest income - external	5,023	1,779	2,365	(1,541)		7,626
Net fees and commission income - internal	177	13	2	(192)		
Net fees and commission income - external	1,029	448	175	312		1,964
Net trading income - external	10	73	(2)	104		185
Other operating income - internal	20	16	6	(42)		
Other operating income - external	34	2,024	108	69	339	2,574
Net operating income	5,383	4,845	1,394	388	339	12,349
Administrative expenses - internal	(650)	(191)			841	
Administrative expenses - external	(1,425)	(762)	(604)	(184)	(1,212)	(4,187)
Depreciation and amortisation	(70)	(1,018)	(46)	(3)	(196)	(1,333)
Other operating expenses			(15)		(118)	(133)
Operating expenses	(2,145)	(1,971)	(665)	(187)	(685)	(5,653)
Impairment losses on loans and advances	(1,278)	(618)	(116)			(2,012)
Impairment losses on investment securities	(22)	(37)	(1)			(60)
Operating profit/(loss)	1,938	2,219	612	201	(346)	4,624
Share of (loss)/profit of jointly controlled entities and associates	(9)	232	18			241
Profit on sale of businesses	87					87
Profit/(loss) before taxation	2,016	2,451	630	201	(346)	4,952

	Retail £m	Corporate £m	International £m	Treasury £m	Other £m	2007 Total £m
Total assets	275,410	135,340	72,600	119,567	715	603,632
Included in total assets:						
Interests in jointly controlled entities and associates	81	1,525	133			1,739
Loans and advances to customers	268,573	122,661	68,300	232	501	460,267

	Retail £m	Corporate £m	International £m	Treasury £m	Other £m	2007 Total £m
Total liabilities	231,322	69,617	32,918	245,502	2,429	581,788
Included in total liabilities:						
Customer accounts	169,883	60,810	24,780	17,167	47	272,687
Capital expenditure on property and equipment and software	6	43	83	13	394	539

Notes to the Financial Statements continued

9 Segmental Analysis continued

Geographical

The table below analyses the Group results and assets by geographical area based on the location of the customer.

	UK £m	Rest of world £m	2008 Total £m	UK £m	Rest of world £m	2007 Total £m
Net interest income	**6,595**	**1,698**	**8,293**	6,308	1,318	7,626
Net fees and commission income	**1,582**	**244**	**1,826**	1,735	229	1,964
Net trading income	**(3,113)**	**150**	**(2,963)**	149	36	185
Other operating income	**4,788**	**(2,874)**	**1,914**	2,421	153	2,574
Net operating income	**9,852**	**(782)**	**9,070**	10,613	1,736	12,349
Administrative expenses	**(3,533)**	**(720)**	**(4,253)**	(3,563)	(624)	(4,187)
Depreciation and amortisation	**(1,482)**	**(60)**	**(1,542)**	(1,281)	(52)	(1,333)
Goodwill impairment	**(142)**		**(142)**			
Other operating expenses	**(37)**		**(37)**	(118)	(15)	(133)
Operating expenses	**(5,194)**	**(780)**	**(5,974)**	(4,962)	(691)	(5,653)
Impairment losses on loans and advances	**(8,899)**	**(958)**	**(9,857)**	(1,893)	(119)	(2,012)
Impairment losses on investment securities	**(2,158)**	**(35)**	**(2,193)**	(59)	(1)	(60)
Operating (loss)/profit	**(6,399)**	**(2,555)**	**(8,954)**	3,699	925	4,624
Share of (loss)/profit of jointly controlled entities and associates	**(880)**	**(58)**	**(938)**	63	178	241
(Loss)/profit on sale of businesses	**102**	**(845)**	**(743)**	87		87
(Loss)/profit before taxation	**(7,177)**	**(3,458)**	**(10,635)**	3,849	1,103	4,952
Total assets	**520,273**	**123,705**	**643,978**	483,207	120,425	603,632
Included in total assets:						
Interests in jointly controlled entities and associates	**789**	**404**	**1,193**	1,457	282	1,739
Total liabilities	**497,326**	**134,727**	**632,053**	449,518	132,270	581,788
Included in total liabilities:						
Capital expenditure on property and equipment and software	**429**	**118**	**547**	456	83	539

10 Impairment Provisions and Losses

a) Impairment provisions and losses on loans and advances to customers designated as loans and receivables

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Impairment provisions				
At 1 January	**3,373**	1,561	**2,997**	1,148
Transfer in under the HBOS Group Reorganisation		1,528		1,643
New impairment provisions less releases	**9,964**	2,111	**9,720**	1,950
Amounts written off	**(2,515)**	(1,726)	**(2,120)**	(1,606)
Disposal of subsidiary undertakings	**(115)**		**3**	(17)
Discount unwind/interest income on impaired loans and advances to customers	**(149)**	(129)	**(140)**	(123)
Foreign exchange translation	**135**	28	**15**	2
At 31 December	**10,693**	3,373	**10,475**	2,997
Impairment provisions are held in respect of:				
Retail secured lending	**1,219**	330	**995**	284
Retail unsecured lending	**1,819**	1,889	**1,819**	1,889
Corporate	**6,563**	832	**7,593**	808
International	**1,092**	322	**68**	16
	10,693	3,373	**10,475**	2,997
Impairment losses				
New impairment provisions less releases	**9,964**	2,111	**9,720**	1,950
Recoveries of amounts previously written off	**(107)**	(99)	**(99)**	(83)
Net charge to income statement	**9,857**	2,012	**9,621**	1,867

b) Impairment provisions and losses on investment securities

Total impairments on investment securities of £2,193m (2007 £60m) have been charged to the income statement, of which £1,270m (2007 £23m) relates to available for sale financial assets (Note 29) and £923m (2007 £37m) relates to loans and receivables, as shown below.

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Impairment provisions				
At 1 January				
New impairment provisions less releases	**923**	37	**415**	24
Amounts written off		(37)		(24)
At 31 December	**923**		**415**	
Impairment provisions are held in respect of:				
Treasury	**773**		**351**	
Corporate	**150**		**64**	
	923		**415**	

Impairment losses	2008 £m	2007 £m	2008 £m	2007 £m
New impairment provisions less releases	**923**	37	**415**	24
Net charge to income statement	**923**	37	**415**	24

Notes to the Financial Statements continued

11 Taxation

The tax credit for the year of £2,448m (2007 tax charge of £1,318m) results in an effective rate of 23% (2007 27%). Included within the tax credit of £2,448m is an overseas tax charge of £218m (2007 £236m).

	2008 £m	2007 £m
Current tax		
Corporation tax on profit for the year	**(525)**	1,112
Adjustments in respect of prior years	**(181)**	(8)
Overseas taxation on profit for the year	**195**	229
Adjustments in respect of prior years	**14**	7
Relief for overseas taxation	**(21)**	(65)
	(518)	1,275
Deferred tax		
Origination and reversal of temporary differences	**(1,931)**	116
Adjustments in respect of prior years	**1**	3
Deferred tax changes in rates of corporation tax (Note 24)		(76)
	(1,930)	43
Total income tax on (loss)/profit	**(2,448)**	1,318

The main UK corporation tax rate reduced from 30% to 28% in April 2008. The average rate of UK corporation tax for the year to December 2008 is 28.5%.

The effective tax rate for the year is 23% (2007 27%) which is lower (2007 lower) than the average rate of corporation tax in the UK of 28.5% (2007 30%). The differences are explained below:

	2008 £m	2007 £m
(Loss)/profit before taxation	**(10,635)**	4,952
Expected tax (credit)/charge at 28.5% (2007 30%)	**(3,031)**	1,486
Effects of:		
Changes in rates of corporation tax on deferred tax assets and liabilities	**10**	(76)
(Income)/expenses not deductible/(chargeable) for tax purposes	**358**	(22)
Net effect of differing tax rates overseas	**83**	6
Gains exempted or covered by losses	**(102)**	(86)
Impairment on investment securities	**52**	16
Adjustments in respect of previous periods	**(166)**	2
Tax losses where no deferred tax provided	**310**	
Other	**38**	(8)
Total income tax on (loss)/profit	**(2,448)**	1,318
Current tax credit recognised directly in equity		
Relating to share plans		(23)
Relating to available for sale investments	**(11)**	(117)
	(11)	(140)
Deferred tax (credit)/charge recognised directly in equity (Note 24)		
Relating to share plans	**2**	59
Relating to available for sale investments	**(1,917)**	(65)
Relating to cash flow hedges	**(371)**	(218)
Relating to employee benefits	**(5)**	
Relating to other		1
Relating to change in rate of UK corporation tax		(5)
	(2,291)	(228)

In addition there is £nil (2007 £2m) recognised in equity relating to changes in the rates of corporation tax (Note 24).

12 (Loss)/Profit Attributable to Equity Shareholders

By virtue of the exemption contained within Section 230 of the Companies Act 1985, the income statement of the Bank is not presented. Of the (loss)/profit attributable to equity shareholders a loss of £4,320m (2007 profit £2,420m) is dealt within the financial statements of the Bank.

13 Financial Instruments Held for Trading

Financial assets and liabilities held for trading (other than derivatives) are as follows:

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Financial assets held for trading				
Debt securities	**13,538**	36,723	**13,538**	34,326
Loans and advances to banks	**3,344**	11,601	**3,344**	11,532
Loans and advances to customers	**5,689**	6,357	**5,689**	6,311
Total	**22,571**	54,681	**22,571**	52,169
Financial liabilities held for trading				
Debt securities in issue		301		
Deposits by banks	**7,631**	8,989	**7,631**	8,989
Customer accounts	**11,220**	13,247	**11,220**	12,988
Other liabilities		168		168
Total	**18,851**	22,705	**18,851**	22,145

Financial assets held for trading include £4,369m (2007 £4,711m) subject to repurchase (Note 42).

Following the International Accounting Standards Board's (IASB) decision in October 2008 to permit the reclassification of financial assets, the Group's Treasury division reclassified certain securities from assets held for trading into the available for sale (AFS) portfolio and, subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS to loans and receivables. Further details of these reclassifications are shown in Note 33.

Notes to the Financial Statements continued

14 Derivatives

The Group's derivative transactions are either customer driven and generally matched, held within policyholder funds as permitted by the investment strategies or are carried out for proprietary purposes within limits approved by the Board. Where a derivative held for economic hedging purposes does not qualify for hedge accounting, it is classified below as held for trading.

The Group uses interest rate swaps, cross currency swaps and other derivative instruments to hedge and reduce the interest rate and currency exposures that are inherent in any banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of the macro cash flow, micro fair value and net investment hedge approaches.

		Group Fair value		2008 Bank Fair value
	Asset £m	**Liability £m**	**Asset £m**	**Liability £m**
Total derivatives assets/liabilities:				
Held for trading	**28,435**	**28,825**	**30,920**	**27,912**
Held as qualifying hedges	**22,082**	**12,002**	**15,454**	**11,736**
Total recognised derivative assets/liabilities	**50,517**	**40,827**	**46,374**	**39,648**

	Asset £m	Group Fair value Liability £m	Asset £m	2007 Bank Fair value Liability £m
Total derivatives assets/liabilities:				
Held for trading	8,978	7,755	8,159	7,581
Held as qualifying hedges	4,816	4,405	3,975	2,965
Total recognised derivative assets/liabilities	13,794	12,160	12,134	10,546

		2008 Fair value		2007 Fair value
Group	**Asset £m**	**Liability £m**	Asset £m	Liability £m
Derivatives held for trading				
Exchange rate related contracts:				
Forward foreign exchange	**2,101**	**3,562**	1,035	856
Cross currency swaps	**3,144**	**1,208**	667	297
Options			1	1
	5,245	**4,770**	1,703	1,154
Interest rate related contracts:				
Interest rate swaps	**18,781**	**20,725**	5,375	5,290
Forward rate agreements	**1,474**	**1,461**	120	111
Options	**884**	**758**	169	286
Futures	**47**	**120**	17	39
	21,186	**23,064**	5,681	5,726
Equity/index and commodity related contracts:				
Options and swaps	**1,256**	**958**	1,408	867
Credit related contracts:				
Credit default swaps	**748**	**33**	186	8
Total derivative assets/liabilities held for trading	**28,435**	**28,825**	8,978	7,755

14 Derivatives continued

Bank	2008 Fair value Asset £m	2008 Fair value Liability £m	2007 Fair value Asset £m	2007 Fair value Liability £m
Derivatives held for trading				
Exchange rate related contracts:				
Forward foreign exchange	**2.205**	**3,677**	1,137	912
Cross currency swaps	**3,131**	**1,207**	715	297
	5,336	**4,884**	1,852	1,209
Interest rate related contracts:				
Interest rate swaps	**21,851**	**19,790**	5,311	5,492
Forward rate agreements	**1,481**	**1,465**	121	111
Options	**882**	**1,006**	169	301
Futures	**47**	**120**	17	39
	24,261	**22,381**	5,618	5,943
Equity and commodity related contract:				
Options and swaps	**618**	**614**	510	421
Credit related contracts:				
Credit default swaps	**705**	**33**	179	8
Total derivative assets/liabilities held for trading	**30,920**	**27,912**	8,159	7,581

The Group and Bank has entered into derivative contracts for qualifying hedges as noted below:

Group	2008 Fair value Asset £m	2008 Fair value Liability £m	2007 Fair value Asset £m	2007 Fair value Liability £m
Derivatives held as qualifying hedges				
Derivatives designated as fair value hedges:				
Interest rate swaps	**4,738**	**805**	739	583
Forward foreign exchange				27
Cross currency swaps	**8,863**	**2,713**	1,728	1,836
	13,601	**3,518**	2,467	2,446
Derivatives designated as cash flow hedges:				
Interest rate swaps	**7,218**	**8,337**	1,558	1,801
Forward rate agreements	**1,037**	**21**	10	4
Cross currency swaps	**180**	**123**	756	139
Options	**46**			
Futures		**3**	25	15
	8,481	**8,484**	2,349	1,959
Total derivative assets/liabilities held as qualifying hedges	**22,082**	**12,002**	4,816	4,405

Notes to the Financial Statements continued

14 Derivatives continued

Bank	2008 Fair value Asset £m	2008 Fair value Liability £m	2007 Fair value Asset £m	2007 Fair value Liability £m
Derivatives held as qualifying hedges				
Derivatives designated as fair value hedges:				
Interest rate swaps	**4,941**	**556**	776	586
Forward foreign exchange				27
Cross currency swaps	**2,588**	**2,713**	926	382
	7,529	**3,269**	1,702	995
Derivatives designated as cash flow hedges:				
Interest rate swaps	**6,681**	**8,337**	1,558	1,802
Forward rate agreements	**1,037**	**3**	17	14
Cross currency swaps	**180**	**123**	673	139
Options	**27**			
Futures		**4**	25	15
	7,925	**8,467**	2,273	1,970
Total derivative assets/liabilities held as qualifying hedges	**15,454**	**11,736**	3,975	2,965

15 Loans and Advances to Customers

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Retail secured lending	**239,758**	235,858	**224,982**	223,429
Retail unsecured lending	**18,592**	18,908	**18,592**	18,908
Corporate, International and Treasury	**225,358**	208,874	**337,156**	214,250
Gross loans and advances to customers	**483,708**	463,640	**580,730**	456,587
Impairment losses on loans and advances (Note 10)	**(10,693)**	(3,373)	**(10,475)**	(2,997)
Net loans and advances to customers	**473,015**	460,267	**570,255**	453,590

Included in loans and advances to customers is £56,858m (2007 £nil) subject to repurchase (Note 42).

Loans and advances to customers include advances securitised under the Group's securitisation and covered bonds programmes. Further details are given in Note 16.

15 Loans and Advances to Customers continued

The Group's gross lending exposure before impairment provisions and before taking account of collateral is analysed below:

	2008 £m	2007 £m
Agriculture, forestry and fishing	**574**	647
Energy	**1,318**	2,269
Manufacturing industry	**3,887**	4,332
Construction and property	**46,634**	41,099
Hotels, restaurants and wholesale and retail trade	**12,368**	12,620
Transport, storage and communication	**7,693**	6,834
Financial	**46,521**	36,572
Other services	**12,688**	14,749
Individuals:		
Residential mortgages	**238,696**	235,771
Other personal lending	**22,604**	19,229
Non-UK residents	**90,725**	89,518
	483,708	463,640

	Group 2008 £m	Group Restated 2007 £m	Bank 2008 £m	Bank Restated 2007 £m
Loans and advances that are neither past due nor impaired	**441,276**	441,649	**544,629**	437,764
Loans and advances that are past due but not impaired (Note 36)	**16,401**	11,629	**12,678**	9,582
Impaired loans (Note 36)	**26,031**	10,362	**23,423**	9,241
	483,708	463,640	**580,730**	456,587

Included in loans and advances that are neither past due nor impaired of the Group are £478m (2007 £229m) of troubled debt restructured loans that would have been past due or impaired had their terms not been renegotiated.

Loans and advances to customers include finance leases analysed as follows:

	2008 £m	2007 £m
Gross investment in finance receivables:		
Within one year	**2,994**	3,206
Between one and five years	**4,904**	5,805
More than five years	**3,986**	4,221
	11,884	13,232
Less: unearned finance income	**(1,849)**	(3,234)
Present value of minimum lease payments	**10,035**	9,998
Analysed as:		
Within one year	**2,407**	2,669
Between one and five years	**3,796**	4,646
More than five years	**3,832**	2,683
Finance lease receivables	**10,035**	9,998

At 31 December 2008 total unguaranteed residual values accrued to the benefit of the Group amounted to £nil (2007 £20m) and total accumulated allowances for uncollectable minimum lease payments receivable amounted to £105m (2007 £67m).

Notes to the Financial Statements continued

16 Securitisation and Covered Bonds

a) Securitisation

Loans and advances to customers include advances securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby some of the risks and rewards of the portfolio are retained by the subsidiary, the SPEs are consolidated fully and all of these advances are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

b) Covered bonds

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security to issues of covered bonds by the Group. The Group retains substantially all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet, with the related covered bonds included within debt securities in issue.

The Group's principal securitisation and covered bonds programmes, together with the balances of the advances subject to notes in issue at 31 December, are listed below. The notes in issue are reported in Note 26.

Securitisation	Type of loan	**2008 Gross assets securitised £m**	**2008 Notes in issue £m**	2007 Gross assets securitised £m	2007 Notes in issue £m
Permanent	UK residential mortgages	**32,613**	**38,490**	31,577	31,540
Mound	UK residential mortgages	**8,063**	**8,238**	4,545	4,454
Swan	Australian residential mortgages			2,726	2,689
Candide	Dutch residential mortgages	**5,569**	**5,704**	2,705	2,759
Prominent	Commercial loans	**1,053**	**1,149**	1,107	1,108
Pendeford	UK residential mortgages	**9,888**	**9,870**	2,508	2,551
Melrose	Commercial loans			750	1,134
Balliol	UK residential mortgages	**12,701**	**12,549**		
Brae	UK residential mortgages	**9,213**	**9,955**		
Dakota	UK residential mortgages	**3,988**	**3,885**		
Deva	UK residential mortgages	**6,747**	**6,703**		
Penarth	Credit card receivables	**4,189**	**2,633**		
Tioba	UK residential mortgages	**2,647**	**2,568**		
Trinity	UK residential mortgages	**12,975**	**12,638**		
Wolfhound	Irish residential mortgages	**4,083**	**4,107**		
Other	UK residential mortgages	**68**	**179**	68	182
		113,797	**118,668**	45,986	46,417
Covered Bonds					
Covered Bonds	UK residential mortgages	**51,756**	**49,408**	34,711	38,315
Social Housing Covered Bonds	UK residential mortgages	**3,475**	**2,919**	2,354	1,519
		55,231	**52,327**	37,065	39,834
Total securitisations and covered bonds		**169,028**	**170,995**	83,051	86,251
Less held by the Group		**(97,363)**	**(94,265)**	(1,258)	(1,258)
Total		**71,665**	**76,730**	81,793	84,993

The balances reported for the Prominent securitisation above include £456m (2007 £459m) advances and £456m (2007 £459m) notes in issue that arise from a funded synthetic securitisation.

Cash deposits of £12,423m (2007 £5,144m) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs and other legal obligations.

In addition to the programmes noted above, the Group entered into synthetic securitisations, referencing an asset pool of £nil (2007 £14,089m), using credit default swaps of £nil (2007 £40m).

In total, the Group has securitised £97,363m of mortgage assets under certain securitisation and covered bond programmes and purchased all of the loan notes in issue relating to those issuances for £94,265m. These transactions did not lead to any derecognition of the mortgage assets as the Group has retained all of the risks and rewards associated with the loan notes. See Note 42 for further details about the Group's repurchase transactions.

16 Securitisation and Covered Bonds continued

c) Other special purpose entities

In addition to the SPEs described above, the Group sponsors two conduit programmes, Grampian and Landale, which invest in asset-backed securities funded by commercial paper or through banking facilities. Details of the assets secured under these conduit programmes are given in Note 17.

The SPEs within these conduit programmes are consolidated fully, except for two of the four SPEs within Landale. One is the central funding company for the conduit that obtains external funding and lends it to the purchasing companies. The second is a purchasing company that has acquired floating rate notes issued under the Group's mortgage securitisation programmes and which is supported by liquidity lines that are provided by third party banks. These entities are not consolidated as there are insufficient indicators of control, in particular as the credit risk relating to the assets held by the entities and the liquidity risks are not borne by the Group. If these two entities were consolidated by the Group the financial impact would be minimal with the principal effects increasing deposits by banks by £1,126m (2007 £1,756m) and customer accounts by £51m (2007 £100m) and increasing debt securities in issue by £50m (2007 decrease by £1,856m). Group profit before tax would be increased by £2m (2007 £0.5m).

17 Investment Securities

2008

Group	At fair value though the income statement £m	Available for sale £m	Loans and receivables £m	Total £m
Listed				
Debt securities	**346**	**22,064**	**25,325**	**47,735**
Equity shares	**3**	**110**		**113**
Total listed	**349**	**22,174**	**25,325**	**47,848**
Unlisted				
Debt securities	**217**	**3,714**	**13,553**	**17,484**
Equity shares	**293**	**2,147**		**2,440**
Total unlisted	**510**	**5,861**	**13,553**	**19,924**
Total	**859**	**28,035**	**38,878**	**67,772**
Comprising:				
Debt securities	**563**	**25,778**	**38,878**	**65,219**
Equity shares	**296**	**2,257**		**2,553**

2007

Group	At fair value through the income statement £m	Available for sale £m	Loans and receivables £m	Total £m
Listed				
Debt securities	639	31,944		32,583
Equity shares	10	261		271
Total listed	649	32,205		32,854
Unlisted				
Debt securities	151	14,833	527[1]	15,511
Equity shares	308	2,942		3,250
Total unlisted	459	17,775	527	18,761
Total	1,108	49,980	527	51,615
Comprising:				
Debt securities	790	46,777	527	48,094
Equity shares	318	3,203		3,521

(1) Restated by £739m as explained in Note 18.

Included in investment securities is £37,263m (2007 £8,996m) subject to repurchase (Note 42).

Following the International Accounting Standards Board's (IASB) decision in October 2008 to permit the reclassification of financial assets, the Group's Treasury division reclassified certain securities from assets held for trading into the available for sale (AFS) portfolio and, subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS to loans and receivables. Further details of these reclassifications are shown in Note 33.

Notes to the Financial Statements continued

17 Investment Securities continued

The fair value movement during the year on investment securities held at fair value through the income statement is a gain of £37m (2007 £65m) and the fair value movement during the year on investment securities classified as available for sale is a loss of £8,173m (2007 loss of £432m).

Loans and receivables debt securities include asset backed securities of £17,703m (end 2007 available for sale debt securities £18,563m) which are held in the Group's Grampian conduit. This is a series of bankruptcy remote special purpose entities (SPEs) that are funded by the issue of commercial paper and banking facilities. The commercial paper is included within debt securities in issue. As some of the rewards and risks of the portfolio are retained by the Group, including the provision of liquidity facilities by Bank of Scotland plc to the conduit, the assets and liabilities of the conduit are consolidated as part of the Group. The Group also has a smaller conduit, Landale, of which two of the four SPEs are consolidated. These hold available for sale debt securities of £681m (2007 £604m). Details of the Landale SPEs that are not consolidated by the Group are given in Note 16.

2008

Bank	**At fair value through the income statement £m**	**Available for sale £m**	**Loans and receivables £m**	**Total £m**
Listed				
Debt securities	**346**	**21,333**	**45,419**	**67,098**
Equity shares	**3**	**5**		**8**
Total listed	**349**	**21,338**	**45,419**	**67,106**
Unlisted				
Debt securities		**1,943**	**37,745**	**39,688**
Equity shares		**1,058**		**1,058**
Total unlisted		**3,001**	**37,745**	**40,746**
Total	**349**	**24,339**	**83,164**	**107,852**
Comprising:				
Debt securities	**346**	**23,276**	**83,164**	**106,786**
Equity shares	**3**	**1,063**		**1,066**

2007

Bank	At fair value through the income statement £m	Available for sale £m	Loans and receivables £m	Total £m
Listed				
Debt securities	292	20,327		20,619
Equity shares		8		8
Total listed	292	20,335		20,627
Unlisted				
Debt securities	113	5,231	7	5,351
Equity shares		1,042		1,042
Total unlisted	113	6,273	7	6,393
Total	405	26,608	7	27,020
Comprising:				
Debt securities	405	25,558	7	25,970
Equity shares		1,050		1,050

18 Interests in Jointly Controlled Entities and Associates

Interests in jointly controlled entities	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Group carrying value £m	Bank cost of investment £m
At 1 January 2008 (as restated)	1,214	148	1,362	5	1,367	103
Exchange translation	(5)		(5)		(5)	
Acquisitions and subscriptions of capital	312		312		312	
Disposals	(40)	(3)	(43)		(43)	
Loss after tax		(651)	(651)		(651)	
Dividends paid		(10)	(10)		(10)	
At 31 December 2008	1,481	(516)	965	5	970	103

The Group's share of jointly controlled entities include the following:

	Income £m	Expenses £m	Tax £m	(Loss) /profit after tax £m	Current assets £m	Non-current assets £m	Current liabilities £m	Non-current liabilities £m	Equity £m
2008	(557)	(119)	25	(651)	2,149	4,885	(1,429)	(4,635)	970
2007	433	(185)	(7)	241	5,589	5,272	(4,691)	(4,803)	1,367

The Group's unrecognised share of losses for the year is £164m (2007 £22m). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis is £211m (2007 £68m).

Interests in associates	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Group carrying value £m
At 1 January 2008 (as restated)	357	15	372		372
Acquisitions and subscriptions of capital	160		160		160
Disposals	(14)		(14)		(14)
Loss after tax		(287)	(287)		(287)
Dividends paid		(8)	(8)		(8)
At 31 December 2008	503	(280)	223		223

The Group's share of associates include the following:

	Revenue £m	Loss after tax £m	Assets £m	Liabilities £m	Equity £m
2008	(277)	(287)	2,688	(2,465)	223
2007	26		1,875	(1,503)	372

The Group's unrecognised share of losses for the year is £126m (2007 £5m). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis is £131m (2007 £4m).

Notes to the Financial Statements continued

18 Interests in Jointly Controlled Entities and Associates continued

The Group's main jointly controlled entities in operation at 31 December 2008 are as follows:

	Nature of business		Issued share capital	Group's interest	Statutory accounts made up to	Principal area of operations
Jointly controlled entities						
AA Personal Finance Limited	Finance	ordinary	£3,000,002	50%	Dec 2008	UK
Green Property Investment Fund 1 plc	Investment	ordinary	41,198,100	50%	Jun 2008	Ireland
Sainsbury's Bank plc	Banking	ordinary	£170,000,000	50%	Dec 2008	UK

Except for the Green Property Investment Fund 1 plc which is incorporated in Ireland, all of the interests in jointly controlled entities above are incorporated in the UK. All interests in jointly controlled entities are held by subsidiaries. Where entities have accounts that are drawn up to a date other than 31 December management accounts are used when accounting for them by the Group. The Group's remaining holding of 13% in Rightmove plc was disposed of during the year (Note 4).

During the year, the Group reviewed the classification of its investments in jointly controlled entities and associates together with its long term investment loans to joint ventures, (collectively the Group's longer term interests in jointly controlled entities and associates) in light of the deteriorating economic environment. As a result of this review, certain longer term investment securities that in substance form part of the Group's overall net investment in jointly controlled entities and associates have been transferred from investment securities – debt securities classified as loans and receivables to interests in jointly controlled entities and associates. These longer term interests include loans for which settlement is neither planned nor likely to occur in the foreseeable future. Accordingly, the Group's interest in jointly controlled entities and associates have been restated in the 2007 consolidated balance sheet as shown below. There is no overall impact on the net assets as at 31 December 2007 as a result of this restatement. Certain 2007 disclosures have been amended accordingly.

Interests in jointly controlled entities	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Group carrying value £m
At 1 January 2007 (as published)	398	54	452	2	454
Transfer from investment securities	515		515		515
At 1 January 2007 (as restated)	913	54	967	2	969
At 31 December 2007 (as published)	699	148	847	5	852
At 31 December 2007 (as restated)	1,214	148	1,362	5	1,367

Interests in associates	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Group carrying value £m
At 1 January 2007 (as published)	123	56	179		179
Transfer from investment securities	224		224		224
At 1 January 2007 (as restated)	347	56	403		403
At 31 December 2007 (as published)	133	15	148		148
At 31 December 2007 (as restated)	357	15	372		372

19 Investments in Subsidiaries

Investments in subsidiaries comprise investments in ordinary shares and capital contributions carried at cost.

Bank	Banks £m	Others £m	Total £m
At 1 January 2008	48	3,225	3,273
Subscriptions of capital		1,217	1,217
Impairment losses		(107)	(107)
At 31 December 2008	48	4,335	4,383

Impairment losses have been incurred as a result of deteriorating economic conditions. The critical accounting estimate in respect of investment in subsidiaries explains how such investments are tested for impairment.

The main subsidiaries at 31 December 2008 are as follows:

	Bank's interest in ordinary share capital and voting rights	*Principal business*	Country of incorporation
Bank of Scotland (Ireland) Ltd	100%	Banking	Ireland
HBOS Australia Pty Ltd and subsidiaries	100%	Banking	Australia
Banco Halifax Hispania SA	100%	Banking	Spain
Halifax Estate Agencies Ltd	100%	Estate agency and financial services	UK
HBOS Covered Bonds LLP	100%[a]	Residential mortgage loans	UK
Uberior Investments plc	100%	Investment holding	UK

(a) HBOS Covered Bonds LLP does not have ordinary share capital. The Group consolidates a 100% interest in this activity.

The above information is provided in relation to the principal related undertakings and, in accordance with Section 231(5) of the Companies Act 1985, a full list of related undertakings, as at 31 December 2008, will be annexed to the Company's next Annual Return to be delivered to the Registrar of Companies for Scotland.

On 17 September 2007 in accordance with the provisions of the HBOS Group Reorganisation Act 2006 (the Act), the Governor and Company of the Bank of Scotland registered as a public limited company under the Companies Act and changed its name to Bank of Scotland plc. On the same day, under the Act, the business activities, assets (including investments in subsidiaries) and liabilities of CAPITAL BANK plc, Halifax plc and HBOS Treasury Services plc transferred to Bank of Scotland plc.

All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the relevant regulators; this may impact those subsidiaries' ability to make distributions.

Notes to the Financial Statements continued

20 Goodwill and Other Intangible Assets

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Goodwill	**667**	1,041	**376**	426
Other intangibles	**481**	476	**394**	357
	1,148	1,517	**770**	783

Goodwill	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
At 1 January	**1,041**	342	**426**	66
Transfer in under HBOS Group Reorganisation		649		360
Exchange translation	**24**	38		
Additions		21		
Disposals	**(256)**	(9)		
Impairment losses charged to the income statement	**(142)**		**(50)**	
At 31 December	**667**	1,041	**376**	426

Goodwill is analysed on a divisional basis as follows:

	2008 £m	2007 £m
Retail	**376**	385
Corporate	**268**	342
International	**23**	314
Total	**667**	1,041

20 Goodwill and Other Intangible Assets continued

The primary component of goodwill disposed of comprises £240m in respect of the sale of Bank of Western Australia Limited and St. Andrews Australia Pty Limited to Commonwealth Bank of Australia Limited (Note 4).

The Group carries out semi-annual and, if necessary, other impairment reviews of cash-generating units to which goodwill is allocated as described in the accounting policy on goodwill. The critical accounting estimate in respect of goodwill explains the assumptions used and sensitivity of the impairment testing.

The goodwill impairment of £142m principally comprises £72m being the full write-down of goodwill held in respect of the acquisition of the ICC business banking division in Ireland and £50m being the write-down of goodwill relating to a specialist area of the UK credit card business to a recoverable amount, based on a value in use, of £20m. The write-downs have been triggered principally by deteriorating economic conditions.

Cumulative impairment losses charged to the income statement total £183m (2007 £41m, 2006 £41m and 2005 £nil).

Group	2008 Purchased value of in-force investment contracts £m	2008 Software and other intangible assets £m	2008 Total £m	2007 Purchased value of in-force investment contracts £m	2007 Software and other intangible assets £m	2007 Total £m
Cost						
At 1 January	**2**	**1,187**	**1,189**	2	359	361
Transfer in under HBOS Group Reorganisation					574	574
Exchange translation		**24**	**24**		34	34
Acquired through business combination					7	7
Additions		**276**	**276**		242	242
Disposals		**(100)**	**(100)**		(29)	(29)
Disposal of subsidiary undertakings	**(2)**	**(94)**	**(96)**			
At 31 December		**1,293**	**1,293**	2	1,187	1,189
Amortisation						
At 1 January		**713**	**713**		197	197
Transfer in under HBOS Group Reorganisation					359	359
Exchange translation					32	32
Amortisation charge for the year		**153**	**153**		130	130
Disposals		**(2)**	**(2)**		(5)	(5)
Disposal of subsidiary undertakings		**(52)**	**(52)**			
At 31 December		**812**	**812**		713	713
Carrying value						
At 1 January	**2**	**474**	**476**	2	162	164
At 31 December		**481**	**481**	2	474	476

Software

Bank	2008 £m	2007 £m
Cost		
At 1 January	**929**	270
Transfer in under HBOS Group Reorganisation		506
Additions	**186**	162
Disposals	**(40)**	(9)
At 31 December	**1,075**	929
Amortisation		
At 1 January	**572**	162
Transfer in under HBOS Group Reorganisation		306
Exchange translation	**(1)**	
Amortisation for the year	**119**	102
Additions		2
Disposals	**(9)**	
At 31 December	**681**	572
Carrying value		
At 1 January	**357**	108
At 31 December	**394**	357

Notes to the Financial Statements continued

21 Property and Equipment

Group	Property £m	Equipment £m	2008 Total £m	Property £m	Equipment £m	2007 Total £m
Cost						
At 1 January	**1,541**	**1,530**	**3,071**	380	585	965
Transfer in under HBOS Group Reorganisation				1,072	936	2,008
Exchange translation	**17**	**44**	**61**	5	13	18
Additions	**63**	**208**	**271**	117	180	297
Disposals	**(116)**	**(132)**	**(248)**	(41)	(179)	(220)
Disposal of subsidiary undertakings	**(53)**	**(108)**	**(161)**		(2)	(2)
Transfer from investment property (Note 22)				5		5
Transfers and other movements				3	(3)	
At 31 December	**1,452**	**1,542**	**2,994**	1,541	1,530	3,071
Depreciation						
At 1 January	**625**	**1,155**	**1,780**	80	430	510
Transfer in under HBOS Group Reorganisation				509	609	1,118
Exchange translation	**7**	**30**	**37**	3	7	10
Depreciation charge for the year	**61**	**150**	**211**	57	161	218
Disposals	**(18)**	**(102)**	**(120)**	(26)	(50)	(76)
Disposal of subsidiary undertakings	**(16)**	**(85)**	**(101)**			
Transfers and other movements				2	(2)	
At 31 December	**659**	**1,148**	**1,807**	625	1,155	1,780
Carrying value						
At 1 January	**916**	**375**	**1,291**	300	155	455
At 31 December	**793**	**394**	**1,187**	916	375	1,291

Included within Group property and equipment are assets that are in the course of construction amounting to £89m (2007 £127m) which are not depreciated until the assets are brought into use. These are primarily properties that will be classified as investment properties upon completion.

Bank	Property £m	Equipment £m	2008 Total £m	Property £m	Equipment £m	2007 Total £m
Cost						
At 1 January	**1,395**	**1,345**	**2,740**	222	362	584
Transfer in under HBOS Group Reorganisation				1,089	987	2,076
Exchange translation	**2**	**3**	**5**			
Additions	**48**	**184**	**232**	98	157	255
Disposals	**(83)**	**(108)**	**(191)**	(17)	(158)	(175)
Transfers and other movements				3	(3)	
At 31 December	**1,362**	**1,424**	**2,786**	1,395	1,345	2,740
Depreciation						
At 1 January	**600**	**1,032**	**1,632**	44	270	314
Transfer in under HBOS Group Reorganisation				521	668	1,189
Exchange translation	**(1)**	**(1)**	**(2)**			
Depreciation charge for the year	**55**	**133**	**188**	51	143	194
Disposals	**(13)**	**(80)**	**(93)**	(17)	(48)	(65)
Transfers and other movements				1	(1)	
At 31 December	**641**	**1,084**	**1,725**	600	1,032	1,632
Carrying value						
At 1 January	**795**	**313**	**1,108**	178	92	270
At 31 December	**721**	**340**	**1,061**	795	313	1,108

22 Investment Properties

Group	2008 £m	2007 £m
At 1 January	**34**	39
Transfer in under HBOS Group Reorganisation		54
Additions	**18**	
Disposals		(52)
Exchange translation	**1**	
Fair value movement	**(10)**	(2)
Transfer to property and equipment (Note 21)		(5)
At 31 December	**43**	34

Investment properties are carried at their fair value as determined by independent qualified surveyors having recent experience in the location and category of the property being valued. Fair values were determined having regard to recent market transactions for similar properties and in accordance with guidance published by the Royal Institution of Chartered Surveyors. Valuations are performed at least annually.

Rental income and expenses in respect of the above properties amounted to £2m and £nil respectively (2007 £1m and £nil respectively).

23 Operating Lease Assets

Assets leased to customers include the following amounts in respect of operating lease assets:

Group	2008 Cost £m	2008 Depreciation £m	2008 Carrying value £m	2007 Cost £m	2007 Depreciation £m	2007 Carrying value £m
At 1 January	**6,483**	**(1,840)**	**4,643**	3,293	(1,209)	2,084
Transfer in under HBOS Group Reorganisation				2,871	(274)	2,597
Exchange translation	**96**	**(34)**	**62**	(28)	30	2
Additions	**1,488**		**1,488**	1,785		1,785
Disposals	**(1,733)**	**685**	**(1,048)**	(1,438)	598	(840)
Depreciation charge for the year		**(1,178)**	**(1,178)**		(985)	(985)
At 31 December	**6,334**	**(2,367)**	**3,967**	6,483	(1,840)	4,643

Bank	2008 Cost £m	2008 Depreciation £m	2008 Carrying value £m	2007 Cost £m	2007 Depreciation £m	2007 Carrying value £m
At 1 January	**30**	**(1)**	**29**	30	(2)	28
Transfer in under HBOS Group Reorganisation						
Exchange translation	**2**		**2**		1	1
Additions						
Disposals	**(30)**	**(5)**	**(35)**		(3)	(3)
Depreciation charge for the year		**6**	**6**		3	3
At 31 December	**2**		**2**	30	(1)	29

Future minimum lease payments under non-cancellable operating leases are due to be received in the following periods:

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Not later than one year	**849**	864	**2**	24
Later than one year and not later than five years	**2,245**	1,920		
Later than five years	**52**	689		
	3,146	3,473	**2**	24

Included in the depreciation charge for the year is £144m (2007 £1m) in relation to changes in the estimated residual values of certain operating lease assets.

Total future minimum sub-lease income of £13m at 31 December 2008 (£19m at 31 December 2007) is expected to be received under non-cancellable sub-leases of the Group's premises.

Notes to the Financial Statements continued

24 Deferred Tax

Statutory and tax position	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Deferred tax liability	**787**	1,300	**159**	202
Deferred tax asset	**(3,969)**	(335)	**(2,282)**	(354)
Net position	**(3,182)**	965	**(2,123)**	(152)

At 31 December 2008 a deferred tax liability of £156m (2007 £171m) relating to investments in subsidiaries has not been recognised because the Bank controls whether or not the liability will be incurred and it is satisfied that it will not be incurred in the foreseeable future.

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable.

Deferred tax assets of £92m (2007 £nil) have not been recognised in respect of unrealised capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition deferred tax assets of £42m (2007 £42m) have not been recognised in respect of Eligible Unrelieved Foreign Tax (EUFT) carried forward as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. EUFT can be carried forward indefinitely

As a result of the Finance Act 2007, the main UK corporation tax rate reduced from 30% to 28% in April 2008. UK deferred tax balances that are not expected to have been realised by April 2008 have been restated at the rate of 28%. In addition, the German corporation tax rate reduced from 25% to 15% in January 2008.

The movement in the net position is as follows:

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
At 1 January	**965**	371	**(152)**	(205)
Transfer in under HBOS Group Reorganisation		786		113
(Credit)/charge to income for the year (Note 11)	**(1,930)**	119	**(611)**	79
Credit to equity for the year (Note 11)	**(2,291)**	(223)	**(1,347)**	(149)
Disposals	**41**			
Changes in rate of corporation tax recognised in income (Note 11)		(76)		9
Changes in rate of corporation tax recognised in equity (Note 11)		(5)		3
Other movements	**33**	(7)	**(13)**	(2)
At 31 December	**(3,182)**	965	**(2,123)**	(152)

Deferred tax liabilities

Group	Capital allowances £m	Available for sale investments £m	Cash flow hedges £m	Effective interest rate £m	Other £m	2008 Total £m
At 1 January	**1,067**	**15**		**98**	**120**	**1,300**
Credit to income for the year	**(516)**			**(12)**	**(7)**	**(535)**
(Credit)/charge to equity for the year		**(14)**			**2**	**(12)**
Disposals	**(3)**				**(3)**	**(6)**
Other movements	**72**	**(1)**			**(31)**	**40**
At 31 December	**620**			**86**	**81**	**787**

24 Deferred Tax continued

Deferred tax assets

2008

Group	Cash flow hedges £m	Employee benefits £m	Provisions £m	Available *for sale* investments £m	Trading losses *carried* forward £m	Other £m	Total £m
At 1 January	**(34)**	**(19)**	**(168)**			**(114)**	**(335)**
Charge/(credit) to income for the year		**5**	**(348)**	**977**	**(1,513)**	**(516)**	**(1,395)**
Credit to equity for the year	**(371)**	**(5)**		**(1,903)**			**(2,279)**
Disposals			**47**				**47**
Other movements			**(9)**	**2**	**(1)**	**1**	**(7)**
At 31 December	**(405)**	**(19)**	**(478)**	**(924)**	**(1,514)**	**(629)**	**(3,969)**

Deferred tax liabilities

2007

Group	Capital allowances £m	Available for sale investments £m	*Cash flow* hedges £m	*Effective* interest rate £m	Other £m	Total £m
At 1 January	362	97	177		63	699
Transfer in under HBOS Group Reorganisation	749	(8)	5	121	35	902
Charge/(credit) to income for the year	39	(2)		(19)	(24)	(6)
Charge/(credit) to equity for the year		(65)	(182)		59	(188)
Change in rate of corporation tax recognised in income	(76)			(7)	(10)	(93)
Change in rate of corporation tax recognised in equity		(7)				(7)
Other movements	(7)			3	(3)	(7)
At 31 December	1,067	15		98	120	1,300

Deferred tax assets

2007

Group	Cash flow hedges £m	Employee benefits £m	Provisions £m	Effective interest rate adjustment £m	Other £m	Total £m
At 1 January		(10)	(162)	(49)	(107)	(328)
Transfer in under HBOS Group Reorganisation		(13)	(40)	49	(112)	(116)
Charge to income for the year		3	25		97	125
(Credit)/charge to equity for the year	(36)				1	(35)
Change in rate of corporation tax recognised in income		1	9		7	17
Change in rate of corporation tax recognised in equity	2					2
At 31 December	(34)	(19)	(168)		(114)	(335)

Deferred tax liabilities

2008

Bank	Capital allowances £m	Available for sale investments £m	Cash flow hedges £m	Effective interest rate £m	Other £m	Total £m
At 1 January	**33**	**18**		**102**	**49**	**202**
(Credit)/charge to income for the year	**(33)**	**975**		**(13)**	**8**	**937**
(Credit)/charge to equity for the year		**(982)**			**2**	**(980)**
At 31 December		**11**		**89**	**59**	**159**

Notes to the Financial Statements continued

24 Deferred Tax continued

Deferred tax assets

Bank	Capital allowances £m	Cash flow hedges £m	Employee benefits £m	Provisions £m	Trading losses carried forward £m	Other £m	2008 Total £m
At 1 January		**(39)**	**(10)**	**(160)**		**(145)**	**(354)**
(Credit)/charge to income for the year	**(53)**	**13**	**4**	**18**	**(1,495)**	**(35)**	**(1,548)**
Credit to equity for the year		**(367)**					**(367)**
Other movements		**(13)**					**(13)**
At 31 December	**(53)**	**(406)**	**(6)**	**(142)**	**(1,495)**	**(180)**	**(2,282)**

Deferred tax liabilities

Bank	Capital allowances £m	Available for sale investments £m	Cash flow hedges £m	Effective interest rate £m	Other £m	2007 Total £m
At 1 January	10	3			18	31
Transfer in under HBOS Group Reorganisation	30	13	171	182	5	401
(Credit)/charge to income for the year	(5)	(2)		(72)	54	(25)
(Credit)/charge to equity for the year		5	(171)		(23)	(189)
Change in rate of corporation tax recognised in income	(2)			(8)	(4)	(14)
Other movements		(1)			(1)	(2)
At 31 December	33	18		102	49	202

Deferred tax assets

Bank	Cash flow hedges £m	Employee benefits £m	Provisions £m	Effective interest rate adjustment £m	Other £m	2007 Total £m
At 1 January		(5)	(137)	(59)	(35)	(236)
Transfer in under HBOS Group Reorganisation		(4)	(57)		(227)	(288)
(Credit)/charge to income for the year		(2)	22	59	25	104
(Credit)/charge to equity for the year	(42)				82	40
Change in rate of corporation tax recognised in income		1	12		10	23
Change in rate of corporation tax recognised in equity	3					3
At 31 December	(39)	(10)	(160)		(145)	(354)

25 Provisions

	Group			Bank		
	Regulatory provisions £m	Other provisions £m	Total £m	Regulatory provisions £m	Other provisions £m	Total £m
At 1 January 2008	106	66	172	106	29	135
Exchange translation		3	3			
Charge to administrative expenses	200	31	231	200	7	207
Utilised in year	(10)	(51)	(61)	(10)		(10)
At 31 December 2008	296	49	345	296	36	332

The Group is an authorised institution and operates in the UK or overseas within the regulatory framework established in the UK by the Financial Services Authority or overseas by local regulatory bodies. As a result of this, regulatory provisions are established when a legal or constructive obligation exists as a result of a past event where it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate can be made. Regulatory provisions include the following:

i. the estimated cost of making redress payments to customers in respect of past product sales where sales processes have been deficient or where fees and premiums have been overcharged; and

ii. the costs estimated by management for the FSCS management expense levy against deposit taking firms to fund the UK compensation scheme for customers of authorised financial services firms that are unable to pay claims made against them. Further details are given below.

In addition, other provisions include property-related costs in respect of surplus leased space that amounted to £39m (2007 £25m) at the year end, provisions for long term and annual leave, provisions in respect of legal liabilities and for obligations under reward programmes.

The timing of cash outflows for regulatory and other provisions can be uncertain and depend on a number of variables outwith the control of the Group. It is estimated that £191m (2007 £35m) of the outstanding provisions will be settled within the next year.

Financial Services Compensation Scheme (FSCS)
The Financial Services Compensation Scheme (FSCS) is the UK's statutory compensation scheme for customers of authorised financial services firms that are unable to pay claims made against them. Bank of Scotland plc, as an authorised firm, is obliged to pay levies to the FSCS as part of its funding arrangements, as explained below.

The FSCS raises levies against firms authorised by the Financial Services Authority (FSA) in respect of its management expenses and compensation costs. Under a new funding system introduced on 1 April 2008, the levies are split into five broad classes, one of which is protected deposits. Each deposit-taking firm contributes an amount in respect of these costs, which is proportionate to their share of the protected deposits for the relevant year. The levies are subject to the maximum thresholds determined by the FSA.

Since October 2008, the FSCS has contributed to the costs of transferring, and/or paid compensation to, the customers of certain failed firms (including Bradford & Bingley plc, Kaupthing Singer & Friedlander Limited, Heritable Bank plc, Landsbanki's Icesave and London Scottish Bank plc). As a result, the FSCS is now a creditor of these firms.

To fund these activities, the FSCS has obtained interest-only finance from HM Treasury of £19.7 billion (as at 16 December 2008), which is due to be refinanced in 2011. The FSCS expects the amounts owed to it by failed firms to be reduced as assets are realised or other payments are made to creditors. In turn, this will enable the FSCS to reduce its borrowings from HM Treasury. In the meantime, the FSCS will need to meet its anticipated obligations in respect of interest payments on its borrowings through management expenses levies on authorised firms.

The FSA, on behalf of the FSCS, has issued guidance regarding the levies to be made by the FSCS in 2009. This guidance indicates that the FSCS is expected to raise the next levy before 31 March 2009 and that the annual limit on the FSCS management expenses levy for 2008/09 has been set at £1 billion. BoS has accrued a charge of £200m in respect of forecast management expenses levies for the levy years 2008/09 and 2009/10 that are based upon its share of protected deposits as at 31 December 2007 and 2008 respectively.

When the existing borrowing with HM Treasury is refinanced in 2011, a repayment schedule for the outstanding principal will be agreed between HM Treasury and the FSCS, after which the FSCS will raise compensation costs levies against firms in respect of these amounts. These levies could be significant. However, no provision has been made for these costs to date as their amount is unknown and is not expected to be quantifiable until 2011 at the earliest.

Notes to the Financial Statements continued

26 Debt Securities in Issue

Group	2008 At fair value through the income statement £m	2008 At amortised cost £m	2008 Total £m	2007 At fair value through the income statement £m	2007 At amortised cost £m	2007 Total £m
Certificates of deposit		**50,956**	**50,956**		63,680	63,680
MTNs issued		**48,630**	**48,630**		29,199	29,199
Covered bonds		**34,022**	**34,022**		39,184	39,184
Commercial paper		**12,132**	**12,132**		28,648	28,648
Securitisation		**42,708**	**42,708**	1,842	43,967	45,809
		188,448	**188,448**	1,842	204,678	206,520

Included within commercial paper above is £2,979m (2007 £11,954m) issued by the Grampian conduit and £nil (2007 £137m) issued by the Landale conduit.

The additional amount contractually payable on maturity of the debt securities held at fair value through the income statement at 31 December 2007 was £294m. During 2007, £0.1m movement in the fair value of these liabilities was attributable to changes in credit spread risk.

Bank	2008 At fair value through the income statement £m	2008 At amortised cost £m	2008 Total £m	2007 At fair value through the income statement £m	2007 At amortised cost £m	2007 Total £m
Certificates of deposit		**50,956**	**50,956**		63,680	63,680
MTNs issued		**47,897**	**47,897**		29,939	29,939
Covered bonds		**34,022**	**34,022**		39,184	39,184
Commercial paper		**9,086**	**9,086**		16,385	16,385
Securitisation		**1,495**	**1,495**			
		143,456	**143,456**		149,188	149,188

27 Other Borrowed Funds

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Preferred securities	**403**	2,417		
Preference shares	**1,227**	1,227	**1,227**	1,227
Subordinated liabilities				
Dated	**11,201**	10,485	**10,505**	9,522
Undated	**5,948**	3,752	**6,350**	4,106
	18,779	17,881	**18,082**	14,855

Preferred securities	Group 2008 £m	Group 2007 £m
£250m 8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class A)	**250**	250
£150m 7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B)	**150**	150
£2bn 6.0064/6.0895% Fixed Rate Perpetual Securities		2,000
Fortrose preference shares		2
Newburgh preference shares		2
Accrued interest	**3**	13
	403	2,417

During 2007 Fortrose Investments Limited, a subsidiary, issued £2,000m of Fixed Rate Perpetual Securities and other subsidiaries issued Preferred Securities totalling £4m, all of which were redeemed during 2008.

Preference Shares	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
£300m 9 1/4% Non-cumulative Irredeemable £1 preference shares	**300**	300	**300**	300
£100m 9 3/4% Non-cumulative Irredeemable £1 preference shares	**100**	100	**100**	100
£800m 6 1/8% Non-cumulative preference shares	**800**	800	**800**	800
Accrued interest	**27**	27	**27**	27
	1,227	1,227	**1,227**	1,227

There have been no new issues during 2008.

Notes to the Financial Statements continued

27 Other Borrowed Funds continued

Dated subordinated liabilities	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
500m 5.50% Instruments 2009	**478**	367	**478**	367
650m 4.75% Subordinated Bonds 2009*	**621**	477	**621**	477
US$500m Notes 2010	**342**	249	**342**	249
US$150m Notes 2011	**103**	75	**103**	75
12.8m 6.25% Instruments 2012	**12**	9		
325m 6.125% Notes 2013	**310**	239	**310**	239
1,000m Subordinated Callable Fixed/Floating Rate Instruments 2013		734		734
£250m 6.375% Instruments 2019	**250**	250	**250**	250
750m 5.5% Notes 2012	**716**	551	**716**	551
US$1,000m 4.25% Subordinated Guaranteed Notes 2013	**684**	499		
£330m Floating Rate Subordinated Notes 2014	**330**	330	**330**	330
£300m Floating Rate Subordinated Notes 2014	**300**	300	**300**	300
£700m Floating Rate Subordinated Notes 2014	**700**	700	**700**	700
£300m Floating Rate Subordinated Notes 2014	**300**	300	**300**	300
£250m 11% Subordinated Bonds 2014*	**250**	250	**250**	250
Aus$200m instruments 2014		88		
Aus$125m instruments 2015		55		
Aus$200m instruments 2016		88		
Aus$200m instruments 2016		88		
£150m 10.5% Subordinated Bonds 2018*	**150**	150	**150**	150
£500m 9.375% Subordinated Bonds 2021*	**500**	500	**500**	500
£520m Floating Rate Subordinated Notes 2014	**520**	520	**520**	520
£300m Floating Rate Subordinated Notes 2014*	**300**	300	**300**	300
£300m Floating Rate Subordinated Notes 2014*	**300**	300	**300**	300
£270m Floating Rate Subordinated Notes 2014*	**270**	270	**270**	270
£500m Floating Rate Subordinated Notes 2014	**500**	500	**500**	500
£2,000 Floating Rate Subordinated Notes 2014	**2,000**	2,000	**2,000**	2,000
Aus$300m Floating Rate Subordinated Notes 2017		131		
£1,000m Floating Rate Subordinated Notes 2014	**1,000**		**1,000**	
Fair value hedge adjustments	**120**	28	**120**	28
Unamortised premiums, discounts and issue costs	**(1)**	(1)	**(1)**	(1)
Accrued interest	**146**	138	**146**	133
	11,201	10,485	**10,505**	9,522

* Transferred in under the HBOS Group Reorganisation Act 2006

On 30 June 2008, £1bn floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR plus 67 basis points.

27 Other Borrowed Funds continued

During 2007 the Bank issued floating rate subordinated notes at par to its parent HBOS plc, as follows:

On 28 February 2007, £520m floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 76 basis points.

On 26 August 2007, A$300m floating rate subordinated notes were issued by a subsidiary of the Bank, at par, to its ultimate parent undertaking HBOS plc. These instruments bear interest at the three month Australian Bank Bill rate plus 76 basis points.

On 31 October 2007, £500m floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 76 basis points.

On 31 December 2007, £2bn floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 76 basis points.

No repayment, for whatever reason, of dated subordinated liabilities prior to their stated maturity and no purchase by the relevant entity of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary, the claims of the holders of dated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary other than creditors whose claims are expressed to rank pari passu with, or junior to, the claims of the holders of the dated loan capital.

	Group		Bank	
Undated subordinated liabilities	**2008 £m**	2007 £m	**2008 £m**	2007 £m
US$300m Reset Notes				
£200m Perpetual Notes	**200**	200	**200**	200
£300m Perpetual Regulatory Tier 1 Securities	**300**	300	**300**	300
500m Instruments	**478**	367	**478**	367
US$250m Floating Rate Primary Capital Notes	**171**	125	**171**	125
£150m Instruments	**150**	150	**150**	150
JPY 17bn Instruments	**128**	76	**128**	76
£100m Instruments	**100**	100	**100**	100
JPY 9bn Instruments		40		
£300m Instruments	**300**	300	**300**	300
£250m Perpetual Preferred Notes			**250**	250
£150m Perpetual Preferred Notes			**150**	150
£150m Floating Rate Subordinated Notes	**150**	150	**150**	150
£500m Floating Rate Subordinated Notes	**500**	500	**500**	500
£100m 12% Perpetual Subordinated Bonds*	**100**	100	**100**	100
£100m 8.75% Perpetual Subordinated Bonds*	**100**	100	**100**	100
£75m 13.625% Perpetual Subordinated Bonds*	**75**	75	**75**	75
£50m 9.375% Perpetual Subordinated Bonds*	**50**	50	**50**	50
£500m Floating Rate Subordinated Notes*	**500**	500	**500**	500
£300m Floating Rate Subordinated Notes*	**300**	300	**300**	300
£250m Floating Rate Subordinated Notes*	**250**	250	**250**	250
£2,000 Floating Rate Subordinated Notes	**2,000**		**2,000**	
Fair value hedge adjustments	**67**	43	**66**	33
Unamortised premiums, discounts and issue costs	**(4)**	(5)	**(4)**	(5)
Accrued interest	**33**	31	**36**	35
	5,948	3,752	**6,350**	4,106

* Transferred in under the HBOS Group Reorganisation Act 2006

On 30 September 2008, £2bn floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 133 basis points.

No exercise of any redemption option or purchase by the relevant entity of any of the undated subordinated liabilities may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary, the claims of the holders of undated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the undated loan capital. The undated loan capital is junior in point of subordination to the dated loan capital referred to above.

Notes to the Financial Statements continued

28 Share Capital

Allotted, called up and fully paid	Ordinary shares £m
At 1 January 2007	436
Shares issued	63
At 31 December 2007 and 1 January 2008	**499**
Shares issued	**825**
At 31 December 2008	**1,324**

Authorised share capital
At 31 December 2008 the authorised share capital comprised:

Ordinary shares
8,085 million ordinary shares of 25 pence each (2007 2,085 million).

On 26 February 2009 an ordinary resolution was passed to increase the authorised ordinary share capital of BoS plc by a further 16,000 million to 24,085 million (Note 44).

Preference shares
The terms of the following preference shares when issued are such that these shares are classified as other borrowed funds rather than as issued share capital.

375,000,000 9.25% non-cumulative irredeemable preference shares of £1 each (2007 375,000,000),

125,000,000 9.75% non-cumulative irredeemable preference shares of £1 each (2007 125,000,000),

250,000 8.117% non-cumulative perpetual preference shares class 'A' of £10 each (2007 250,000),

150,000 7.754%, non-cumulative perpetual preference shares class 'B' of £10 each (2007 150,000).

Note 27 details the preference shares that have been issued and classified as other borrowed funds.

Issued share capital
At 31 December 2008 the Company's issued ordinary share capital amounted to 5,296,712,311 shares (2007 1,996,712,311).

During June 2008, 300 million ordinary shares were issued at £5.00 each. In September 2008 500 million ordinary shares were issued at £3.00 each and in December 2008, 2,500 million ordinary shares were issued at £1.00 each. On 26 February 2009 13,918,333,333 ordinary shares were issued at £0.60 each (Note 44).

29 Shareholders' Equity

Group	Share capital £m	Share premium £m	Other reserves[c] Cash flow hedge reserve £m	Other reserves[c] Available for sale reserve[a] £m	Other reserves[c] Other reserves[b] £m	Retained earnings £m	Minority interests £m	Total £m
At 1 January 2008	499	6,343	(85)	(313)	1,565	13,479	356	21,844
Foreign exchange translation				(23)	118		11	106
Available for sale investments:								
Net change in fair value				(8,173)				(8,173)
Tax thereon				2,276				2,276
Realised gain on sale transferred to the income statement (Note 3)				(24)				(24)
Tax thereon				7				7
Impairment recognised in income statement (Note 10b)				1,270				1,270
Tax thereon				(355)				(355)
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			(3,889)					(3,889)
Tax thereon			1,088					1,088
Losses transferred to income statement (Note 3)			2,561					2,561
Tax thereon			(717)					(717)
(Loss)/profit for the year						(8,238)	51	(8,187)
Total recognised income and expense			(957)	(5,022)	118	(8,238)	62	(14,037)
Dividends paid (Note 30)						(1,228)	(43)	(1,271)
Issue of new shares (Note 28)	825	4,675						5,500
MI acquisitions							242	242
Repayment of equity to minority shareholders							(353)	(353)
At 31 December 2008	1,324	11,018	(1,042)	(5,335)	1,683	4,013	264	11,925

(a) The available for sale reserve is comprised of £(5,285)m (2007 £(450)m) in respect of treasury assets and £(50)m (2007 £137m) in respect of corporate and other investments.
(b) Other reserves principally include the merger reserve of £494m arising from the combination of Halifax and Bank of Scotland in 2001 and the merger reserve of £612m arising under the HBOS Group Reorganisation.
(c) The cumulative balance for exchange translation at 31 December 2008 is £67m (2007 £(28)m).

Notes to the Financial Statements continued

29 Shareholders' Equity continued

Group	Share capital £m	Share premium £m	Other reserves: Cash flow hedge reserve £m	Other reserves: Available for sale reserve (a) £m	Other reserves: Other reserves (b) £m	Retained earnings £m	Minority interests £m	Total £m
At 1 January 2007	436	3,926	416	204	486	6,568	369	12,405
Foreign exchange translation				2	(6)		12	8
Available for sale investments:								
Net change in fair value				(432)				(432)
Tax thereon				96				96
Realised gains on sale transferred to the income statement (Note 3)				(281)				(281)
Tax thereon				80				80
Impairment recognised in income statement (Note 10b)				23				23
Tax thereon				(6)				(6)
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			(313)					(313)
Tax thereon			97					97
Gains transferred to income statement (Note 3)			(417)					(417)
Tax thereon			125					125
Profit for the year						3,608	30	3,638
Total recognised income and expense			(508)	(518)	(6)	3,608	42	2,618
Transfer in under HBOS Group Reorganisation			7	1	1,085	5,011	15	6,119
Dividends paid (Note 30)						(1,672)	(43)	(1,715)
Issue of new shares (Note 28)	63	2,417					98	2,578
Disposal of subsidiaries							(125)	(125)
Movements in share-based compensation reserve						(36)		(36)
At 31 December 2007	**499**	**6,343**	**(85)**	**(313)**	**1,565**	**13,479**	**356**	**21,844**

(a) The available for sale reserve is comprised of £(5,285)m (2007 £(450)m) in respect of treasury assets and £(50)m (2007 £137m) in respect of corporate and other investments.

(b) Other reserves principally include the merger reserve of £494m arising from the combination of Halifax and Bank of Scotland in 2001 and the merger reserve of £612m arising under the HBOS Group Reorganisation.

29 Shareholders' Equity continued

Bank	Share capital £m	Share premium £m	Other reserves: Cash flow hedge reserve £m	Other reserves: Available for sale reserve[(a)] £m	Other reserves: Other reserves[(b)] £m	Retained earnings £m	Total £m
At 1 January 2007	436	3,926		7	564	3,872	8,805
Foreign exchange translation					(7)		(7)
Available for sale investments:							
Net change in fair value				(310)			(310)
Tax thereon				62			62
Net gains transferred to income statement				(62)			(62)
Tax thereon				51			51
Cash flow hedges:							
Effective portion of changes in fair value taken to equity			(299)				(299)
Tax thereon			90				90
Net losses transferred to income statement			(410)				(410)
Tax thereon			120				120
Profit for the year						2,420	2,420
Total recognised income and expense			(499)	(259)	(7)	2,420	1,655
Transfer in under HBOS Group Reorganisation			386	18	1,086	5,457	6,947
Dividends paid (Note 30)						(1,672)	(1,672)
Issue of new shares (Note 28)	63	2,417					2,480
Movements share-based compensation reserve						(36)	(36)
At 31 December 2007 and 1 January 2008	**499**	**6,343**	**(113)**	**(234)**	**1,643**	**10,041**	**18,179**
Available for sale investments:							
Net change in fair value				**(4,181)**			**(4,181)**
Tax thereon				**1,189**			**1,189**
Net gains transferred to income statement				**43**			**43**
Tax thereon				**(12)**			**(12)**
Impairment recognised in income statement				**651**			**651**
Tax thereon				**(185)**			**(185)**
Cash flow hedges:							
Effective portion of changes in fair value taken to equity			**(3,881)**				**(3,881)**
Tax thereon			**1,092**				**1,092**
Net losses transferred to income statement			**2,588**				**2,588**
Tax thereon			**(725)**				**(725)**
Loss for the year						**(4,320)**	**(4,320)**
Total recognised income and expense			**(926)**	**(2,495)**		**(4,320)**	**(7,741)**
Dividends paid (Note 30)						**(1,205)**	**(1,205)**
Issue of new shares (Note 28)	**825**	**4,675**					**5,500**
At 31 December 2008	**1,324**	**11,018**	**(1,039)**	**(2,729)**	**1,643**	**4,516**	**14,733**

(a) The available for sale reserve is comprised of £(2,468)m (2007 £450m) in respect of treasury assets and £(261)m (2007 £137m) in respect of corporate and other investments.
(b) Other reserves principally include the merger reserve of £494m arising from the combination of Halifax and Bank of Scotland in 2001 and the merger reserve of £612m arising under the HBOS Group Reorganisation. The cumulative balance for exchange translation at 31 December 2008 is £(28)m (2007 £(28)m).

Notes to the Financial Statements continued

30 Dividends

Dividends are charged to reserves only when the Bank has a contractual obligation to pay. The following dividends have been charged to retained earnings during the year:

	Group and Bank 2008 £m	2007 £m
Ordinary share dividends		
2006 final dividend		1,050
2007 interim dividend		622
2007 final dividend	**1,205**	
Preference dividends		
Equity dividends paid	**23**	
	1,228	1,672

31 Contingent Liabilities and Commitments

	Group 2008 £m	2007 £m	Bank 2008 £m	2007 £m
Contingent liabilities				
Acceptances and endorsements		43		37
Guarantees and irrevocable letters of credit	**4,898**	6,491	**10,223**	10,124
	4,898	6,534	**10,223**	10,161
Commitments				
Short term trade related transactions	**137**	115	**76**	86
Undrawn formal standby facilities, credit lines and other commitments to lend with a maturity:				
Up to and including one year	**50,211**	68,253	**47,116**	71,620
Over one year	**33,109**	31,416	**30,971**	26,384
	83,457	99,784	**78,163**	98,090

Included above in the Bank's disclosures are guarantees to subsidiaries of £5,866m (2007 £4,288m) and commitments to subsidiaries of £nil (2007 £12,851m). The Bank provides credit enhancement on the assets of its Grampian conduit vehicles through letter of credit. A liability of £422m has been recognised covering the collective impairment on asset backed securities (ABS) held in the Grampian vehicles.

The contractual amounts above indicate the volume of business outstanding at the year end and do not reflect the underlying credit and other risks, which are significantly lower as some facilities will not be drawn down and some facilities that are drawn will be supported by collateral.

Where the Group or Bank is a lessee the future minimum lease payments under non-cancellable operating leases are due to be paid in the following periods:

	Group 2008 £m	2007 £m	Bank 2008 £m	2007 £m
Not later than one year	**161**	170	**129**	124
Later than one year and not later than five years	**593**	627	**470**	453
Later than five years	**1,120**	1,205	**720**	751
	1,874	2,002	**1,319**	1,328

Where the Group is a lessee the future obligations payable under finance leases are as follows:

Group	2008 £m	2007 £m
Not later than one year		1

Commitments in respect of capital expenditure on property and equipment that is authorised but not provided for in the accounts, for contracts which have been entered into amount to £18m (2007 £21m). Commitments for contracts which have been placed in relation to operating lease assets amount to £10m (2007 £11m).

31 Contingent Liabilities and Commitments continued

Legal and regulatory matters

a) Unarranged overdraft charges

On 27 July 2007 it was announced that members of the Group, along with seven other major UK current account providers, had reached agreement with the OFT to commence legal proceedings in the High Court of England and Wales for a declaration (or declarations) to resolve legal uncertainties concerning the fairness and lawfulness of unarranged overdraft charges (the Test Case). It was also announced that HBOS and those other providers will seek a stay of all current and potential future court proceedings which are brought against them in the UK concerning these charges and have obtained the consent of the Financial Ombudsman Service (FOS) not to proceed with consideration of the merits of any complaints concerning these charges that are referred to them prior to the resolution of the Test Case. By virtue of a waiver granted by the FSA of its complaints handling rules, HBOS (and other banks, including the banks party to the Test Case) will not be dealing with or resolving customer complaints about unarranged overdraft charges while the waiver is in force. On 22 January 2009, the FSA confirmed that it is extending its waiver regarding unarranged overdraft charges complaints until 26 July 2009.

The first step in the Test Case was a trial of certain preliminary issues concerning the legal status and enforceability of contractual terms relating to unarranged overdraft charges. This preliminary trial concluded on 8 February 2008 and the judgment was handed down on 24 April 2008. The judgment held that the contractual terms relating to unarranged overdraft charges currently used by the Group (i) are not capable of being penalties, but (ii) are not exempt from assessment for fairness under the Unfair Terms in Consumer Contract Regulations 1999 (UTCCRs).

At a court hearing on 22 and 23 May 2008, the Judge granted HBOS and the other Test Case banks permission to appeal his decision that current unarranged overdraft charges are assessable for fairness under the UTCCRs. This appeal concluded on 5 November 2008. On 26 February 2009, the Court of Appeal dismissed the banks' appeal and held that the charges are assessable for fairness. The banks will now be applying to the House of Lords for permission to appeal this judgement.

A further hearing took place in early July 2008, at which the Court was asked to consider whether terms and conditions previously used by the Test Case banks are capable of being penalties and whether the Judge's decision in April 2008 (that the banks' current contractual terms are capable of being assessed for fairness under the UTCCRs) can be applied to historic terms.

The Court handed down its judgment on 8 October 2008 on this second stage of the test case process. The Court ruled that charges applied under Halifax and Bank of Scotland's previously used terms and conditions cannot be penalties. However, the Court also ruled that the historic terms and conditions are not exempt from assessment for fairness under the UTCCRs. The banks intend to appeal this latter decision.

Further Court hearings will be required before the test case process is concluded.

A definitive outcome of the Test Case is unlikely to be known for at least twelve months.

Given the early stage of these proceedings and the uncertainty as to their outcome, it is not practicable at this time to estimate any potential financial effect.

b) Payments Protection Insurance (PPI)

The final report from the Competition Commission (CC) into Payment Protection Insurance (PPI) was received on 29 January 2009. The remedies published were broadly similar to those outlined in the CC's Provisional Decision with some changes to the sales process.

Whilst the Group believe many of the remedies could improve customer searching and enable switching, the inability to sell appropriate insurance products at a point when customers take on increased financial commitment, will likely result in lower levels of protection for UK consumers.

The Group is actively reviewing its customer propositions in light of the CC's final report to ensure that the Group continue to offer a valuable protection product to the Group's customers.

The Group took the decision to launch a regular premium protection product. This was launched in early February 2009.

The FOS has been receiving a large number of complaints in relation to PPI sold by a number of providers and has written to the FSA suggesting an industry wide review of PPI sales standards. In response, the industry is working on a Statement of Principles to define a consistent way of handling sales complaints. The FSA is considering FOS' suggestions and a statement from the FSA in relation to its most recent thematic work in relation to PPI is expected in the first quarter of 2009.

c) Other legal and regulatory matters

The Group is engaged in other litigation in the UK and overseas arising out of its normal business activities. The Group considers that none of these actions are material and has not disclosed any contingent liability in respect of these actions because it is not practical to do so.

Notes to the Financial Statements continued

32 Measurement Basis of Financial Assets and Liabilities

The accounting policies describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

								2008
			At fair value through the income statement					
as hedging instruments £m	trading £m	Derivatives designated initial recognition £m	Held for £m	Designated upon £m	Available for sale at amortised cost £m	Loans and receivables £m	Financial liabilities	Total Group
As at 31 December 2008								
Financial assets								
Cash and balances with central banks						2,502		2,502
Items in course of collection						445		445
Financial assets held for trading			22,571					22,571
Derivative assets		22,082	28,435					50,517
Loans and advances to banks						12,445		12,445
Loans and advances to customers						473,015		473,015
Investment securities				859	28,035	38,878		67,772
Other financial assets						362		362
Total financial assets		22,082	51,006	859	28,035	527,647		629,629
Financial liabilities								
Deposits by banks							97,066	97,066
Customer accounts							262,201	262,201
Financial liabilities held for trading			18,851					18,851
Derivative liabilities		12,002	28,825					40,827
Debt securities in issue							188,448	188,448
Other borrowed funds							18,779	18,779
Other financial liabilities							241	241
Total financial liabilities		12,002	47,676				566,735	626,413

32 Measurement Basis of Financial Assets and Liabilities continued

2007

Group	Derivatives designated as hedging instruments £m	At fair value through the income statement: Held for trading £m	At fair value through the income statement: Designated upon initial recognition £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost £m	Total £m
As at 31 December 2007							
Financial assets							
Cash and balance with central banks					2,944		2,944
Items in course of collection					945		945
Financial assets held for trading		54,681					54,681
Derivative assets	4,816	8,978					13,794
Loans and advances to banks					4,095		4,095
Loans and advances to customers					460,267		460,267
Investment securities			1,108	49,980	527		51,615
Other financial assets					557		557
Total financial assets	4,816	63,659	1,108	49,980	469,335		588,898
Financial liabilities							
Deposits by banks						41,513	41,513
Customer accounts						272,687	272,687
Financial liabilities held for trading		22,705					22,705
Derivative liabilities	4,405	7,755					12,160
Debt securities in issue			1,842			204,678	206,520
Investment contract liabilities			98				98
Other borrowed funds			50			17,831	17,881
Other financial liabilities						286	286
Total financial liabilities	4,405	30,460	1,990			536,995	573,850

Notes to the Financial Statements continued

32 Measurement Basis of Financial Assets and Liabilities continued

2008

Bank	Derivatives designated as hedging instruments £m	At fair value through the income statement: Held for trading £m	Designated upon initial recognition £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost £m	Total £m
As at 31 December 2008							
Financial assets							
Cash and balances with central banks					**1,820**		**1,820**
Items in course of collection					**449**		**449**
Financial assets held for trading		**22,571**					**22,571**
Derivative assets	**15,454**	**30,920**					**46,374**
Loans and advances to banks					**34,144**		**34,144**
Loans and advances to customers					**570,255**		**570,255**
Investment securities			**349**	**24,339**	**83,164**		**107,852**
Other financial assets					**649**		**649**
Total financial assets	**15,454**	**53,491**	**349**	**24,339**	**690,481**		**784,114**
Financial liabilities							
Deposits by banks						**97,091**	**97,091**
Customer accounts						**458,967**	**458,967**
Financial liabilities held for trading		**18,851**					**18,851**
Derivative liabilities	**11,736**	**27,912**					**39,648**
Debt securities in issue						**143,456**	**143,456**
Other borrowed funds						**18,082**	**18,082**
Other financial liabilities						**133**	**133**
Total financial liabilities	**11,736**	**46,763**				**717,729**	**776,228**

2007

Bank	Derivatives designated as hedging instruments £m	At fair value through the income statement: Held for trading £m	Designated upon initial recognition £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost £m	Total £m
As at 31 December 2007							
Financial assets							
Cash and balance with central banks					1,667		1,667
Items in course of collection					890		890
Financial assets held for trading		52,169					52,169
Derivative assets	3,975	8,159					12,134
Loans and advances to banks					25,458		25,458
Loans and advances to customers					453,590		453,590
Investment securities			405	26,608	7		27,020
Other financial assets					2,235		2,235
Total financial assets	3,975	60,328	405	26,608	483,847		575,163
Financial liabilities							
Deposits by banks						47,321	47,321
Customer accounts						316,849	316,849
Financial liabilities held for trading		22,145					22,145
Derivative liabilities	2,965	7,581					10,546
Debt securities in issue						149,188	149,188
Other borrowed funds						14,855	14,855
Other financial liabilities						103	103
Total financial liabilities	2,965	29,726				528,316	561,007

33 Financial Asset Reclassifications

Following the publication by the International Accounting Standards Board (IASB) and subsequent endorsement by the European Union in October 2008 of the amendments to International Accounting Standard 39 'Financial Instruments: Recognition and Measurement' (IAS 39) and IFRS 7 'Financial Instruments: Disclosures', the Group has reviewed the classification of its trading portfolio.

The Group has noted that the ongoing market dislocation and the deterioration of the world's financial markets that has occurred during the third quarter of 2008 is a sufficiently rare circumstance to warrant a review of the classification of financial assets held for trading.

With effect from 1 July 2008, the Group transferred from the held for trading classification certain asset backed securities (ABS) and floating rate notes (FRNs) with fair values at the time of £9,112m and £3,098m respectively, to the available for sale (AFS) classification within investment securities. The carrying values as at 31 December 2008 are £10,132m and £3,410m respectively and the fair values as at 31 December 2008 are £10,047m and £3,410m respectively.

Subsequent to the transfers performed on 1 July 2008, the Group determined in light of increasing illiquidity in the markets for ABS to change the classification of certain ABS assets from AFS to loans and receivables. A portfolio of ABS was reclassified to loans and receivables with effect from 1 November 2008 with fair values at that time of £35,446m. The carrying values and fair values as at 31 December 2008 are £37,173m and £36,191m respectively.

The financial impact of the reclassifications described above is set out below.

a) Debt securities reclassified from held for trading to AFS, with effect from 1 July 2008
Negative fair value adjustments of £730m were taken through the income statement relating to these assets for the period from 1 January 2008 to 30 June 2008 (full year 2007 £212m). If these assets had not been reclassified during the year additional negative fair value adjustments of £981m, net of accretion of discount of £96m, would have been recognised in the income statement and the AFS reserve movement would have been reduced by £776m (post tax) for the period from 1 July 2008 to 31 December 2008.

At 1 July 2008 the effective interest rates on the reclassified debt securities ranged from 3% to 12% with expected recoverable cash flows of £13,359m.

b) ABS reclassified from available for sale to loans and receivables, with effect from 1 November 2008
Negative fair value adjustments of £3,301m (post tax) were taken through AFS reserves for the period from 1 January 2008 to 31 October 2008 (full year 2007 £319m post tax). If these assets had not been reclassified during the year additional negative fair value adjustments of £708m (post tax) would have been recognised in the AFS reserves for the period from 1 November 2008 to 31 December 2008.

Following this change in classification, these securities are no longer subject to measurement at fair value, although they will continue to be subject to regular impairment testing.

At 1 November 2008 the effective interest rates on the ABS reclassified, ranged from 3% to 12% with expected recoverable principal flows of £40,968m.

Notes to the Financial Statements continued

34 Fair Value of Financial Instruments

The following table summarises the carrying amounts and fair values of financial assets and liabilities not carried on the Group's balance sheet at their fair values. This note provides additional information in respect of financial instruments carried as loans and receivables or held at amortised cost (Note 32).

Group	**Carrying amount 2008 £m**	Carrying amount 2007 £m	**Fair value 2008 £m**	Fair value 2007 £m
Financial assets				
Loans and advances to banks	**12,445**	4,095	**12,478**	4,095
Loans and advances to customers	**473,015**	460,267	**462,062**	462,363
Investment securities	**38,878**	527	**38,056**	527
Other financial assets	**362**	557	**362**	557
Financial liabilities				
Deposits by banks	**97,066**	41,513	**97,100**	41,528
Customer accounts	**262,201**	272,687	**262,952**	273,883
Debt securities in issue	**188,448**	204,678	**182,470**	203,579
Other borrowed funds	**18,779**	17,831	**20,839**	18,414
Other financial liabilities	**241**	286	**240**	286

Bank	**Carrying amount 2008 £m**	Carrying amount 2007 £m	**Fair value 2008 £m**	Fair value 2007 £m
Financial assets				
Loans and advances to banks	**34,144**	25,458	**34,179**	25,834
Loans and advances to customers	**570,255**	453,590	**559,933**	455,319
Investment securities	**83,164**	7	**81,057**	7
Other financial assets	**649**	2,235	**649**	2,235
Financial liabilities				
Deposits by banks	**97,091**	47,321	**97,126**	47,338
Customer accounts	**458,967**	316,849	**459,717**	317,903
Debt securities in issue	**143,456**	149,188	**139,388**	148,306
Other borrowed funds	**18,082**	14,855	**17,514**	15,469
Other financial liabilities	**133**	103	**133**	103

The valuation methodologies for calculating the fair value of financial instruments carried as loans and receivables and at amortised cost are set out below.

34 Fair Value of Financial Instruments continued

Fair value is the amount for which the Group could exchange an asset, or could settle a liability, with other knowledgeable, willing parties in an arm's length transaction. The objective of the valuation techniques applied is to determine what the values would have been at year end in an arm's length transaction motivated by normal business considerations.

Loans and advances to banks, loans and advances to customers, deposits by banks and customer accounts are not regularly traded and so market prices are not available. In this instance, valuation techniques are applied to determine the fair value of these instruments.

For loans and deposits with variable interest rates, the fair value is represented by the carrying value as these products are at an administered rate that can be immediately repriced. The portfolios are stratified into various sub-groups, and also distinguish between performing loans and non-performing loans. For performing loans, counterparty credit risk is taken into account in determining the fair value with reference to current spreads at which similar products are currently priced, as appropriate. For non-performing loans, fair value is determined taking into account expected cash flows and discounting them over the period when they are expected to be recovered.

For other loans fair value is estimated by discounting anticipated contractual cash flows at current market interest rates. The portfolios are stratified into various sub-groups, and also distinguish between performing loans and non-performing loans. For performing loans, current market interest rates are derived by reference to the rates at which similar products are currently priced and after taking into account significant changes in credit spreads. Credit spreads are determined with reference to new originations for similar products, and take into account the type of product, the maturity profile of the portfolio and collateral held. For non-performing loans, fair value is determined taking into account expected cash flows and discounting it over the period when they are expected to be recovered.

For other customer deposits, fair value is estimated by discounting anticipated contractual cash flows at current market interest rates.

For investment securities held as loans and receivables and debt securities in issue and other borrowed funds carried at amortised cost, the fair values have been derived using quoted prices where available, broker valuations and where these are not available, cash flow models, adjusted for credit spreads where appropriate. Cash flow models take into account expected cash flows and the expected maturity of the instrument.

The fair values have been calculated on a product basis and as such do not necessarily represent the value that could have been obtained for a portfolio if it were sold at 31 December 2008.

Notes to the Financial Statements continued

35 Expected Maturity

The tables below set out the expected maturity of financial assets and liabilities.

Group	Less than 12 months £m	12 months or more £m	2008 Total £m	Less than 12 months £m	12 months or more £m	2007 Total £m
Financial assets						
Cash and balances at central banks	**2,502**		**2,502**	2,944		2,944
Financial assets held for trading	**18,324**	**4,247**	**22,571**	36,921	17,760	54,681
Loans and advances to banks	**11,169**	**1,276**	**12,445**	3,313	782	4,095
Loans and advances to customers	**144,016**	**328,999**	**473,015**	167,597	292,670	460,267
Investment securities	**18,077**	**49,695**	**67,772**	6,154	45,461	51,615
Derivative assets	**9,332**	**41,185**	**50,517**	3,492	10,302	13,794
Financial liabilities						
Deposits by banks	**94,861**	**2,205**	**97,066**	40,192	1,321	41,513
Customer accounts	**251,102**	**11,099**	**262,201**	252,870	19,817	272,687
Financial liabilities held for trading	**18,851**		**18,851**	22,503	202	22,705
Derivative liabilities	**9,319**	**31,508**	**40,827**	3,404	8,756	12,160
Investment contract liabilities				98		98
Debt securities in issue	**91,107**	**97,341**	**188,448**	116,918	89,602	206,520
Other borrowed funds	**2,317**	**16,462**	**18,779**	1,909	15,972	17,881

Bank	Less than 12 months £m	12 months or more £m	2008 Total £m	Less than 12 months £m	12 months or more £m	2007 Total £m
Financial assets						
Derivative assets	**8,790**	**37,584**	**46,374**	3,486	8,648	12,134
Investment securities	**15,129**	**92,723**	**107,852**	2,675	24,345	27,020
Financial liabilities						
Derivative liabilities	**8,984**	**30,664**	**39,648**	3,091	7,455	10,546
Other borrowed funds	**1,304**	**16,778**	**18,082**	919	13,936	14,855

36 Credit Risk

The Group's approach to managing credit risk is set out on pages 14 to 20 of the Risk Management report. The table below sets out the Group's and Bank's exposure to credit risk relating to financial instruments before taking account of collateral and other security.

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Assets				
Cash and balances at central banks	**2,502**	2,944	**1,820**	1,667
Items in the course of collection	**445**	945	**449**	890
Financial assets held for trading	**22,571**	54,681	**22,571**	52,169
Derivative assets	**50,517**	13,794	**46,374**	12,134
Loans and advances to banks	**12,445**	4,095	**34,144**	25,458
Loans and advances to customers	**473,015**	460,267	**570,255**	453,590
Debt securities	**65,219**	48,094	**106,786**	25,970
Other financial assets (excluding equity shares)	**362**	557	**649**	2,235
	627,076	585,377	**783,048**	574,113
Contingent liabilities and commitments	**88,355**	106,318	**88,386**	108,251
Total	**715,431**	691,695	**871,434**	682,364

Loans and advances to customers

Loans and advances to customers are managed on a divisional basis as shown in Note 9. Further analysis of loans and advances to customers is given in Note 15.

Included in loans neither past due nor impaired are the following troubled debt restructured loans which would have been past due or impaired had their terms not been renegotiated.

	Group 2008 £m	Group 2007 £m	Bank 2008 £m	Bank 2007 £m
Renegotiated loans	**478**	229	**424**	210

Retail - residential mortgage lending

Loan to value analysis of residential mortgage lending

	Group 2008 %	Group 2007 %	Bank 2008 %	Bank 2007 %
Less than 60%	**28**	47	**29**	47
60% to 70%	**10**	18	**11**	19
70% to 80%	**13**	18	**13**	18
80% to 90%	**16**	13	**16**	13
90% to 100%	**16**	4	**15**	3
Greater than 100%	**17**		**16**	-
Total	**100**	100	**100**	100

The average loan to value of residential mortgage stock held by the Group was 56% (2007 44%) and for new residential lending in the Group was 67% (2007 65%). For impaired mortgages in the Group, the average loan to value was 76% (2007 57%). The stock of residential mortgages includes past due loans.

Notes to the Financial Statements continued

36 Credit Risk continued

Corporate, International and Treasury

The Group's Corporate, International and Treasury neither past due nor impaired lending exposures are analysed by internal credit rating below:

Internal rating	2008 %	Group 2007 %	2008 %	Bank 2007 %
Better than satisfactory risk	**45**	46	**74**	65
Satisfactory risk	**40**	42	**19**	26
Viable but monitoring	**12**	10	**6**	8
High risk	**3**	2	**1**	1
	100	100	**100**	100

Past due but not impaired

The ageing of the Group's and Bank's lending exposure that is past due but not impaired (before impairment provisions) is analysed below:

	2008 £m	Group 2007 £m	2008 £m	Bank 2007 £m
0 to 3 months	**15,273**	11,407	**12,257**	9,542
3 to 6 months	**922**	152	**420**	9
More than 6 months	**206**	70	**1**	31
Total	**16,401**	11,629	**12,678**	9,582

Impaired loans

The Group's and Bank's impaired gross lending exposure (before impairment provisions) is analysed below:

	2008 £m	Group 2007 £m	2008 £m	Bank 2007 £m
Retail secured lending	**6,914**	4,234	**6,010**	3,773
Retail unsecured lending	**2,209**	2,269	**2,210**	2,269
Corporate - no loss	**1,242**	1,648	**1,242**	1,648
Corporate - with loss	**12,606**	1,570	**13,566**	1,480
International	**3,060**	641	**395**	71
	26,031	10,362	**23,423**	9,241

Loans categorised as impaired with no loss represent loans that have been individually assessed as having impairment characteristics but where the Group expect, after taking into consideration collateral and other credit enhancements, full recovery of both interest and capital.

The ageing of the Group's gross lending exposure that is impaired (before impairment provisions) is analysed below:

	2008 £m	Group 2007 £m	2008 £m	Bank 2007 £m
0 to 3 months	**9,973**	1,428	**9,747**	1,194
3 to 6 months	**5,862**	3,002	**4,957**	2,628
6 to 12 months	**4,760**	2,139	**4,031**	1,885
Over 12 months	**2,878**	1,599	**2,423**	1,424
Recoveries	**1,784**	1,795	**1,785**	1,795
Possession	**774**	399	**480**	315
Total	**26,031**	10,362	**23,423**	9,241

Impairment provisions as a % of closing net advances were 2.26% (2007 0.73%) for the Group and 1.84% (2007 0.66%) for the Bank.

Impaired loans as a % of closing net advances were 5.50% (2007 2.25%) for the Group and 4.11% (2007 2.04%) for the Bank.

Impairment provisions as a % of impaired loans was 41% (2007 33%) for the Group and 45% (2007 32%) for the Bank.

36 Credit Risk continued

Collateral and other credit enhancements held

Financial assets that are past due or individually assessed as impaired may be partially or fully collateralised or subject to other forms of credit enhancement.

Assets in these categories subject to collateralisation are mainly corporate and residential mortgage loans.

For corporate loans, security may be in the form of floating charges where the value of the collateral varies with the level of assets such as inventory and receivables held by customer. For these and other reasons collateral given is only accurately valued on origination of the loan or in the course of enforcement actions and as a result it is not practicable to estimate the fair value of the collateral held.

A description and the estimated fair value of collateral held in respect of residential mortgage loans that are past due or individually assessed as impaired was as follows:

	2008 Fair value £m	2007 Fair value £m
Nature of assets		
- Residential property	**13,534**	10,660
	13,534	10,660

Collateral included in the above table reflects the Group's interest in the property in the event of default. That held in the form of charges against residential property in the UK is restricted to the outstanding loan balance. In other territories, where the Group is not obliged to return any sale proceeds to the mortgagee, the full estimated fair value has been included.

Repossessed collateral

During 2008 the Group obtained assets as a result of the enforcement of collateral held as security as follows:

	2008 Carrying amount £m	2007 Carrying amount £m
Nature of assets		
- Residential property	**617**	292
	617	292

The Group does not use assets obtained in its operations. Assets obtained are normally sold, generally at auction, or realised in an orderly manner to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

Credit ratings

The internal credit ratings of the Group are assessed on a comparable basis to those given by external credit rating agencies. Where external credit ratings are available, these have been used in the analysis below.

Group **As at 31 December 2008**	**AAA %**	**AA %**	**A %**	**BBB %**	**Other rated %**	**Unrated %**	**Total %**
Financial assets held for trading	**67.4**	**19.3**	**12.1**	**0.5**	**0.7**		**100.0**
Derivative assets	**4.1**	**34.6**	**44.2**	**0.8**		**16.3**	**100.0**
Loans and advances to banks	**31.0**	**35.8**	**20.2**	**9.3**	**0.1**	**3.6**	**100.0**
Debt securities	**52.3**	**22.9**	**17.0**	**3.4**	**3.1**	**1.3**	**100.0**

Group As at 31 December 2007	AAA %	AA %	A %	BBB %	Other rated %	Unrated %	Total %
Financial assets held for trading	51.5	34.2	13.7	0.1	0.3	0.2	100.0
Derivative assets	4.3	62.1	16.3	0.5		16.8	100.0
Loans and advances to banks	17.3	45.2	10.6	24.4	0.3	2.2	100.0
Debt securities	60.4	23.6	12.5	0.2	0.1	3.2	100.0

Notes to the Financial Statements continued

36 Credit Risk continued

Bank

As at 31 December 2008	AAA %	AA %	A %	BBB %	Other rated %	Unrated %	Total %
Financial assets held for trading	**67.4**	**19.3**	**12.1**	**0.5**	**0.7**		**100.0**
Derivative assets	**5.1**	**32.5**	**44.3**	**0.9**		**17.2**	**100.0**
Loans and advances to banks	**11.0**	**72.7**	**6.9**	**3.3**		**6.1**	**100.0**
Debt securities	**50.2**	**24.5**	**20.1**	**1.8**	**3.0**	**0.4**	**100.0**

Bank

As at 31 December 2007	AAA %	AA %	A %	BBB %	Other rated %	Unrated %	Total %
Financial assets held for trading	53.4	32.4	13.9		0.3		100.0
Derivative assets	5.0	63.8	18.9	0.6		11.7	100.0
Loans and advances to banks	2.5	6.2	16.7	3.9	0.1	70.6	100.0
Debt securities	49.4	28.8	20.5	0.4	0.3	0.6	100.0

Financial assets held for trading
Financial assets held for trading are almost exclusively invested in investment grade investments. An analysis of financial assets held for trading is given in Note 13.

Derivative assets
Derivative assets are primarily traded with investment grade counterparties. An analysis of derivative assets is given in Note 14. The above analysis excludes certain intercompany derivative balances which represent 6% of the Bank's derivative assets.

Loans and advances to banks
Loans and advances to banks are primarily invested with investment grade banks.

Debt securities
Debt securities are primarily held within the Treasury & Asset Management and Corporate divisions and are almost exclusively issued by investment grade counterparties. Excluded from the above analysis of debt securities held by the Bank are certain securitisation loan notes issued by Special Purpose Entities which are held by the Bank. Had these been included at the Group's credit rating of 'AA' then 90% of the debt securities would be rated 'AA' or above.

Amounts owed by Group entities
The Bank's inter-company assets are primarily transacted with companies in the Group that have credit rates of 'AA'.

Contingent liabilities and commitments
Contingent liabilities and commitments are analysed in Note 31. This amount reflects the outstanding business at the year end and reflects the maximum credit exposure that could be drawn down. Some facilities will not be drawn down or may be only partially utilised.

36 Credit Risk continued

Treasury debt securities - credit exposure

As part of its investment credit activities Treasury holds a portfolio of debt securities which are analysed below. The investment credit business has two functions: firstly it manages part of the Group's prudential liquidity portfolio and secondly it takes investment positions principally through the Grampian conduit.

Following the International Accounting Standards Board's (IASB) decision to permit the reclassification of financial assets, Treasury reclassified certain securities from assets held for trading into available for sale (AFS) portfolio and, subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS, to loans and receivables (Note 33).

Treasury's total debt securities portfolio as at 31 December 2008, net of fair value adjustments and impairment provisions, is summarised in the following table:

				2008
Asset class	**Loans & receivables £m**	**Available for sale £m**	**Fair value through income statement £m**	**Total £m**
Asset Backed Securities:				
Direct	**20,443**		**3,054**	**23,497**
Grampian conduit	**16,730**			**16,730**
	37,173		**3,054**	**40,227**
Covered bonds		**4,062**		**4,062**
Bank/financial institutional Floating Rate Notes (FRNs)		**15,985**	**1,901**	**17,886**
Bank certificates of deposit (CDs)		**2,960**	**3,068**	**6,028**
Other[1]		**1,787**	**6,045**	**7,832**
Total Treasury Assets	**37,173**	**24,794**	**14,068**	**76,035**
Landale		**695**		**695**
Total (net of fair value adjustments and impairment provisions)	**37,173**	**25,489**	**14,068**	**76,730**

				2007
Asset class	Loans & receivables £m	Available for sale £m	Fair value through income statement £m	Total £m
Asset Backed Securities:				
Direct		9,612	13,729	23,341
Grampian conduit		18,563		18,563
		28,175	13,729	41,904
Covered bonds		3,070		3,070
Bank/financial institutional Floating Rate Notes (FRNs)		11,396	5,997	17,393
Bank certificates of deposit (CDs)		1,774	13,618	15,392
Other[1]		1,877	982	2,859
Total Treasury Assets		46,292	34,326	80,618
Landale		611		611
Total (net of net of fair value adjustments and impairment provisions)		46,903	34,326	81,229

(1) Principally Governments and Supra-nationals.

Notes to the Financial Statements continued

36 Credit Risk continued

Fair value adjustments and impairment losses

For the year to 31 December 2008, the impact of fair value adjustments and impairments on the Treasury debt securities portfolio (after reclassification) is as follows:

Asset class	**Income Statement Year ended 2008 £m**	Income Statement Year ended 2007 £m	**AFS Reserve Year ended 2008 £m**	AFS Reserve Year ended 2007 £m
Fair value adjustments				
Asset Backed Securities	**2,781**	167	**4,959**	443
FRNs	**343**	102	**1,309**	169
Other	**(597)**	(42)	**359**	95
Total fair value adjustments	**2,527[1]**	227[1]	**6,627**	707
Impairment losses				
Asset Backed Securities	**773**			
FRNs	**618**			
Other	**30**			
Total impairment losses pre tax	**1,421**			
Total fair value adjustments and impairment losses pre tax	**3,948**	227	**6,627**	707
Tax on Banking Book fair value adjustments			**(1,856)**	(198)
Total fair value adjustments taken to AFS reserve			**4,771**	509

(1) Included in Net Trading Income (Note 2) as part of interest bearing securities and related non hedging derivatives.

Exposure to Asset Backed Securities (ABS)

	Net Exposure 2008 £m	**Book value 2008 %**	Net Exposure 2007 £m	Book value 2007 %
Mortgage Backed Securities				
US RMBS[1]	**6,922**	**64**	9,307	98
Non-US RMBS	**7,867**	**93**	7,920	99
CMBS[1]	**3,314**	**95**	3,340	99
	18,103	**79**	20,567	99
Collaterised Debt Obligations				
CBO[1]	**2,129**	**49**	3,320	98
CLO[1]	**3,455**	**91**	3,214	99
	5,584	**68**	6,534	99
Personal Sector				
Auto loans	**1,620**	**98**	1,526	100
Credit cards	**3,494**	**96**	2,772	99
Personal loans	**1,096**	**95**	980	98
	6,210	**96**	5,278	99
FFELP Student Loans[1]	**6,992**	**94**	5,586	98
Other ABS	**637**	**89**	672	99
Total Uncovered ABS	**37,526**	**82**	38,637	99
Negative Basis[2]	**2,701**	**70**	3,267	99
Total ABS[3][4]	**40,227**	**81**	41,904	99

(1) RMBS means Residential Mortgage backed Securities; CMBS means Commercial Mortgage Backed Securities; CBO means Collaterised Bond Obligations; CLO means Collaterised Loan Obligations; FFELP means Federal Family Education Loan Programme.
(2) Negative basis means bonds held with separate matching credit default swap (CDS) protection.
(3) The total comprises US securities of £24,304m (2007 £16,333m), and Non-US securities of £15,923m (2007 £25,571).
(4) There has been no increase in net exposure as a result of the purchase of ABS during the year. Any increase in net exposure is the result of exchange rate movement in excess of paydowns, NFVAs and impairments.

37 Market Risk

The HBOS Group's approach to managing market risk is set out on pages 20 to 23 of the Risk Management report. The tables below set out the HBOS Group's sensitivity to market risk through exposure to the trading book and non-trading financial instruments.

The table below sets out by major currency the sensitivity (before tax) of the Group's and Bank's Net Interest Income (NII) over one year to an immediate 25 basis points (bps) shift to all interest rates as at the balance sheet date. The table excludes the sensitivity to insurance contracts and investment contracts which are not material.

As at 31 December				Group
		2008		2007
Impact of interest rate shift on income statement (expense)/income	**+25bps £m**	**-25bps £m**	+25bps £m	-25bps £m
Currency				
Sterling	**82.4**	***(119.6)***	(21.2)	21.6
US Dollar	**(2.9)**	**2.7**	(0.6)	0.5
Euro	**(8.0)**	**8.1**	(4.3)	4.3
Australian Dollar	**(1.5)**	**1.5**	0.1	(0.1)
Other	**(0.3)**	**0.3**	0.1	(0.1)
Total	**69.7**	**(107.0)**	(25.9)	26.2

Base case projected NII is calculated on the basis of the HBOS Group's current balance sheet, with forward rate paths implied by current market rates, and contractual (or behaviourally adjusted) re-pricing dates. It also incorporates corporate planning assumptions about future balance sheet volumes. The sensitivities show how this projected NII would change in response to an immediate parallel shift to all relevant interest rates - market and administered.

The principal driver of the risk is re-pricing mismatch but the methodology also recognises that behavioural re-pricing assumptions, for example prepayment rates, are themselves a function of the level of interest rates.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount. Also, it does not recognise the impact of management actions that, in the event of an adverse movement, could reduce the impact on NII.

In addition to the net interest sensitivity, the Group's net equity is also exposed to movements in the fair value of available for sale investment securities and cash flow hedging derivatives.

Non-trading currency exposure

HBOS Group structural currency exposures are shown in the Risk Management report. Structural currency exposures arise from the Group's investments in overseas subsidiaries, branches and other investments and are noted in the table below.

			2008			2007
Functional currency of the operation	***Net* investments in overseas operations £m**	***Borrowing* taken out to hedge net investments £m**	**Remaining structural currency exposure £m**	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	Remaining structural currency exposure £m
Australian Dollar	**2,015**	**2,015**		2,023	1,811	212
Euro	**2,201**	**2,201**		1,352	1,299	53
US Dollar	**191**	**181**	**10**	97	97	
Other	**(23)**		**(23)**	4		4
Total	**4,384**	**4,397**	**(13)**	3,476	3,207	269

At 31 December 2008 and 31 December 2007 there are no material net currency exposures in the non-trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses. Additional information on the HBOS Group's foreign exchange risk is set out on pages 21 to 22 of the Risk Management report.

The table below sets out the sensitivity before tax of the HBOS Group's available for sale and cash flow hedge reserves to an immediate 25 bps shift to all interest rates as at the balance sheet date.

As at 31 December				Group
		2008		2007
Impact of interest rate shift	**+25bps £m**	**-25bps £m**	+25bps £m	-25bps £m
Available for sale	**(14.5)**	**14.5**	(15.7)	15.7
Cash flow hedge reserve	**84.9**	**(84.9)**	116.1	(116.1)
Total	**70.4**	**(70.4)**	100.4	(100.4)

Notes to the Financial Statements continued

38 Liquidity Risk

The HBOS Group's approach to managing liquidity risk is set out on pages 23 to 26 of the Risk Management report.

The tables below set out the contractual cash flows attaching to the Group's financial liabilities. Certain long dated financial liabilities allow for the early termination at the option of the Group. Where the terms of these instruments have been designed to economically compel the Group to early settle, the earlier settlement date has been applied. For undated instruments the earlier of 20 years or expected date of maturity has been applied.

Group Liabilities	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	2008 Over 5 years £m
Deposits by banks	**49,711**	**41,710**	**3,880**	**1,428**	**492**
Customer accounts	**160,985**	**16,669**	**42,758**	**25,795**	**30,133**
Financial liabilities held for trading	**10,994**	**4,640**	**3,518**		
Derivative liabilities:					
Gross settled derivatives - outflows	**35,701**	**31,615**	**19,016**	**42,827**	**35,077**
Gross settled derivatives - inflows	**(36,761)**	**(32,588)**	**(19,028)**	**(42,323)**	**(33,121)**
Gross settled derivatives - net flows	**(1,060)**	**(973)**	**(12)**	**504**	**1,956**
Net settled derivative liabilities	**1,041**	**1,085**	**8,557**	**15,198**	**7,576**
Derivative liabilities	**(19)**	**112**	**8,545**	**15,702**	**9,532**
Debt securities in issue	**21,684**	**25,443**	**40,453**	**83,513**	**26,732**
Other borrowed funds	**28**	**861**	**1,150**	**5,936**	**20,636**
Other financial liabilities	**365**				
Undrawn loan commitments	**44,961**	**3,041**	**7,031**	**23,263**	**7,071**
	288,709	**92,476**	**107,335**	**155,637**	**94,596**

Group Liabilities	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	2007 Over 5 years £m
Deposits by banks	23,563	12,413	4,369	629	673
Customer accounts	194,728	19,975	26,811	21,090	25,923
Financial liabilities held for trading	10,610	5,556	6,540	242	
Derivative liabilities:					
Gross settled derivatives - outflows	20,581	21,997	15,723	39,253	15,802
Gross settled derivatives - inflows	(20,562)	(22,105)	(15,471)	(38,558)	(15,104)
Gross settled derivatives - net flows	19	(108)	252	695	698
Net settled derivative liabilities	286	516	1,355	4,144	2,024
Derivative liabilities	305	408	1,607	4,839	2,722
Investment contract liabilities					98
Debt securities in issue	26,990	48,086	42,900	75,693	36,843
Other borrowed funds	49	282	1,619	6,463	21,511
Other financial liabilities	286				
Undrawn loan commitments	48,060	2,670	5,761	22,006	6,995
	304,591	89,390	89,607	130,962	94,765

38 Liquidity Risk continued

Bank Liabilities	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	2008 Over 5 years £m
Deposits by banks	51,118	40,900	5,620	8,779	579
Customer accounts	224,968	17,332	49,616	135,900	49,992
Financial liabilities held for trading	10,994	4,640	3,518		
Derivative liabilities:					
Gross settled derivatives - outflows	37,667	33,718	18,561	39,760	34,320
Gross settled derivatives - inflows	(38,784)	(34,704)	(18,578)	(39,254)	(32,721)
Gross settled derivatives - net flows	(1,117)	(986)	(17)	506	1,599
Net settled derivative liabilities	877	1,087	8,571	15,183	7,161
Derivative liabilities	(240)	101	8,554	15,689	8,760
Debt securities in issue	15,443	24,994	38,335	48,826	25,573
Other borrowed funds	28	861	1,121	5,138	20,636
Other financial liabilities	638				
Undrawn loan commitments	44,961	3,041	7,031	23,263	7,071
	347,910	91,869	113,795	237,595	112,611

Bank Liabilities	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	2007 Over 5 years £m
Deposits by banks	26,612	14,914	5,283	2,260	759
Customer accounts	185,148	16,032	30,282	83,681	68,744
Financial liabilities held for trading	10,139	5,478	6,525	242	
Derivative liabilities:					
Gross settled derivatives - outflows	19,897	22,966	13,464	18,063	7,396
Gross settled derivatives - inflows	(19,923)	(23,189)	(13,456)	(18,095)	(7,513)
Gross settled derivatives - net flows	(26)	(223)	8	(32)	(117)
Net settled derivative liabilities	194	371	1,370	4,178	2,407
Derivative liabilities	168	148	1,378	4,146	2,290
Debt securities in issue	21,536	40,627	35,902	37,951	27,798
Other borrowed funds	28	254	1,489	5,738	17,823
Other financial liabilities	103				
Undrawn loan commitments	43,812	2,545	5,491	20,977	6,668
	287,546	79,998	86,350	154,995	124,082

Notes to the Financial Statements continued

39 Related Party Transactions

Banking transactions are entered into by the Bank with its subsidiaries in the normal course of business and are at normal commercial terms. These include loans, deposits and foreign currency transactions. The ultimate parent of the group during 2008 was HBOS plc. The group also enters into banking transactions with it and its subsidiaries in the normal course of business. Interest income and interest expense are £2,101m (2007 £1,554m) and £2,873m (2007 £1,904m) respectively. HBOS plc is the principal employer of the group and staff and other costs in the year of £2,251m (2007 £2,190m) were recharged to the group.

In the year ended 31 December 2008, the group provided both administration and processing services to Sainsbury's Bank plc. The amount payable to the Group during the year was £26m (2007 £42m), of which £10m is outstanding at the year end (2007 £18m). At 31 December 2008, Sainsbury's Bank plc also has balances with the Group and Bank that are included in loans and advances to banks of £906m (2007 £726m). Balances with the Group and Bank that are included in deposits by banks are £1,274m (2007 £3,430m) and £1,274m (2007 £3,430m) respectively.

Included within balances of the group and Bank are the following amounts relating to jointly controlled entities and associated undertakings:

	Group		Bank	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Loans and advances to customers	**14,180**	11,373	**14,153**	11,186
Customer accounts	**213**	521	**213**	521

Included within balances of the group and Bank are the following amounts relating to fellow subsidiary undertakings:

	Group		Bank	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Loans and advances to customers	**36,341**	30,258	**37,106**	29,760
Customer accounts	**37,354**	29,578	**38,513**	29,554

Included within balances of the Bank are the following amounts relating to its own subsidiaries:

	2008 £m	2007 £m
Loans and advances to banks	**22,826**	21,798
Loans and advances to customers	**141,859**	60,434
Deposits by banks	**7,676**	10,315
Customer accounts	**76,407**	8,022

40 Transactions with Key Management Personnel

Key management personnel comprise members of the Bank of Scotland Board, the Company Secretary and, as the senior executive committee of the Group, the HBOS Executive Committee.

Product transactions

Key management personnel and other colleagues, as well as receiving salary, incentives, shares, pensions and other benefits are entitled to enter into product transactions with HBOS plc and its subsidiaries. These transactions are generally in the form of banking, savings, mortgage, loan, insurance, assurance and investment products. Any product offerings that are received on beneficial terms compared to the terms received by customers and which give rise to taxable benefits in kind are declared to HM Revenue & Customs and taxed accordingly.

Key management personnel and connected persons have undertaken transactions with HBOS plc and its subsidiaries, jointly controlled entities and associated undertakings in the normal course of business, details of which have been disclosed to the Group are given below:

Mortgages, credit cards and term loans

	Number of key management personnel	£'000
At 1 January 2007	5	2,160
Amounts advanced during the year	6	2,892
Interest charged	8	271
Amounts repaid during the year	11	(2,036)
Upon resignation	3	(1,460)
At 31 December 2007	**7**	**1,827**
Amounts advanced during the year	**8**	**453**
Interest charged	**9**	**110**
Amounts repaid during the year	**8**	**(567)**
At 31 December 2008	**8**	**1,823**

Included above is £1,675k (2007 £1,682k) in respect of mortgages, £18k (2007 £15k) in respect of credit cards and £130k (2007 £130k) in respect of terms loans.

Bank, cheque or current accounts

	Number of key management personnel	Credit balances £'000	Debit balances £'000	Net balances £'000
At 1 January 2007	9	7,345	(1,017)	6,328
Net movement during the year	15	(575)	(419)	(994)
Upon resignation	3	(129)	1,236	1,107
At 31 December 2007	**12**	**6,641**	**(200)**	**6,441**
Net movement during the year	**12**	**(2,892)**	**189**	**(2,703)**
At 31 December 2008	**11**	**3,749**	**(11)**	**3,738**

Notes to the Financial Statements continued

40 Transactions with Key Management Personnel continued

Savings and deposit accounts

	Number of key management personnel	£'000
At 1 January 2007	2	471
Upon appointment	2	1,550
Amounts deposited during the year	9	5,952
Interest credited	7	114
Amounts withdrawn during the year	7	(2,393)
Upon resignation	1	(32)
At 31 December 2007	**10**	**5,662**
Amounts deposited during the year	**8**	**4,595**
Interest credited	**9**	**311**
Amounts withdrawn during the year	**9**	**(7,721)**
At 31 December 2008	**7**	**2,847**

Life assurance and investment contracts

	Number of key management personnel	£'000
At 1 January 2007	1	3,684
Upon appointment	1	622
Premiums paid/amounts invested during the year	4	1,705
Other movements including investment returns	4	(1,978)
Total sum insured/value of investment at 31 December 2007	**5**	**4,033**
Premiums paid/amounts invested during the year	**2**	**409**
Other movements including investment returns	**5**	**(3,656)**
Total sum insured/value of investment at 31 December 2008	**4**	**786**

The number of directors, together with their connected persons, who had transactions and balances with banking activities in the Group were as follows:

	Number of directors	2008 £'000	Number of directors	2007 £'000
Loans	**3**	**1,070**	6	1,440
Quasi-loans and credit cards	**4**	**12**	6	14

41 Cash and Cash Equivalents

Group	2008 £m	2007 Restated £m
Cash and balances at central banks	**2,502**	2,944
Less: mandatory reserve deposits	**(296)**	(373)
	2,206	2,571
Loans and advances to banks	**12,445**	4,095
Less: amounts with a maturity of three months or more	**(6,665)**	(3,755)
	5,780	340
Cash and cash equivalents	**7,986**	2,911

Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day to day operations.

Included in total cash and cash equivalents at 31 December 2008 is £864m (2007 £658m) of cash held at the central bank as collateral against notes in circulation of £957m (2007 £881m).

Mandatory reserve deposits of £373m at 31 December 2007 have been reclassified from loans and advances to banks to cash and balances at central banks. In addition, total cash and cash equivalents at 31 December 2007 have been restated to include certain cash deposits held with the central Bank of Ireland of £853m (1 January 2007 £535m) and cash held at the central bank as collateral against notes in circulation of £881m (1 January 2007 £857m) which are available to finance the Group's day to day operations. The cashflow statements have been adjusted accordingly.

Bank	2008 £m	2007 £m
Cash and balances at central banks	**1,820**	1,667
Less: mandatory reserve deposits	**(296)**	(373)
	1,524	1,294
Loans and advances to banks	**34,144**	25,458
Less: amounts with a maturity of three months or more	**(16,315)**	(25,030)
	17,829	428
Cash and cash equivalents	**19,353**	1,722

Notes to the Financial Statements continued

42 Securities Borrowing and Lending, Repurchase and Reverse Repurchase Agreements

The Group enters into securities lending transactions and repurchase agreements, whereby cash and securities are temporarily received or transferred as collateral. Where the securities sold subject to repurchase or pledged as collateral are retained on the balance sheet the funds received under these arrangements are recognised as liabilities. These transactions are all in respect of standard securities borrowing and reverse repurchase agreements which are undertaken under standard market terms and conditions, or are in respect of securities exchange transactions under the Bank of England's Special Liquidity Scheme. Assets and liabilities relating to such arrangements at 31 December are as follows:

Group	Asset 2008 £m	Asset 2007 £m	Related liability 2008 £m	Related liability 2007 £m
Assets subject to repurchase				
Financial assets held for trading (Note 13)	**4,369**	4,711	**3,425**	4,523
Loans and advances to customers (Note 15)	**56,858**		**39,220**	
Investment securities (Note 17)	**37,263**	8,996	**31,682**	7,841
	98,490	13,707	**74,327**	12,364

In addition to the above, financial assets pledged as collateral as part of securities lending transactions amounted to £89,109m (2007 £11,918m).

Securities held as collateral as stock borrowed or under reverse repurchase agreements amounted to £76,018m (2007 £39,975m), of which £64,378m (2007 £28,817m) had been resold or repledged by the Group as collateral for its own transactions. These securities are not recognised as assets, and the cash advanced is recognised within financial assets held for trading, loans and advances to banks and loans and advances to customers.

Bank	Asset 2008 £m	Asset 2007 £m	Related liability 2008 £m	Related liability 2007 £m
Assets subject to repurchase				
Financial assets held for trading (Note 13)	**4,369**	4,711	**3,425**	4,523
Loans and advances to customers (Note 15)	**24,939**		**17,333**	
Investment securities (Note 17)	**62,559**	9,365	**48,484**	8,202
	91,867	14,076	**69,242**	12,725

In addition to the above, financial assets pledged as collateral as part of securities lending transactions amounted to £88,742m (2007 £11,918m).

Securities held as collateral as stock borrowed or under reverse repurchase agreements amounted to £90,699m (2007 £39,975m), of which £67,022m (£28,817m) had been resold or repledged by the Group as collateral for its own transactions. These securities are not recognised as assets, and the cash advanced is recognised within financial assets held for trading, loans and advances to banks and loans and advances to customers.

43 Capital Management

The Group's approach to managing capital is set out on pages 27 to 28 of the Risk Management report. The Group's capital resources are set out in the table below.

	As at 31.12.08 £m	As at 01.01.08 £m
Capital resources		
Tier 1		
Ordinary share capital	**1,324**	499
Eligible reserves	**16,019**	21,380
Minority interests	**318**	285
Perpetual non-cumulative preference shares		
Preference share capital	**1,200**	1,200
Innovative Tier 1		
Preferred securities	**698**	698
Deductions from Tier 1		
Goodwill & other intangible assets	**(1,211)**	(1,611)
Excess expected loss [1]	**(536)**	(875)
Other deductions	**(484)**	(84)
Total Tier 1 capital	**17,328**	21,492
Upper Tier 2		
Available for sale reserve		186
Undated subordinated debt	**5,551**	3,383
Collectively assessed impairment provisions	**1,454**	463
Lower Tier 2		
Dated subordinated debt	**9,094**	9,695
Deductions from Tier 2		
Excess expected loss [1]	**(536)**	(875)
Other deductions	**(325)**	(84)
Total Tier 2 capital	**15,238**	12,768
Supervisory deductions:		
Other deductions	**(919)**	(734)
Total capital resources	**31,647**	33,526

(1) Unaudited

The table below details movements in Tier 1 capital during the year.

	2008 £m
As at 1 January	**21,492**
Loss attributable to parent company shareholders	**(8,238)**
Ordinary dividends paid	**(1,205)**
Ordinary share capital issued	**5,500**
Other	**(221)**
As at 31 December	**17,328**

Notes to the Financial Statements continued

44 Post Balance Sheet Events

a) Lloyds Banking Group

On 18 September 2008, with the support of the UK Government, the boards of HBOS plc (HBOS) and Lloyds TSB Group plc (Lloyds TSB) announced that they had reached agreement on the terms of the recommended acquisition of HBOS by Lloyds TSB. The terms of the acquisition were subsequently amended, as announced on 13 October 2008, at the same time as the announcement of the participation by HBOS and Lloyds TSB in the Government's action plan to recapitalise some of the major UK banks. The acquisition was to be implemented by means of a scheme of arrangement, with a separate scheme of arrangement in relation to preference shares, under sections 895 to 899 of the Companies Act 2006.

On 12 January 2009 the Court of Session in Edinburgh, Scotland made an order sanctioning the scheme of arrangement for the acquisition and the preference share scheme of arrangement. The last day of trading in HBOS ordinary and preference shares was 14 January 2009.

On 15 January 2009 HBOS raised £11.5bn of capital (before costs and expenses) through an issue of £8.5bn of new ordinary shares under a placing with HM Treasury subject to clawback by existing shareholders, and an issue to HM Treasury of £3bn of new preference shares. Lloyds TSB raised £4.5bn (before costs and expenses) through an issue of £3.5bn of new ordinary shares under a placing with HM Treasury subject to clawback by existing shareholders, and an issue to HM Treasury of £1bn of new preference shares.

On 16 January 2009 the Lloyds TSB acquisition of HBOS completed following final court approval and Lloyds TSB was renamed Lloyds Banking Group plc. The exchange of HBOS shares for Lloyds Banking Group shares took place at an exchange ratio of 0.605 of a new Lloyds Banking Group share for every one HBOS share held. As a result, the UK Government through HM Treasury owned approximately 43.4% of the enlarged ordinary share capital of Lloyds Banking Group. In addition, each class of preference share issued by HBOS, including the preference shares issued to HM Treasury in the capital raising was replaced with an equal number of new Lloyds Banking Group preference shares.

HBOS ordinary and preference shares were de-listed from the Official List of UK Listing Authority and admission to trading on the London Stock Exchange was cancelled on 19 January 2009 when trading in the new Lloyds Banking Group shares commenced.

b) Other

On 26 February 2009, the Board of Bank of Scotland plc (BoS) approved an ordinary share capital issuance of £8.351bn to HBOS. This passes the ordinary share capital provided by HM Treasury to HBOS on 15 January 2009 down to BoS. In addition, this fulfils HBOS requirements under the terms of the HM Treasury subscription agreement.

In order to facilitate this capital injection, the authorised ordinary share capital of BoS was increased by 16,000 million ordinary shares of £0.25 each and 13,918,333,333 were issued to HBOS for a total of £8.351bn.

45 Ultimate Parent Undertaking

From 16 January 2009, Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc (formerly Lloyds TSB Group plc) which is incorporated in Scotland. Lloyds Banking Group plc will produce consolidated accounts for the year ended 31 December 2009. Copies of the annual report and accounts of Lloyds TSB Group plc for the year ended 31 December 2008 may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN.

Prior to 16 January 2009, HBOS plc was the ultimate parent undertaking of Bank of Scotland plc. Copies of the annual report and accounts of HBOS plc for the year ended 31 December 2008 may be obtained from HBOS plc's registered office at The Mound, Edinburgh, EH1 1YZ or downloaded via www.lloydsbankinggroup.com.