BANK OF SCOTLAND
ANNUAL REPORT AND ACCOUNTS

FOR THE YEAR ENDED 31 DECEMBER 2005

CONTENTS

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Business and Financial Review

Introduction

The Directors are pleased to present the consolidated results of the Bank of Scotland and its subsidiaries (the “group”) for the year ended 31 December 2005. The Bank of Scotland (the “bank”) is a directly held subsidiary of HBOS plc.

Group profit before tax amounts to £2,546 million (2004 - £2,319 million).

Basis of Preparation

The HBOS Group and Divisional financial information included in the following Financial Review and the Divisional Reviews has been prepared on the basis fully explained on page 31.

Business Sector Analysis of Results

The business sector results of the Bank of Scotland group presented below exclude HBOS merger integration costs.

Following an internal reorganisation, from 1 July 2005 the HBOS Group reports the year’s results through five divisions, as noted below and Group Items. 2004 figures have been restated to reflect this new structure.

The business sectors reported are aligned with those of the HBOS Group (the “HBOS Group”) and comprise:-

- Retail
- Corporate
- Treasury & Asset Management
- Insurance & Investment
- International

Business And Financial Review (continued)

Retail

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Net interest income	**911**	928
Non-interest income	**229**	254
Net operating income	**1,140**	1,182
Operating expenses *	**(363)**	(399)
Operating profit before provisions	**777**	783
Impairment losses on loans and advances	**(245)**	(177)
Share of profits of associates and jointly controlled entities	**7**	33
Non operating income		13
Pre-tax profit *	**539**	652

* Excluding HBOS merger integration costs.

Corporate

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Net interest income	**1,689**	1,278
Non-interest income	**1,276**	1,242
Net operating income	**2,965**	2,520
Operating expenses*	**(1,156)**	(1,010)
Operating profit before provisions	**1,809**	1,510
Impairment losses on loans and advances	**(429)**	(368)
Impairment on investment securities	**(45)**	(25)
Share of profits of associates and jointly controlled entities	**46**	65
Pre-tax profit*	**1,381**	1,182

* Excluding HBOS merger integration costs.

Underlying profit before tax in Corporate increased by 17 per cent to £1,381 million due to continued measured growth in advances.

Business And Financial Review (continued)

Insurance & Investment

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Net interest income	**2**	
Non-interest income	**15**	31
Net operating income	**17**	31
Impairment on investment securities		1
Pre-tax profit*	**17**	32

* Excluding HBOS merger integration costs.

The group's insurance business relates to repayment insurance on the group's lending products. Commission income which is included within non-interest income and pre-tax profit have declined in the year as the insurance interests are progressively re-aligned within the wider HBOS Group.

International

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Net interest income	**1,016**	604
Non-interest income	**223**	256
Net operating income	**1,239**	860
Operating expenses *	**(505)**	(348)
Operating profit before provisions	**734**	512
Impairment losses on loans and advances	**(177)**	(184)
Impairment on investment securities	**(6)**	
Share of (losses)/profits in associates and jointly controlled entities	**(2)**	13
Pre-tax profit *	**549**	341

* Excluding HBOS merger integration costs.

The newly enlarged International Division now includes a third operating division of Europe & North America ("ENA") in addition to Australia and Ireland. The primary objective of all three divisions is to leverage the already proven UK operating model in selected markets, where opportunities exist for value added growth within our defined risk appetite.

Underlying profits in International increased by 61 per cent to £549 million. The strong result is led by ENA, where full year consolidation of our investment in Drive Financial Services added to strong underlying growth in our European and U.S. businesses. In Australia, strong growth in income is a result of market share gains while in Ireland the business bank performed well delivering profit growth alongside investment in the recently launched Retail operations.

Business And Financial Review (continued)

Treasury & Asset Management

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Net interest income	**181**	170
Non-interest income	**188**	205
Net operating income	**369**	375
Operating expenses *	**(133)**	(116)
Pre-tax profit *	**236**	259

* Excluding HBOS merger integration costs.

Underlying profit before tax in Treasury & Asset Management decreased by 9 per cent to £236 million. Excluding the £31 million impact of the first time inclusion of IFRS derivative hedge accounting, underlying profit before tax on a 'like-for-like' basis increased by 3 per cent to £267 million. Asset quality remains high and no credit provisions were required in the period.

Overview of Results

Group underlying profit before tax amounts to £2,546 million (2004 - £2,348 million) and is derived as follows:-

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Group profit before tax	**2,546**	2,319
Add back:		
Goodwill impairment		6
Merger integration costs		23
Group underlying profit before tax	**2,546**	2,348

On a divisional basis, group underlying profit before tax is made up as follows:-

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Retail	**539**	652
Corporate	**1,381**	1,182
Insurance & Investment	**17**	32
International	**549**	341
Treasury & Asset Management	**236**	259
Group Items *	**(176)**	(118)
	2,546	2,348

* Group Items comprise costs incurred in the management of the group as a whole.

Group net interest income in the year of £3,799 million is up £819 million, reflecting strong asset led growth.

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Interest receivable	**18,054**	15,072
Interest payable	**(14,255)**	(12,092)
Net interest income	**3,799**	2,980

Business And Financial Review (continued)

Non-interest income amounted to £1,931 million for the year compared with £1,988 million for the year to 31 December 2004.

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Net fees and commission income	**595**	1,026
Operating lease rental income	**610**	528
Net trading income	**214**	208
Profit on sale of investment securities	**182**	105
Other operating income	**330**	121
Non-interest income	**1,931**	1,988

Operating expenses increased 16 per cent to £2,333 million as a result of the planned investment in people and infrastructure in International and Treasury & Asset Management and a full year charge for Drive, which did not become a subsidiary until November 2004.

	Year ended 31 December 2005 £ million	Year ended 31 December 2004 £ million
Staff costs	**1,051**	876
Accomodation, repairs and maintenance	**135**	121
Technology	**32**	55
Marketing and communication	**133**	125
Depreciation:		
Property and equipment and intangible assets other than goodwill	**100**	96
Operating lease assets	**505**	381
Other	**377**	364
	2,333	2,018

Taxation

The tax charge for the year of £678 million (2004 - £661 million), represents 27 per cent (2004 – 29 per cent) of profit before tax compared with a UK corporation tax rate of 30 per cent applicable to both periods. The difference in tax rates is explained in more detail in note 8 on page 52.

Balance Sheet

Gross advances to customers increased by 11 per cent to £179 billion. The mix of the group's lending portfolio at the year end is summarised in the following table and gross lending exposure is shown in more detail in note 12 on page 54.

	Year ended 31 December 2005		Year ended 31 December 2004	
Gross advances	**£ billion**	**%**	£ billion	%
Commercial	**121**	**68**	109	68
Residential Mortgages	**47**	**26**	41	25
Other Personal	**11**	**6**	11	7
Total	**179**	**100**	161	100

Business And Financial Review (continued)

Impairment Provisions and Impaired Loans

The total charge for loan impairment losses against group profits was £851 million (2004 - £729 million).

Closing provisions as a percentage of customer advances are analysed in the following table:

		2005		2004
		As % of customer		As % of customer
	£ million	**advances**	£ million	advances
Impairment provisions	**1,637**	**0.91**	1,227	0.76

Capital Structure

	31 December 2005	31 December 2004
Risk Weighted Assets	**£ million**	£ million
On balance sheet – Banking book	**144,239**	132,383
On balance sheet – Trading book	**5,967**	5,726
Off balance sheet	**11,527**	10,324
Total Risk Weighted Assets	**161,733**	148,433
Tier 1		
Ordinary share capital	**410**	410
Preference share capital	**400**	400
Perpetual securities	**298**	297
Eligible reserves	**8,931**	8,110
Minority interests (equity)	**734**	411
Preference instruments (non-equity):		
Preferred securities	**400**	400
Less: goodwill & other intangible assets	**(952)**	(496)
Total Tier 1 Capital	**10,221**	9,532
Tier 2		
Available for sale reserve	**107**	
Undated subordinated debt	**2,339**	2,318
Dated subordinated debt	**3,983**	3,711
Other minority interest (non-equity)	**492**	458
Collectively assessed impairment provisions	**1,172**	545
Total Tier 2 Capital	**8,093**	7,032
Supervisory deductions:		
Unconsolidated investments – other	**(6)**	(5)
Investments in other banks	**(10)**	(18)
Other deductions	**(805)**	(706)
Total supervisory deductions	**(821)**	(729)
Total regulatory capital	**17,493**	15,835
Tier 1 capital ratio (%)	**6.3**	6.4
Total capital ratio (%)	**10.8**	10.7

Risk Management

Introduction

The risk management process within the Bank of Scotland group is part of the overall framework that is applied across the HBOS Group. The discussion below is in relation to the HBOS Group overall.

The HBOS Group is involved in the provision of retail, business and corporate banking, treasury services, investment management, insurance and life assurance. Inherent within the provision of financial services are a number of diverse risks, which may have a material impact on the HBOS Group's financial performance. These include, though not exclusively, credit, market, liquidity, operational and insurance risk.

Identification, measurement and management of risk is a strategic priority for the HBOS Group. A comprehensive framework of internal controls for risk management has been established at both HBOS Group level and within all constituent businesses. The HBOS Board ("Board") has overall responsibility for the HBOS Group's system of control, including approval of the principal risk policies and standards and of the terms of reference of Board Committees, though some aspects are delegated to Board and Executive Committees and to senior management within the HBOS Group. The Board is also responsible for reviewing the effectiveness of the systems and controls. The system of controls described in this section has been in place throughout the period to the date of approval of the Annual Report and Accounts. It accords with the Turnbull guidance on internal control and has also been reviewed by the Board specifically for the purposes of this statement.

Information on the principal risks and the HBOS Group's approach to risk management and the system of controls adopted is described in the following sections.

Management and Controls

Principles

The system of internal control provides clear accountabilities for risk management and applies across the HBOS Group's operations. It covers strategic, financial, regulatory and operational risks and provides assurances to successive levels of management and to the Board. Additional information about the particular types of risks faced by the HBOS Group is given below.

The HBOS Group seeks to maintain high standards in the management of risk and the system of controls is continually evolving. Specialist risk managers are tasked with researching industry best practice and with ensuring that standards and policies within the Group are progressively developed to improve risk management practice.

Within the HBOS Group risk is managed in accordance with the following principles:

- Key risks are identified, measured where appropriate, and managed to achieve a balance between risk and reward which is acceptable to the Board. Each year the Board carries out a formal strategic review of risk management, and also reassesses its appetite for risk in light of the HBOS Group's annual business plan. This focus on aligning the taking of risk with the achievement of business objectives means that the control system is designed to manage, rather than eliminate, risk and can provide only reasonable – and not absolute – assurance against material misstatement or loss.
- Responsibility for risk is a key element of all managers' competencies. Necessary for each major risk type, specialist teams have been established where appropriate, both in the divisions and at HBOS Group level, to ensure that guidance is available for all managers within the HBOS Group.
- Staff and systems resources are dedicated to ensuring that risk management information is accurate, timely and relevant to the business, reflecting the true position at any given time.

The Risk Management Framework

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

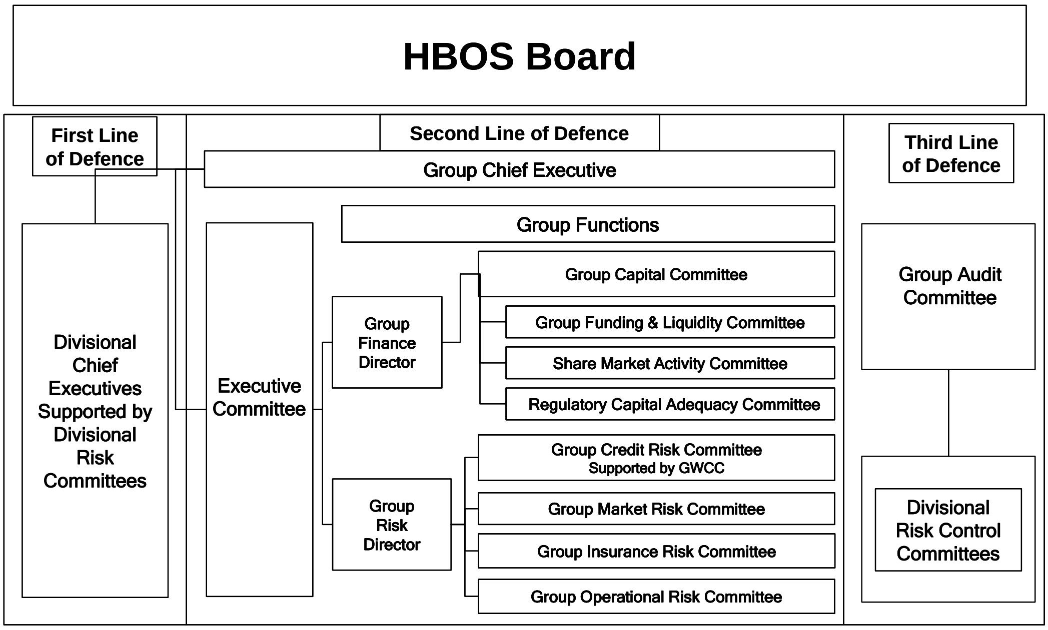
- Within the operating divisions, primary management responsibility for strategy, performance management and risk control lies with the Divisional Chief Executives (first line of defence);
- Centralised policies and standards are developed and objective oversight of risk management is exercised by specialist risk functions, supporting the Group's Executive Committees and Executive Risk Committees (second line of defence); and
- Independent and objective assurance on the effectiveness of control systems is provided by Group Internal Audit and the HBOS Group Audit Committee (third line of defence).

This model operates through a formal governance structure, comprising committees with specified areas of responsibility, supported by management functions with a similar remit.

Risk Management (continued)

Increasingly, the actions required to actively manage the overall capital, liquidity and operating position of the Group are converging. In recognition of this, and in anticipation of the potential changes to the overall risk sensitivity of the regulatory capital position under a Basel II framework, a revised formal governance structure for the HBOS Group will be incorporated within the risk framework. This represents a change to the governance structure that operated in 2005 and is illustrated below. To assist in comparison with previous years, the changes in governance structure have been incorporated within the detailed commentary on each risk area.

Risk Management Structure



Strategy, Performance Measurement and Risk Control

The HBOS Group's risk appetite is established by the Board. The strategy for managing risk is formulated by the HBOS Executive Committee ("Executive Committee") and recommended to the Board for approval. The Executive Committee also reviews the effectiveness of risk management systems through reports from management and from the HBOS Group Executive Risk Committees.

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 control breakdowns, disruption of information systems, competition and regulatory requirements. The assessment process is designed to be consistent across the divisions and HBOS Group Functions and uses an iterative challenge process to provide successive assurances to ascending levels of management up to the Board.

In judging the effectiveness of the HBOS Group's controls, the Board reviews the reports of the HBOS Group Audit Committee and management. It also considers key performance indicators and reviews monthly financial and business performance showing variances against budget.

Divisional Chief Executives have responsibility for managing strategic, market, credit, liquidity, regulatory and operational issues and risks affecting their own operations within the parameters of the HBOS Group policies set by the Board. Each business division also has its own risk management committee or committees.

Policy, Performance and Risk Oversight

The HBOS Group's Executive Risk Committees consider risks and risk management from the HBOS Group's perspective and are supported by the specialist HBOS Group Risk function. Together they develop the policies and parameters within which business divisions are required to manage risk. They provide central oversight by reviewing and challenging the work of the business divisions' own risk committees and by providing functional leadership in the development and implementation of risk management techniques.

Committees covering specific types of risk assist the Board to formulate risk appetite, policies and strategies for that specific risk type, and are responsible for the implementation and maintenance of the risk management framework relating to that risk.

The four specific Executive Risk Committees are:
- HBOS Group Credit Risk Committee, which covers all credit risk matters;
- HBOS Group Market Risk Committee (formerly the HBOS Group Asset & Liability Committee) which is responsible for all trading and market risk matters;
- HBOS Group Insurance Risk Committee (formerly the HBOS Group Insurance & Investment Risk Committee) which is responsible for insurance risks within the insurance and investment businesses; and
- HBOS Group Operational Risk Committee, responsible for operational and regulatory risks.

Risk Management (continued)

The HBOS Group has established specialist HBOS Group Risk function, reporting to the HBOS Group Risk Director, in support of these Committees. Its accountabilities are:

- to recommend HBOS Group policies, standards and limits;
- to monitor compliance with those policies, standards and limits; and
- to aggregate risks arising in the business divisions and to monitor the overall Group position independently from the divisions' own analysis.

HBOS Group Risk is also responsible for oversight of the HBOS Group's adherence to regulatory requirements and for oversight of communications with regulators on a HBOS Group-wide basis, with direct responsibility for relations with the Financial Services Authority ("FSA"), the HBOS Group's principal regulator.

Integrated Capital and Liquidity Management

A critical element of the HBOS Group's management philosophy is the consideration of capital, liquidity and balance sheet management on an integrated basis. As a result, from 2006 responsibility for the capital and funding related activities of the HBOS Group will be integrated into the HBOS Group Capital Committee. Appropriate sub-committees will report the HBOS Group's requirements into the main committee.

This serves to clarify and reinforce that the prime responsibility, ownership and accountability for managing and controlling all matters relating to funding and capital sits with the HBOS Group Finance Director, whilst separating the management and control of risk at the highest level. The HBOS Group Capital Committee, chaired by the HBOS Group Finance Director, operates under delegated authority from the Board to:

- Oversee and manage the HBOS Group's Balance Sheet and Capital in accordance with the Board approved HBOS Group Business Plan through:
  - Establishing and monitoring compliance with the HBOS Group's Capital Plan in line with the Board approved HBOS Group Capital Policy;
  - Establishing and monitoring compliance with the HBOS Group Funding Plan; and
  - Establishing policies and minimum standards to measure and monitor the financial resource requirements of the HBOS Group in accordance with regulatory requirements, including:
    - Establishing and monitoring execution of strategies for the management of non-trading related balance sheet risks, within approved risk appetite, policy and minimum standards (as monitored by the HBOS Group Market Risk Committee),
    - Establishing and reviewing stress, scenario and contingency planning and management strategies in that regard (in co-operation with the Executive Risk Committees)
- Establish and recommend for approval to the Board, the HBOS Group's appetite for Liquidity Risk, including relevant policy (HBOS Group Liquidity Policy Statement) and minimum standards and monitoring the implementation of those policies and standards within the Group.

Independent Assurance

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

The HBOS Group Audit Committee, which is supported by Divisional Risk Control Committees, obtains assurance about the internal control and risk management environment through regular reports from HBOS Group Risk and HBOS Group Internal Audit. It also considers external auditors' reports and reviews the minutes and work of the Divisional Risk Control Committees.

Basel II Accord

The HBOS Group approach to Basel II has consistently focussed on improving how we do business as opposed to regulatory compliance per se. Our Basel programme is aligned with internal plans to deliver improved risk management capability at both a divisional and HBOS Group level. These activities will enhance our ability to measure and monitor the risks facing the HBOS Group and provide a clear focus on delivering sustainable income streams to generate added shareholder value.

HBOS intends to adopt the advanced approaches for both Credit and Operational Risk. Regulatory guidance is still evolving with the publication of the second FSA Consultation Paper, which will be followed by the publication of 'FSA Near Final Rules' in mid 2006 and 'FSA Final Rules' in October 2006. We continue to play an active role in discussions within the industry and the FSA to shape the regulatory approach.

HBOS continues to promote a prudent and responsible approach to the management of capital. Management and the Board's view of future requirements will continue to be the main determinant of total capital holdings. Whilst Basel II advocates a risk sensitive regulatory capital framework, HBOS believes that management of capital volatility is of paramount importance.

Management of Key Risks

The HBOS Group is committed to developing its risk management techniques and methodologies, both to maintain high standards of risk management practice and to fulfil the requirements of UK and international regulators.

Credit Risk

Credit risk is the risk of financial loss from a customer's failure to settle financial obligations as they fall due. The HBOS Group Credit Risk Committee, one of the Executive Risk Committees described above, is chaired by the HBOS Group Risk Director and comprises senior executives from across the business divisions and group functions. It meets monthly and reviews the HBOS Group's lending portfolio to ensure a HBOS Group-wide understanding and control of credit risk. The HBOS Group Credit Risk Policy Statement, which is applied across all businesses subject to credit risk, is approved by the Board on an annual basis.

HBOS Group Credit, a specialist support function within HBOS Group Risk provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance of each divisional portfolio to the HBOS Group Credit Risk Committee, HBOS Group Credit exercises independent oversight over the effectiveness of credit risk management arrangements and adherence to agreed 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 the Board. Typical functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts.

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

- For Retail portfolios use is made of software technology in credit scoring new applications where it is practical to do so. In addition, where practical, 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. Collection activity for credit card, current accounts and personal loans is centralised for the various products and software systems are used to prioritise action. Mortgage collection is conducted through a number of payment collection departments. Small business customers may be rated using scorecards in a similar manner to retail customers.
- For Corporate portfolios, a full independent credit assessment of the financial strength of each potential transaction and/or customer is undertaken, awarding an internal risk rating. Internal ratings are reviewed regularly. The same approach is also used for larger small to medium enterprise ("SME") customers.
- Within Treasury, which largely incorporates the HBOS Group's wholesale, sovereign and banking related exposures, focused credit risk policies are established and reviewed by the HBOS Group Wholesale Credit Committee, a subcommittee of the HBOS Group Credit Risk Committee.

An additional measure within the credit risk framework is the establishment of industrial sector and country limits to avoid excessive concentrations of risk within volatile economic sectors or individual countries. All such limits are set and monitored by the HBOS Group Credit Risk Committee. The controls applied to lending assessment processes consider environmental risk and the potential impact this may have on the value of the underlying security.

Minimum standards have been established across the HBOS Group for the management of credit risk. All divisions are committed to continuously improving credit risk management and there have been significant levels of investment in the development of risk rating tools, including portfolio risk measurement systems in preparation for the introduction of Basel II.

Within the insurance and investment businesses the formal policies and overall risk appetites approved by the board of the relevant insurance subsidiary, are applied together with a regular monitoring process to ensure compliance.

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), commodities and equities; or
- the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions.

The objectives of the HBOS 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 HBOS Group's financial capability, management understanding and staff competence;
- The HBOS Group complies with all regulatory requirements relating to the taking of market risk;
- The quality of the HBOS Group's profits is appropriately managed and its reputation safeguarded; and
- Appropriate information on market risk is known to those making decisions, such that the taking of market risk is designed to enhance shareholder value.

Risk appetite is set by the Board which allocates responsibility for oversight and management of market risk to the HBOS Group Market Risk Committee (formerly the HBOS Group Asset & Liability Committee), one of the Executive Risk Committees described above, and chaired by the HBOS Group Risk Director. Market risk is controlled across the HBOS Group by setting limits using a mixture of measurement methodologies. 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 operating division. Each divisional policy document requires appropriate divisional sanction, and is then forwarded to the HBOS Group Market Risk Committee (formerly the HBOS Group Asset & Liability 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 company. In the case of the risk borne by the customer, this

Risk Management (continued)

is controlled by adherence to, and regular monitoring of, investment mandates and, if appropriate, unit pricing systems and controls. In the case of the company, overall risk appetites and policies as approved by the company's Board, together with regular monitoring ensures that risk is appropriately controlled.

HBOS Group items (net free reserves, subordinated debt and structural foreign exchange) are managed within separate policies and limits/mandates as set by the HBOS Group Capital Committee (formerly delegated to the HBOS Group Asset & Liability Committee).

Interest Rate Risk

The primary market risk faced by the HBOS Group is interest rate risk. Interest rate risk exists where the HBOS Group's financial assets and liabilities have interest rates set under different bases or reset at different times.

The Board limit for structural interest rate risk is expressed in terms of potential volatility of net interest income in adverse market conditions using Earnings at Risk ("EaR") methodology. The EaR methodology combines an analysis of the HBOS Group's interest rate risk position overlaid with behavioural assessment and repricing assumptions of planned future activity. In addition to this primary control, a number of other risk methodologies are applied to manage risk, including:

- Present Value of a Basis Point ("PVBP"). PVBP is a measure of market value sensitivity and quantifies the change in present value of cash flows for a one basis point change in interest rates. This method is primarily used for Treasury banking book activities where there is a limited impact from behavioural and/or internal re-pricing issues.
- Net asset/liability repricing maturity matrices. EaR focuses on positions over the detailed planning horizon and can be directly related back to reported performance. To ensure that the HBOS Group does not have long-term embedded risks that are not being appropriately controlled, limits are set on net asset/liability positions that re-price beyond one year.

The Board has delegated authority to the HBOS Group Market Risk Committee (formerly HBOS Group Asset & Liability Committee) to allocate limits to business areas as appropriate within the HBOS Group's risk appetite. In turn, the HBOS Group Market Risk Committee (formerly HBOS Group Asset & Liability Committee) has set limits, which represent the risk tolerance for each division. Interest rate risk arising in the course of business is required to be transferred to HBOS Treasury Services plc ("HBOSTS") from the banking divisions. The residual risk in the banking divisions is primarily that related either to behavioural characteristics or to basis risk arising from imperfect correlations in the adjustment of rates earned and paid on different instruments with otherwise similar characteristics. Risk in the business divisions is measured by EaR. With respect to HBOSTS the primary risk measure is the impact attributable to a one basis point parallel move in the yield curve. This is a more appropriate control given the nature of exposures that HBOSTS's banking book carries. These two measures have been calibrated and expressed as an EaR equivalent. The HBOS Group Market Risk Committee undertakes to ensure that the aggregate exposure does not exceed the total HBOS Group risk appetite.

Sensitivity to interest rate movements is shown in note 39 to the accounts, which provides the year end repricing profile for the HBOS Group's financial assets and liabilities in the non-trading book, which includes lending, funding and liquidity activities. The methodology used in analysing the year end repricing profile does not take into consideration the effects of behavioural and basis risk issues, hence for internal management of risk the HBOS Group relies on a number of methodologies, including EaR.

Foreign Exchange Risk

The Board has delegated authority to the HBOS Group Market Risk Committee (formerly the HBOS Group Asset & Liability Committee) to set structural foreign exchange limits. The HBOS Group Market Risk Committee has established limits for foreign exchange transaction and translation risk.

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 foreign exchange exposures are set out in note 41 to the accounts.

Trading

The HBOS Group's market risk trading activities are principally conducted by HBOSTS. This activity is subject to a Trading Book Policy Statement, which is approved by the Board and limits set by the HBOS Group Market Risk Committee (formerly HBOS Group Asset & Liability 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. The framework for managing the market risk in these activities requires detailed and tailored modelling techniques, which are the responsibility of the HBOSTS Market Risk team.

The HBOS 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 forecasts the HBOS Group's exposure to market risk within an estimated level of confidence over a defined time period.

The HBOS Group average VaR value in 2005 was £6.0 million. The calculation is based upon a confidence level of 99 per cent with a one day holding period. The principal areas of market risk taken are interest rate (outright positioning, basis, spread and volatility risk), and foreign exchange risk. There is no material commodity exposure and limited equity exposure.

The current methodology for providing an aggregated VaR for the business uses very conservative assumptions. In order to assess the effectiveness of VaR the HBOS Group uses a technique known as 'back testing', which compares the daily profit and loss from trading activities to the VaR estimate for that day. Daily standard deviation of trading profit and loss was £0.7 million.

The HBOS Group recognises that the VaR methodology cannot guarantee the maximum loss that may be suffered in any trading period, particularly in the event of market turmoil. Therefore, stress testing is used to simulate the effect of selected adverse market movements.

Derivatives

In the normal course of banking business, the HBOS 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, forward foreign exchange contracts and futures. The HBOS Group uses derivatives as a risk management tool for hedging interest rate and foreign exchange rate risk.

Examples of how derivatives are used in managing and mitigating market risk exposures arising from banking services and activities are:

- Fixed interest rate swaps, to manage the sensitivity of the investment of reserves and other non-interest bearing liabilities to falls in interest rates.
- Purchase of interest rate caps, to manage exposure to capped rate mortgage lending.

The HBOS Group's activity in derivatives is controlled within risk management limits set by the Board and overseen by the HBOS Group Market Risk Committee. This framework recognises the principal risks including credit, operational, liquidity and market risk associated with derivatives. Details of derivative contracts outstanding at the year end are included in note 35 to the accounts.

Liquidity Risk (Funding)

Liquidity risk is the risk that the HBOS Group does not have sufficient financial resources to meet its obligations when they come due, or will have to do so at excessive cost. This risk can arise from mismatches in the timing of cash flows relating to assets, liabilities and off-balance sheet instruments.

The HBOS Group Liquidity Policy Statement is approved by the Board and defines the core principles for identifying, measuring, managing and monitoring liquidity risk across the HBOS Group. Detailed liquidity risk framework documents and limit structures are in place for the HBOS Group's operations in the UK and Australia, where liquidity is managed on a group basis, and for overseas banking units subject to specific regulatory requirements. The responsibility to direct the management of liquidity and to report against policy is delegated to the HBOS Group Capital Committee (formerly delegated to the HBOS Group Asset & Liability Committee).

Policy is reviewed at least annually to ensure its continued relevance to the HBOS Group's current and planned operations. Operational liquidity management is delegated to HBOSTS and the HBOS Group Funding & Liquidity Committee (a sub-Committee of the HBOS Group Capital Committee) oversees the controls exercised by HBOSTS.

The Board requires that prudential liquidity limits should be set by HBOS Group Capital Committee, (formerly delegated to the HBOS Group Asset & Liability Committee) both at aggregate levels and for individual currencies in which the HBOS Group has significant wholesale funding. These limits are established by way of cash flow mismatch and are quantified over two time horizons, from sight to eight days and from sight to one month.

For the purpose of calculation, marketable assets are subject to both instrument concentration limits and prudential discount factors. An assessment is also made for the possible outflow from customer deposits and committed facilities, determined by prudential behavioural modelling.

The HBOS Group's approach to the management of liquidity goes beyond the Sterling Stock Liquidity approach used by the FSA, in that it includes measures of liquidity cover out to one month, and measures for currencies other than sterling. Whilst following this approach, the HBOS Group also adheres to the FSA's Sterling Stock Liquidity policy, of which a key element is that a bank should hold a stock of high quality liquid assets that can be sold 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 should enable the bank to continue business, whilst providing an opportunity to arrange more permanent funding solutions.

The FSA has a prescriptive regime for retail banks that specifies the formula for determining both the quantum and type of assets qualifying for Sterling Stock Liquidity. Sterling Stock Liquidity is regarded as a cost of doing business. It is not regarded as an operational liquidity pool as it will always be required in case of emergency. From an operational perspective, the HBOS Group will place greater reliance on market access to funding sources and the retention of a pool of diversified assets that can be sold in an efficient and discreet manner.

The funding capacity of the HBOS Group is dependent upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position. The HBOS Group Capital Committee assesses the HBOS Group funding mix to ensure that adequate diversity is maintained. It is HBOS Group policy to manage its balance sheet profile to ensure customer deposits sourced outside of HBOSTS represents a significant component of its overall funding, and the HBOS Group Funding and Liquidity Committee, a sub-committee of the HBOS Group Capital Committee, directs and co-ordinates the activities of the operating divisions in raising liabilities from a range of sources. Within HBOSTS, the HBOS Group avoids undue concentration by maintaining both a widespread mix of counterparties and inward credit lines and a core set of bank and non-bank depositor relationships providing a stable source of funding. The HBOS Group Capital Committee approves the appropriate balance of short to medium term funding (formerly delegated to the HBOS Group Asset & Liability Committee).

The HBOS Group has established a comprehensive Liquidity Contingency Planning Framework to identify liquidity stress situations at an early stage.

Risk Management (continued)

Insurance and Investment Risk

Insurance risk is the potential for loss from both life and general insurance contracts arising out of adverse claims, expense and persistency experience.

Investment risk is the potential for financial loss arising from the risks associated with the asset management activities of the HBOS Group. Investment risk includes market, credit and liquidity risks. The loss can be as a result of:

- Direct risks relating to changes in the value of HBOS Group assets in support of the general insurance and long term insurance contracts;
- Indirect risks arising from policyholder funds where the assets and policyholder liabilities are matched; and
- Indirect risks associated with the management of assets held on behalf of third parties.

The HBOS Group Insurance Risk Committee (formerly the HBOS Group Insurance and Investment Risk Committee), one of the Executive Risk Committees described above, considers regular reports on specified aggregate insurance risks across all of the HBOS Group's insurance and investment businesses. The Committee takes a technical and expert perspective on insurance risks within these businesses. It oversees the development, implementation and maintenance of the overall insurance risk management framework, covering insurance risk in each business individually, as well as in aggregate. As part of the overall HBOS Group risk management framework, the HBOS Group Insurance Risk Committee provides regular support to the HBOS Group Market Risk Committee and to the HBOS Group Credit Risk Committee on the inter-relationship between insurance risk and investment risks (market credit and liquidity risks respectively) arising within these businesses, and the development of appropriate policies and standards for the management of those risks.

The majority of the HBOS Group's long term insurance and investment contract liabilities are managed within the HBOS Insurance and Investment Division and Insight Investment with approximately only two per cent operated by the life businesses outside the UK. Day to day management of insurance and investment risk is undertaken both by divisional and business management supported by specialist risk functions. Use is made of the statutory actuarial roles, both to ensure regulatory compliance in respect of the authorised insurance companies in the HBOS Group and to meet HBOS Group standards in respect of the operation of comprehensive Insurance and Investment Risk Management frameworks.

Operational Risk

Operational risk is defined within the Basel Capital Accord as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". The definition includes legal risk but excludes strategic and reputational risk. Major sources of operational risk may 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 HBOS Group has recently revised its approach to align the definition to day-to-day management activity. The key enhancement is to focus on the explicit risk management of specialist areas that underpin the HBOS Group's operational risk framework. The four more material areas are Customer Risk, Information and IT Risk, Human Resources Risk and Financial Crime Prevention.

All specialist functions have clear roles defined to help lead the identification, management and measurement of risks relevant to their areas across the HBOS Group. The HBOS Group Operational Risk team defines the operational risk framework, co-ordinates the specialist areas, designs and maintains two group-wide operational risk systems and owns the modelling programme.

Each of the specialist areas is led by a HBOS Group Function which leads and co-ordinates a community of specialists in the divisions. The responsibilities of the HBOS Group specialists are laid down in the Board Control Manual and the revised operational risk approach reinforces and strengthens their roles.

The main components of the operational risk framework include regular risk and control assessment, internal loss reporting and capture of risk event information, key risk indicator monitoring and evaluation of external events. The HBOS Group specialist functions have a specific challenge and oversight role over the risk information generated through these components.

The HBOS Group Operational Risk Committee is one of the four Executive Risk Committees chaired by the HBOS Group Risk Director. It is attended by senior executives from the Divisions and HBOS Group specialist areas. The committee meets a minimum of six times a year to consider the management of cross HBOS Group issues and exposures, oversight of the operational risk communities, the HBOS Group's operational risk capital requirement and approval of policy and standards.

Directors' Report

The Directors have pleasure in presenting their Annual Report and Accounts for the year ended 31 December 2005.

Principal Activities

The principal activity of the group is the provision of financial services. The group's existing business, future prospects and key financial features are reviewed in the Business and Financial Review on pages 2 to 15. A list of the main subsidiary undertakings, and the nature of their business, is given in note 16 to the accounts on page 59.

Results and Dividends

The profit before tax for the year ended 31 December 2005 amounted to £2,546 million (year ended 31 December 2004 - £2,319 million).

An interim dividend of £230 million was paid in October 2005. The final dividend of £254 million in respect of the year ended 31 December 2004 was paid in March 2005. The Directors recommend payment of a final dividend of £467 million in respect of the year ended 31 December 2005.

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

The average number of days credit taken at 31 December 2005 by the group was 13 days.

Employees

The principal employer for UK based employees is HBOS plc. The group encourages applications for employment from disabled people and gives full consideration to such applicants based on their skills and abilities. In the event of an existing employee becoming disabled, counselling and training support is provided and a suitable alternative position within the group is sought if the individual is unable to continue in their previous role. The group offers training and career development for all disabled staff. The views of colleagues with a disability are sought through disability forums to ensure that the group's policies continue to recognise their requirements.

Directors

The current Directors are: James Crosby, Peter Cummings, Phil Hodkinson, Andy Hornby, Colin Matthew, together with the following Non-executive Directors: Charles Dunstone, Sir Ronald (Ron) Garrick, Anthony Hobson, Brian Ivory, Karen Jones, Coline McConville, Lord Stevenson (Governor), Katherine (Kate) Nealon and David Shearer.

Mark Tucker resigned as a Director on 24 March 2005, John Maclean retired as a Director on 27 April 2005 and George Mitchell retired as a Director on 31 December 2005.

James Crosby, Charles Dunstone and Andy Hornby will retire by rotation at the 2006 AGM and resolutions for their re-election will be proposed at the meeting. Lord Stevenson and Sir Ron Garrick retire annually and resolutions for their re-election will be proposed at the 2006 AGM.

Peter Cummings and Karen Jones were appointed Directors from 1 January 2006 and 24 January 2006 respectively. Both will retire at the forthcoming 2006 AGM and offer themselves for election.

Details of Directors' interests in the shares of the group are disclosed in the appendix to this report.

Directors' Report (continued)

Charitable and Other Donations

Charitable donations by the group in the UK during the year amounted to £nil.

Going Concern

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.

Share Capital

Full details of the movements in the issued share capital during the year are provided in note 29 to the Accounts on page 70.

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.

Corporate Governance and Directors' Remuneration

No separate report on corporate governance or Directors' remuneration is presented here as the group follows the principles of good governance set out in the Combined Code, full details of which are contained in the Report and Accounts of HBOS plc, the Bank's ultimate parent undertaking.

Auditors

A resolution to re-appoint KPMG Audit Plc as auditors will be put to Shareholders at the forthcoming Annual General Meeting.

On behalf of the Board

H F Baines

Company Secretary

28 February 2006

Appendix To Directors' Report

Directors Share Interests

1. Shares

The beneficial interests of the Directors and their immediate families in the ordinary shares of HBOS plc are set out below:

Table 1	**Number of shares at 31 December 2005**	Number of shares at 31 December 2004
Governor		
Dennis Stevenson	**301,006**	221,726
Executive Directors		
James Crosby	**284,758**	279,407
Phil Hodkinson	**207,648**	112,919
Andy Hornby	**496,780**	252,640
Colin Matthew	**213,445**	88,032
George Mitchell	**202,233**	90,562
Non-Executive Directors		
Charles Dunstone	**100,000**	100,000
Sir Ronald Garrick	**23,268**	19,611
Anthony Hobson	**6,500**	6,500
Brian Ivory	**7,000**	7,000
Coline McConville	**5,320**	2,070
Kate Nealon	**12,879**	8,198
David Shearer	**10,000**	10,000

Notes to Table 1

Note 1:

James Crosby, George Mitchell and Brian Ivory now have no interest as at 31 December 2005 over ordinary shares of the HBOS Group (2004 - 2,217,507) as Trustees of the Bank of Scotland Profit Sharing Stock Ownership Scheme. Brian Ivory has a non-beneficial interest over 4,500 ordinary shares (2004 - 4,500).

Note 2:

Certain Directors may obtain further interests in the ordinary shares of the HBOS Group as a result of short term incentive plans and the long term incentive plans as set out in Tables 2, 3, 4, 5 and 6.

Note 3:

No Director had any interest in the preference shares of HBOS or in the loan or share capital of any HBOS Group undertaking at the beginning or during or at the end of the financial year. No options to subscribe for shares in other HBOS Group companies are granted to Directors of the HBOS Group.

Neither James Crosby nor Phil Hodkinson, who were both Non-executive Directors of St James's Place Capital plc during 2005, nor their immediate families, had any interest in the ordinary shares of that company throughout 2005. Phil Hodkinson resigned as a Non-executive Director with effect from 22 July 2005.

Note 4:

There has been no change in the share interests as set out in the table between the end of the financial year and 28 February 2006, the date of approval of this Annual Report and Accounts.

Appendix to Directors' Report (Continued)

2. Short-Term Incentive Plans – HBOS Directors

Certain Executive Directors have conditional entitlements to shares arising from the annual incentive sharekicker. Where the annual incentive for 2002 and/or 2003 and/or 2004 and/or 2005 was taken in shares and these shares are retained in trust for three years, additional shares may also be transferred to the Directors. The basic shares shown below which vested in 2005 are also included in Table 1. The additional shares shown below arise as a result of sharekicker.

Table 2	Grant	At 31 December 2004		Granted in year			At 31 December 2005	
	effective from	Basic shares	Additional shares	Basic shares	Additional shares	Released in year	Basic shares	Additional shares
James Crosby	March 2002	38,671	19,335			58,006	-	-
	March 2003	32,177	16,088				32,177	16,088
	March 2004	24,850	12,425				24,850	12,425
	March 2005			38,458	19,229		38,458	19,229
		95,698	47,848				95,485	47,742
Phil Hodkinson	March 2002	10,327	5,163			15,490	-	-
	March 2003	18,282	9,141				18,282	9,141
	March 2004	12,826	6,413				12,826	6,413
	March 2005			20,511	10,255		20,511	10,255
		41,435	20,717				51,619	25,809
Andy Hornby	March 2002	23,525	11,762			35,287	-	-
	March 2003	21,939	10,969				21,939	10,969
	March 2004	18,437	9,218				18,437	9,218
	March 2005			28,436	14,218		28,436	14,218
	April 2005			141,826	70,913		141,826	70,913
		63,901	31,949				210,638	105,318
Colin Matthew	March 2002	11,384	5,692			17,076	-	-
	March 2003	18,282	9,141				18,282	9,141
	March 2004	12,505	6,252				12,505	6,252
	March 2005			20,511	10,255		20,511	10,255
		42,171	21,085				51,298	25,648
George Mitchell	March 2002	14,035	7,017			21,052	-	-
	March 2003	23,889	11,944				23,889	11,944
	March 2004	17,315	8,657				17,315	8,657
	March 2005			26,338	13,169		26,338	13,169
		55,239	27,618				67,542	33,770

Notes to Table 2

Note 1:

Shares under these plans were granted using the market price at the date of grant, as follows:

Plan	Share Grant Price
	£
March 2002 – March 2005	7.68
March 2003 – March 2006	6.76
March 2004 – March 2007	7.36
March 2005 – March 2008	8.19
April 2005 – April 2008	8.32

Note 2:

Shares will be released after three years, subject to the basic shares still being held and subject to the participant still being in the HBOS Group's employment at that time or being a qualifying leaver.

Note 3:

Because the basic shares are shown net of each participant's original income tax and National Insurance liability, the additional incentive shares are shown in a like manner. Those released in 2005 represented the basic shares purchased by the Director's own annual cash incentive in March 2002 plus the additional shares.

Note 4:

Following his retirement on 31 December 2003, Gordon McQueen retains interests under the short term incentive plan through grants of basic and additional shares of 18,406 and 9,203, respectively (effective from March 2003) and 17,128 and 8,564, respectively (effective from March 2004). These remain subject to the same plan rules as apply to existing Executive Directors.

Following his retirement on 31 December 2004, Mike Ellis retains interests under the short term incentive plan through grants of basic and additional shares of 23,889 and 11,944, respectively, (effective from March 2003), 17,315 and 8,657, respectively, (effective from March 2004) and 34,069 and 17,034, respectively, (effective from March 2005). These remain subject to the same plan rules as apply to existing Executive Directors.

Appendix to Directors' Report (Continued)

3. Long-term Incentive Plan and Special Long-term Bonus Plan – HBOS Directors

Details of the shares which have been conditionally awarded to Executive Directors and the Governor under these plans are set out below. The performance conditions relating to these conditional awards are set out in the notes below the table.

Table 3	Grant effective from	At 31 Dec 2004	Granted (G) or lapsed (L) in year	Added as a result of performance	Dividend reinvestment shares	Vested in year	At 31 Dec 2005
James Crosby	January 2002	75,000		75,000	22,606	172,606	-
	January 2003	103,125					103,125
	January 2004	108,089					108,089
	January 2005		98,214(G)				98,214
		286,214					309,428
Andy Hornby	January 2002	45,625		45,625	13,752	105,002	-
	January 2002	260,000	19,616(L)			240,384	-
	January 2003	70,312					70,312
	January 2004	80,195	-				80,195
	January 2005		72,619(G)				72,619
		456,132					223,126
Phil Hodkinson	January 2002	87,500		87,500	26,372	201,372	-
	January 2003	58,593					58,593
	January 2004	55,788					55,788
	January 2005		52,380(G)				52,380
		201,881					166,761
Colin Matthew	January 2002	45,625		45,625	13,752	105,002	-
	January 2003	58,593					58,593
	January 2004	54,393					54,393
	January 2005		52,380(G)				52,380
		158,611					165,366
George Mitchell	January 2002	56,250		56,250	16,954	129,454	-
	January 2003	76,562					76,562
	January 2004	75,313					75,313
	January 2005		67,261(G)				67,261
		208,125					219,136
Dennis Stevenson	January 2002	56,250		56,250	16,954	129,454	-
	January 2003	77,343					77,343
	January 2004	73,221					73,221
	January 2005		65,476(G)				65,476
		206,814					216,040

Appendix to Directors' Report (Continued)

Notes to Table 3

Note 1:

Shares under these plans, other than in relation to the second grant effective from January 2002 for Andy Hornby, were granted using the average market price in the ten business days ending at the previous year, as follows:

Plan and Performance Period	Share Grant Price £
January 2002 – December 2004/06	8.00
January 2003 – December 2005/07	6.40
January 2004 – December 2006	7.17
January 2005 – December 2007	8.40

Note 2:

The grant effective from January 2002 for Phil Hodkinson, over shares having a value equal to 200 per cent of salary, was necessary to facilitate his recruitment in September 2001. The normal grant level would have been 100 per cent of salary.

Following his leaving on 7 May 2005, all Mark Tucker's interests under the plan lapsed.

Following his retirement on 31 December 2003, Gordon McQueen retains interests under the plan through a grant of 61,718 shares effective from January 2003. These remain subject to the same plan rules as apply to existing Executive Directors.

Following his retirement on 31 December 2004, Mike Ellis retains interests under the plan through grants of 76,562 and 75,313 shares effective from January 2003 and January 2004, respectively. These remain subject to the same plan rules as apply to existing Executive Directors.

Note 3:

Awards are not pensionable.

Note 4:

The performance period for the January 2002 grant ended on 31 December 2004. HBOS's TSR over the performance period exceeded the weighted average of the comparator group by 7.44 per cent p.a. so a maximum 200 per cent of share grants have been released to grant recipients. Without a maximum payout limit of 200 per cent, the plan would have released 248 per cent of share grants. The shares granted in January 2002 vested on 3 March 2005. The closing market price of the HBOS Group's ordinary shares on that date was £8.3175. In addition, dividend reinvestment shares have been released to grant recipients as set out in the table and as provided for under the rules of the plans. The dividend reinvestment shares are the additional shares which would have accrued on the overall share grants actually released had dividends due during the performance period been reinvested in shares.

Note 5:

Subject to performance, the shares granted under the long term plan effective from January 2003 will be released to most individuals shortly after the three-year anniversary of the grant date.

Note 6:

As explained in last year's report, for the 2002 and 2003 grants, all participants could or can choose to take any shares released after three years based on the three-year performance outcome or could or can continue to participate in the plan for a further two years and take shares at that point based on the better of the three-year and the five-year performance outcomes. This design feature seeks to motivate participants continually to sustain strong performance or to improve lesser performance for their benefit and the benefit of shareholders. This feature does not apply for the 2004 grants and does not apply for any grants in subsequent years, to reflect the preference on "retesting" expressed by most major institutional investors. As the outcome for the 2002 grant was at the 200% per cent maximum level all Executive Directors chose to take their 2002 grants in 2005 based on that three year performance outcome.

Note 7:

In the case of the Governor, it is not possible to include him in the standard Long Term Incentive Plan. Nor is it possible to include him in such an arrangement where the grant is denominated in shares. He is therefore included as the sole participant in the Special Long Term Bonus Plan where the grants are awards of notional shares. He will become entitled to the cash value of any notional shares on vesting but has agreed that this value will, subject to any withholdings for income tax or National Insurance, be applied in acquiring shares in HBOS plc on his behalf.

Appendix to Directors' Report (Continued)

Note 8:

The number of shares to be released to participants is dependent on the HBOS Group's TSR over a three year period, compared to the annualised weighted average TSR of a basket of comparator companies over an equivalent period. For the grants effective from January 2002 and January 2003, a five year period could or can also apply. This basket of companies comprises:

- for the January 2002, 2003 and 2004 grants: Abbey National, Aviva, Barclays, Legal & General, Lloyds TSB, Prudential, Royal & Sun Alliance and Royal Bank of Scotland, but with Abbey National replaced by Alliance & Leicester, Bradford & Bingley and Northern Rock with effect from 1 July 2004. The Committee decided to remove Abbey National from the comparator group, in respect of the January 2002, 2003 and 2004 grants, effective from the end of June 2004 (immediately before bid activity started);and replace it with Alliance & Leicester, Bradford & Bingley and Northern Rock effective from the start of July 2004;
- for the January 2005 and subsequent grants: Alliance & Leicester, Aviva, Barclays, Bradford & Bingley, Legal & General, Lloyds TSB, Northern Rock, Prudential, Royal & Sun Alliance and Royal Bank of Scotland.

Shares have been or will be released as follows:

HBOS Group's relative TSR performance 2002, 2003, 2004 and 2005 grants	Amount released as a % of share grant
0% pa (or below)	0
+3% pa	100*
+6% pa (or above)	200

Intermediate positions are determined by interpolation.

* Shown as granted in the table.

Note 9:

The performance period for the January 2003 grant ended on 31 December 2005. HBOS's TSR over the performance period exceeded the weighted average of the comparator group by 5.49 per cent p.a., so 183 per cent of share grants will be released to grant recipients, subject to note 6 above.

In addition, dividend reinvestment shares will be released to grant recipients as provided for under the rules of the plans. The dividend reinvestment shares are the additional shares which would have accrued on the overall share grants actually released had dividends due during the performance period been reinvested in shares.

Full details concerning these shares, which will be released to the Governor and the Executive Directors in March 2006, will be set out in the 2006 Annual Report and Accounts.

The performance periods for the January 2004 and January 2005 grants do not end until 31 December 2006 and 31 December 2007, respectively. So far, HBOS's TSR over the two year and one year elapsed periods exceeds the weighted average of the comparator group by 15.13 per cent and 8.08 per cent, respectively.

Note 10:

The second grant effective from January 2002 for Andy Hornby relates to a different arrangement which applies only to him based on terms as set out in last year's report.

The performance criteria under the arrangement were satisfied and 240,384 shares were released to Andy Hornby at a market price of £8.32 in April 2005. In accordance with the rules of the special incentive arrangement, Andy Hornby has elected to invest the net amount of shares after tax and National Insurance deductions (141,826 shares) in sharekicker as set out in Table 2.

The 50 per cent sharekicker enhancement will be released if Andy Hornby retains the shares and remains in the service of the HBOS Group until 31 March 2008 (or ranks as a qualifying leaver before that date).

Appendix to Directors' Report (Continued)

4. Long Term Incentive Plan - Former Bank of Scotland Directors

All share options under Bank of Scotland's plans are exercisable in accordance with the rules of the plans, any performance targets having been satisfied, as set out in last year's report.

No further share options have been or will be granted under any of these plans.

Details of the options outstanding under the plans in respect of Executive Directors are set out below:

Table 4	Grant effective from	At 31 Dec 2004	Granted (G), exercised (E) or lapsed (L) in year	At 31 Dec 2005	Share option price	Exercisable
Colin Matthew	October 1995	48,000	48,000(E)	-	2.5983	
	October 1996	50,000		50,000	2.7367	January 2006 – October 2006
	October 1997	28,000		28,000	5.3533	January 2006 – October 2007
	October 1998	5,223		5,223	5.7433	January 2006– October 2008
	October 1998	29,777		29,777	5.835	January 2006– October 2008
	May 2000	40,000		40,000	5.515	January 2006– May 2010
	October 2000	40,000		40,000	6.1	January 2006– October 2010
		241,000	48,000	193,000		
George Mitchell	October 1996	50,000		50,000	2.7367	January 2006– June 2006
	October 1997	35,000		35,000	5.3533	January 2006– June 2006
	October 1998	40,000		40,000	5.835	January 2006– June 2006
	May 2000	5,572		5,572	5.3833	January 2006– June 2006
	May 2000	39,428		39,428	5.515	January 2006– June 2006
	October 2000	50,000		50,000	6.1	January 2006– June 2006
		220,000		220,000		

Notes to Table 4

Note 1:

No Executive Director's share options lapsed in the period 1 January 2006 to 28 February 2006, the date of approval of this Annual Report and Accounts.

Note 2:

On 11 August 2005, Colin Matthew exercised options over 48,000 shares granted effective from 17 October 1995. The closing market price of the HBOS Group's ordinary shares on the date of exercise was £8.905.

Note 3:

Details of the market price of the HBOS Group's ordinary shares during 2005 are given in section 8.

5. Sharesave Plan

The sharesave plan is available to all UK based HBOS Group colleagues.

The plan allows colleagues to save a fixed amount of money on a monthly basis. At the end of a pre-determined period, of three, five or seven years, colleagues have the right, if they so choose, to use the funds accumulated to purchase shares in the HBOS Group at a fixed price, based on a market price or an average market price determined shortly before the effective grant date and discounted by up to 20 per cent. There are no performance conditions.

Appendix to Directors' Report (Continued)

Certain Executive Directors have taken up membership of the plan and the projected numbers of shares which they would be entitled to purchase at the end of the relevant pre-determined periods are set out below:

Table 5	Grant effective from	At 31 Dec 2004/ 1 Jan 2005	Granted (G), exercised (E) or lapsed (L) in year	At 31 Dec 2005	Initial exercise date	Expiry date
James Crosby	September 2002	2,748		2,748	January 2008	June 2008
Phil Hodkinson	September 2002	2,970		2,970	January 2010	June 2010
Andy Hornby	September 2003	1,607		1,607	January 2007	June 2007
George Mitchell	October 2001	1,723	1,723(E)		January 2005	June 2005
	September 2004	1,740		1,740	January 2006	June 2006

Notes to Table 5

Note 1:

Options under these plans were granted using market prices shortly before the dates of the grants, discounted by 20 per cent, as follows:

Effective date of grant	Share Option Price £
October 2001	5.62
September 2002	5.975
September 2003	5.74
September 2004	5.443

Note 2:

On 2 February 2005, George Mitchell exercised options over 1,723 shares granted effective from October 2001. The closing market price of the HBOS Group's ordinary shares on the date of exercise was £8.57.

Note 3:

Details of the market price of the HBOS Group's ordinary shares during 2005 are given in section 8.

Appendix to Directors' Report (Continued)

6. Free Share Plan

The free share plan is available to most HBOS Group colleagues.

The plan grants colleagues free shares on an annual basis. At the end of three years, shares are transferable to colleagues, subject to the participants still being in the HBOS Group's employment at that time or earlier if they are a qualifying leaver. Shares must be held in trust for five years to qualify for full tax and National Insurance benefits. There are no performance conditions.

All Executive Directors have taken up membership of the plan and the projected number of shares which they would be entitled to at the end of the relevant period are set out below:

Table 6

	Grant effective from	At 31 Dec 2004/ 1 Jan 2005	Granted (G), releases (R), lapsed (L), in year	Dividend reinvestment shares acquired in year	At 31 Dec 2005	Grant releasable
James Crosby	August 2005	-	329 (G)	4	333	August 2008
Andy Hornby	August 2005	-	329 (G)	4	333	August 2008
Phil Hodkinson	August 2005	-	329 (G)	4	333	August 2008
Colin Matthew	August 2005	-	329 (G)	4	333	August 2008
George Mitchell	August 2005	-	329 (G)	4	333	August 2008

Notes to Table 6

Note 1:

Shares were awarded at £9.10, the middle market price of the HBOS Group's ordinary shares on the day preceding the date of award.

Note 2:

Participants in this plan have an interest in dividends on the free shares (in the form of dividend shares) as and when they become due. Dividends were paid on 7th October 2005 and were reinvested in shares. The middle market price of the HBOS Group's ordinary shares on that date was £8.50. Dividend reinvestment shares are required to be held for three years from the date of payment.

Note 3:

George Mitchell, who retired as an Executive Director on 31 December 2005 has, as required under the rules of the Free Shares Plan, requested the release of those 333 shares held in trust on his behalf.

The closing market price on the date of release was £10.36.

George Mitchell retained ownership of these shares as at 28 February 2006, the date of approval of this Annual Report and Accounts.

Note 4:

Details of the market price of the HBOS Group's ordinary shares during 2005 are given in section 8.

Appendix to Directors' Report (Continued)

7. Interest in Shares under Trusts

Certain Executive Directors, together with certain other colleagues, are deemed to have or have had an interest or a potential interest as potential discretionary beneficiaries under:

- the HBOS Group's Employee Share Ownership Trusts. As such, they were each treated as at 31 December 2005 as being interested in the 276,879 ordinary shares (31 December 2004 - 5,298,695 ordinary shares) held by the trustees of these Trusts. The shares held in the Trust will be used to satisfy share awards under the Short Term and Long Term Incentive Plans. The relevant Executive Directors' specific individual interests are shown in Tables 2 and 3;
- the HBOS Group's Qualifying Employee Share Ownership Trust. As such, they were each treated as at 31 December 2005 as being interested in the 3,167,458 ordinary shares (31 December 2004 – 8,260,555 ordinary shares) held by the trustee of this Trust. The shares held in the Trust will be used to satisfy entitlements of colleagues arising on the exercise of options under the Sharesave Plan. The relevant Executive Directors' specific individual interests are shown in Table 5; and
- the HBOS Group's Share Incentive Plan Trust. As such, they were each treated as at 31 December 2005 as being interested in the 7,129,501 ordinary shares (31 December 2004 – 0 ordinary shares) held by the trustees of this Trust. The shares held in the Trust will be used to satisfy share awards under the Free Share Plan. The relevant Executive Directors' specific individual interests are shown in Table 6.

All of the HBOS Group's share plans empower new issue shares to be allotted to satisfy share requirements. The HBOS Group's past practice has generally been to purchase shares in the market in relation to the plans described in sections 2 and 3 and to issue new shares in relation to the plans described in sections 4 and 5 and the HBOS Group's share option scheme. This practise was reviewed in 2005 and, as a consequence, purchased shares were also used to satisfy awards under the plan described in section 6 and, to a large extent, in relation to the plan described in section 5 and the HBOS Group's share option scheme. The method by which share plan requirements are satisfied will again be reviewed in 2006 and any changes to the 2005 practise will be set out in the Annual Report and Accounts 2006.

8. General

The closing market price of the HBOS Group's ordinary shares at 31 December 2005 was £9.93. The closing market price of the HBOS Group's ordinary shares at 31 December 2004 was £8.48. The range during the year was £7.725 to £9.93.

There has been no change in the Directors' interests in shares or options granted by the HBOS Group between the end of the financial year and 28 February 2006, the date of approval of this Annual Report and Accounts.

Statement of Directors' Responsibilities in Respect of The Annual Report and The Financial Statements

The Directors are responsible for preparing the Annual Report and Accounts and the group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare group and parent company financial statements for each financial year. They are required to prepare the group financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the EU 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 IFRS as adopted by the EU to fairly present 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 IFRS 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 and regulations, the Directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and the Corporate Governance Statement that comply with that law and those regulations.

Independent Auditors' Report To The Shareholders of Bank of Scotland

We have audited the financial statements of Bank of Scotland group for the year ended 31 December 2005 which comprise the Consolidated Income Statement, the Consolidated and Bank Balance Sheets, the Consolidated and Bank Statements of Recognised Income and Expense, the Consolidated and Bank Cash Flow Statements 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 shareholders, 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 shareholders 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 and Accounts and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 28.

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 are properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the company 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 other information contained in the Annual Report and Accounts 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 judgments made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company'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 financial statements:

- give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the group and Bank's affairs as at 31 December 2005 and of the group's and Bank's profits for the year then ended; and
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

KPMG Audit Plc

Chartered Accountants

Registered Auditor

Edinburgh

28 February 2006

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Accounting Policies

Statement of Compliance

The 2005 statutory consolidated financial statements set out on pages 36 to 97 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS").

The Standards adopted by the group and Bank are those endorsed by the European Union and effective at the date the consolidated IFRS financial statements were approved by the Board.

These are the group's and Bank's first consolidated financial statements prepared in accordance with IFRS. An explanation of how the transition has affected the reported financial position of the group is provided in notes 48 to 52.

The consolidated accounts 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

The consolidated financial statements have been prepared under the historical cost basis, except that the following assets and liabilities are stated at their fair values; derivative financial instruments, 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.

Exemptions on First-time Adoption of IFRS

The group has adopted the following exemptions set out in IFRS 1, 'First-time Adoption of International Financial Reporting Standards'.

Business Combinations

IFRS 3, 'Business Combinations' has not been applied retrospectively to business combinations that occurred before 1 January 2004. Accumulated amortisation on goodwill arising before 1 January 2004 has not therefore been reversed.

Employee Benefits

All cumulative actuarial gains and losses to 1 January 2004 have been recognised in equity at 1 January 2004.

Translation Differences

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 shall exclude translation differences that arose before 1 January 2004, but include later translation differences.

Adopted IFRS not yet applied

IFRS 7 'Financial instruments: Disclosure' applicable for years commencing on or after 1 January 2007 has not been applied. The application of IFRS 7 in 2005 would not have affected the balance sheet or income statement as the standard is concerned only with disclosure.

2004 Comparative Information

Using the exemptions within IFRS 1, IAS 32, IAS 39 and IFRS 4 only became effective from 1 January 2005. Where the implementation of these standards resulted in a change in accounting policy from 1 January 2005, the 2004 comparatives do not reflect the provisions of these standards. The policy applied in respect of such 2004 comparative information has been set out at the end of this section on page 35 (under the heading "2004 Accounting Policies") The related 2005 policy has been annotated with an asterisk in the heading to indicate the change in policy. Where there is no asterisk, the 2005 policy has been applied consistently to both periods presented in the accounts.

Basis of Consolidation

The consolidated financial statements include the results of the Bank and its subsidiary undertakings, together with the group's interest in associates and jointly controlled entities.

Subsidiaries

Subsidiaries and special purpose entities are entities controlled by the group. Control is defined where the group has power, directly or indirectly, to govern the financial and operating policies of such entities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. The financial statements of such entities are consolidated within the group financial statements until the date control ceases.

Associates and Jointly Controlled Entities

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.

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

The attributable share of results of associated undertakings 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.

Trading Portfolio

The group uses trade date accounting when recording trading portfolio transactions.

Derivatives*

Derivatives are initially recognised at fair value on the date the contract is entered into and are subsequently remeasured at their fair value. 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 on remeasurement to fair value at the balance sheet date is taken to the income statement. The only circumstance where this will not apply is 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 must be 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 on an ongoing basis. Broadly a hedge is regarded as effective if the change in fair value or cash flows of the hedge and the hedged item are correlated within a range of 80 per cent to 125 per cent either for the period since effectiveness was last tested or cumulatively since inception.

The group uses three hedge accounting methods.

Firstly, fair value hedging measures the change in the fair value of the derivative against the offsetting changes in the fair value of the hedged item in respect of the risk being hedged. These changes in fair value are recognised through the income statement. If this hedge is highly effective then the net impact on the income statement is minimised.

Secondly, cash flow hedging 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 the derivative is recognised directly in equity and the hedged item is accounted for in accordance with the policy for that financial instrument. Any ineffective part of any gain or loss is recognised immediately in the income statement.

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

In circumstances where the hedge relationship proves ineffective or is terminated then any associated gains and losses that were recognised directly in reserves are reclassified in the income statement in the same period or periods during which the asset acquired or liability assumed affects profit or loss.

Accounting Policies (continued)

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 respect of cash flow hedges, the amount deferred in reserves will either remain in equity until the designated transaction occurs or, if not expected to occur, be recognised in the income statement.

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 on balance sheet at fair value. Movements in fair value are posted to the income statement, whilst the host contract is accounted for according to the policy for that class of financial instrument.

Loans and Advances*

Loans and advances are held at amortised cost less provision for impairment.

The group will assess impairment individually for financial assets that are significant and individually or collectively for assets that are not significant.

Individual impairment is identified at a counterparty specific level following objective evidence that a financial asset is impaired. This may be after an interest or principal payment is missed or when a banking covenant is breached. The present value of estimated cash flows recoverable is determined after taking into account any security held. The amount of any impairment is calculated by comparing the present value of the cash flows discounted at the loan's original effective interest rate with the balance sheet carrying value. If impaired, the carrying value is adjusted and the difference charged to the income statement.

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 receivable within the income statement and represents the unwinding of the discount.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established provisions for impairment or directly to the income statement.

In circumstances where an asset has been individually assessed for impairment and no objective evidence of impairment exists, then it will be subject to a collective assessment.

Collective impairment is identified 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.

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 were acquired by special purpose securitisation companies that fund their purchase primarily through the issue of floating rate notes. These floating rate notes are accounted for as debt securities in issue on the balance sheet.

Finance Leases, Instalment Credit and Operating Leases

Assets leased to customers that transfer substantially all of the risks and rewards incidental to ownership to the customer are classified as finance leases. Together with instalment credit agreements, 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 net investment method (before tax), which reflects a constant periodic rate of return.

All other assets leased to customers are classified as operating leases. These assets are separately disclosed in the balance sheet and are recorded at cost less aggregate depreciation, which is calculated on a straight-line basis. Operating lease rentals are recognised in operating income on a straight-line basis over the lease term. Operating lease assets are reviewed for impairment when there is an indication of impairment.

Investment Securities *

Investment securities held for trading are carried at fair value with income taken to net trading income as they arise. Investment securities designated at fair value through the income statement are carried at fair value with income taken to other operating income.

Debt securities for which there is no active market are classified as loans and receivables and carried on the balance sheet at amortised cost less provision for impairment, with income recognised on an effective interest rate basis.

All other investment securities are classified as available for sale. They are carried on the balance sheet at fair value with unrealised gains or losses being recognised directly through reserves, except for impairment losses or foreign exchange gains or losses, which are recognised immediately in the income statement.

The group uses settlement date accounting when recording the purchase and sales of investment securities.

On sale or maturity previously unrealised gains and losses are recognised in other operating income.

Impairment losses in respect of investments in equity instruments classified as available for sale 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 direct 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.

Income on available for sale debt securities is recognised on an effective interest rate basis and taken to interest receivable through the income statement. Income from available for sale 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.

Repurchase Agreements

Debt 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 or customer accounts. Conversely, debt 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 or loans and advances to customers. 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.

Intangible Assets

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 subsidiary undertakings, associated undertakings (including jointly controlled entities) and other businesses, is capitalised as goodwill.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill carried in the consolidated balance sheet is subject to a six monthly impairment review by comparing the 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 by the amount of any impaired loss identified.

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, will generate future economic benefits and there is an ability to use or sell the asset.

Accounting Policies (continued)

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 depreciation 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 and Equipment

Property 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 with unexpired lease terms of fifty years or less 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 fifteen 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, which are defined as properties which are held either to earn rental income or for capital appreciation or both, are initially recognised at cost and are fair valued annually. Any gains or losses arising from a change in the fair value are recognised in the income statement in the period that they occur. Investment properties are not depreciated.

Taxation

Income tax on the profit and 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.

Deferred tax is provided using the Balance Sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided: goodwill not deductible for tax purposes, the initial recognition of assets and liabilities that affects neither accounting or taxable profit and differences relating to investments in subsidiaries to the extent that they will probably 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, using tax rates at the balance sheet date.

Employee Benefits

The group has both defined benefit and defined contribution schemes.

Defined Contribution Schemes

Obligations for contributions to defined contribution pension schemes are recognised as an expense in the income statement as incurred.

Defined Benefit Schemes

The group's net obligation in respect of defined benefit pension plans is calculated separately for each plan. The net obligation represents the present value of the future benefits owed to employees in return for their service in the current and prior periods, after the deduction of the fair value of any plan assets. The discount rate used is the market yield on high quality corporate bonds at the balance sheet date that have maturity dates approximating to the terms of the group's obligation. The calculation is performed by a qualified actuary using the projected unit credit method. Actuarial gains and losses arising are taken directly to reserves in the period in which they are incurred. The charge to the income statement includes current service cost, past service cost, the interest cost of the scheme liabilities and the expected return on scheme assets.

Share Based Compensation

The group operates various equity-settled, share-based compensation schemes in exchange for employee services received. The fair value of options or shares granted is determined at the date of grant and expensed over the vesting period. The fair value of the options or shares granted are measured using various models, taking into account the terms and conditions upon which the options and shares were granted. At each balance sheet date the group revises its estimate of the number of options or conditional awards that it expects to be exercised and spreads any adjustments required to the income statement over the vesting period except for those which relate to a market condition.

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.

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 payable.

Preferred securities are classified as debt where interest payments are not discretionary. The interest payable on such securities is recognised in the income statement through interest payable.

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

Collateral and Netting*

Assets and liabilities are shown net where there is a legal right of offset and there is an intention and ability to settle on a net basis. The group nets loans, deposits and derivative transactions where it enters into master agreements with counterparties where there is an intention and ability to settle net.

Foreign Currencies

The consolidated financial statements are presented in Sterling which is the Company's functional and presentation currency.

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

Exchange gains and losses arising from the translation at balance sheet date exchange rates of monetary assets and liabilities are recognised in net trading income.

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;
- 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

Accounting Policies (continued)

the transaction dates, in which case income and expenses are translated at the dates of the transactions); and

- all resulting exchange differences are recognised as a separate component of reserves.

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 reserves 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.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

Cash and Cash Equivalents

Cash and cash equivalents are held for the purpose of meeting short term cash commitments rather than investing or other purposes. Cash and cash equivalents consist of cash and balances with central banks that are freely available and financial assets held for trading.

General Insurance Business

The group underwrites general insurance products. For each general insurance policy underwritten, premiums (net of refunds) are credited to net operating income over the duration of the insurance policy.

The cost of claims notified but not settled and claims incurred but not reported at the balance sheet date are estimated and provided for. Estimates are based upon an assessment of the likely costs taking account of all known facts. Where the outcome of outstanding cases is unclear, statistical techniques are used which take into account the cost of recent similar claim settlements.

Assets held and managed in support of the general insurance business are designated at fair value through the income statement.

Long Term Assurance Business*

Product Classification

The group has classified its Long Term Assurance Business in accordance with IFRS 4 ‘Insurance Contracts’ as follows:

- Insurance contracts – contracts containing significant insurance risks.
- Investments contracts with a discretionary participation feature (“DPF”) – contracts that do not contain significant insurance risk but that contain discretionary participation features, which are with-profits contracts.
- Investment contracts – contracts that have neither significant insurance risk nor a discretionary participation feature.

Insurance Contracts and Investment Contracts with DPF

Insurance contracts and investment contracts with DPF relating to both traditional and unitised with profits contracts are calculated with reference to the expected payout using realistic and where applicable market consistent assumptions.

In the case of the former, premiums are recognised as revenue when due from the policyholder and claims payable are recorded as claims when due. In the case of the latter, deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability.

Insurance contract liabilities for contracts without DPF are calculated in accordance with the Prudential Sourcebook for Insurers (“PRU”) issued by the UK financial Services Authority. These are adjusted to remove excessively prudent closure provisions and certain other reserves required under the PRU rules. Premiums are recognised as revenue when due from the policyholder. Claims are the estimated cost of all claims arising during the period. Estimates are based upon an assessment of the likely costs taking account of all known facts.

The accounting policies set out above in respect of the measurement of the policyholder liabilities include liability adequacy testing that meet or exceed the requirements of IFRS 4.

Investment Contracts

The group’s investment contracts, which include collective investment schemes, are primarily unit-linked. The liability is measured at fair value, which is estimated using a valuation technique. In accordance with this technique the liability is established as the bid value of the assets held to match the liability, less an allowance in relation to deductions made to the liability for capital gains tax on the gains relating to the matching assets. Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability with other changes recognised in the income statement.

Revenue in relation to investment management services is recognised as the services are provided. Transaction costs (including commissions paid to intermediaries and other incremental, direct costs related to the acquisition of contracts) are capitalised as deferred origination costs (“DOC”) and amortised as the related revenue is recognised.

Investment contracts acquired in business combinations and portfolio transfers are accounted for as described in the accounting policy for intangible assets.

Long Term Assurance Business Assets

Assets held and managed in support of the Long Term Assurance Business liabilities are designated at fair value through profit and loss. Interest, dividends, foreign exchange gains and losses, and fair value movements including movement on derivatives on those assets are recorded in other operating income.

Effective Interest Rate*

Revenue on financial instruments classified as loans and receivables, available for sale, or financial liabilities at amortised cost, is recognised on an effective interest rate basis. This calculation takes into account interest received or paid, fees and commissions paid or received that are integral to the yield as well as incremental transaction costs. The effective interest rate is the rate that discounts the expected future cash flows over the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or liability at initial recognition.

Accounting Policies (continued)

2004 Accounting Policies

The 2004 comparatives do not reflect the provisions of the standards in respect to IAS 32, IAS 39 and IFRS 4. The policies applied in respect of the 2004 comparative information have been set out below. These policies are in addition to those identified on pages 31 to 34 where the 2005 policy has been applied consistently to both periods presented in the accounts.

Derivatives

Derivative financial instruments used for trading and non-trading purposes include interest rate swaps, cross currency swaps, futures, options, forward rate agreements and caps, floors and collars.

Trading derivatives, which include customer driven and proprietary transactions and hedges thereof, are carried in the accounts at fair value with gains or losses included in net trading income. The fair value is based on quoted market prices. Where representative market prices are not available, the fair value is determined from appropriate financial models using the actual or modelled cash flows. Fair value adjustments are made, where appropriate, to cover credit risk, liquidity risk and future administrative costs.

Non-trading derivatives, which are used primarily as a risk management tool for hedging interest rate and foreign exchange rate risk arising on on-balance sheet assets and liabilities, are accounted for on the same basis as the underlying items being hedged.

In order to qualify as a hedge, a derivative must effectively reduce any risk inherent in the hedged item from potential movements in interest rates, exchange rates and market values. Changes in the fair value of the derivative must be highly correlated with changes in the fair value of the underlying hedged item over the life of the hedged contract. Gains and losses on instruments used for hedging purposes are not recognised until the exposure that is being hedged is itself recognised. Where a hedge transaction is terminated early, any profit or loss is spread over the remainder of the original life of the hedge contract. In other circumstances, where the underlying item subject to the hedge is extinguished, the hedge transaction is measured at fair value and any profit or loss is recognised immediately.

Loans and Advances

Loans and advances are held at cost less provisions.

Specific provisions are made for advances that are recognised to be bad or doubtful. Specific provisions are assessed on a case by case basis or, where this is not practical, as part of a portfolio or similar advances using loan loss estimation models. A general provision, to cover advances that are latently bad or doubtful, but not yet identified as such, is also maintained based on loan loss estimation models. The models reflect the historical loan loss experience relevant to the particular market segment or product and include adjustments for economic and business climate factors and management experience.

Provisions made during the year are charged to the income statement, net of recoveries. If the collection of interest is considered doubtful, it is suspended and excluded from interest income in the income statement. Provisions and suspended interest are written off to the extent that there is no longer any realistic prospect of recovery.

Securitisation

Loans and advances to customers include advances that are subject to non-returnable finance arrangements, where the relevant conditions set out in the UK Accounting Standards Board publication FRS 5, "Reporting the Substance of Transactions" are met. The proceeds from the issue of these notes are shown as a deduction from the securitised assets on the balance sheet.

Debt Securities

Debt securities and other fixed interest securities held for trading are included at market value with gains or losses included in dealing profits. The difference between the cost and market value of securities held for trading is not disclosed as its determination is not practicable.

Debt securities and other fixed interest securities held for the longer term are included at cost less amounts written off and adjusted for the amortisation of premiums or discounts arising on purchase of investments redeemable at fixed dates. Such premiums or discounts are taken to interest receivable on a straight line basis over the period to redemption. The use of a straight line basis does not result in a material difference to the amount of amortisation taken to interest receivable compared to the amortisation had a level gross yield basis been used. Gains or losses on realisation are recorded in other operating income as they arise.

Equity Shares

Equity shares held for investment are stated at cost less amounts written off. Income from listed equity shares is credited to other operating income on the ex-dividend date and from unlisted equity shares on an equivalent basis.

Collateral and Netting

The group nets loans, deposits and derivative transactions where it enters into master agreements with counterparties to ensure that if an event of default occurs all amounts outstanding with these counterparties will be settled on a net basis. Where the master agreements are collateralised, the collateral will take the form of a transfer of title to the group in relation to the counterparty's exposure.

Fees and Commissions

Arrangement fees and commissions receivable for the continuing service of loans and advances are recognised on the basis of work done. Those receivables in respect of bearing risk, including premiums received by the group on high loan to value mortgages, are recognised on a straight line basis over the expected period of the advance or risk exposure. Other fees are recognised when receivable.

Fees and commission payable to third parties are normally charged to the profit and loss account as incurred. For certain categories of business, fees are amortised over a period not exceeding four years.

Dated and Undated Loan Capital

Dated and undated loan capital is included at the nominal value adjusted for premiums, discounts and expenses, all of which are amortised evenly over the period to redemption or reset. This does not result in a material difference to the amount of amortisation had a level gross yield basis been used.

Interest receivable and payable

Interest receivable and payable is recognised in the income statement on an accruals basis. If the collection of interest is considered doubtful, it is suspended and excluded from interest income in the income statement.

Mortgage incentives

All costs associated with mortgage incentive schemes are charged in full in the year in which the expense is incurred.

Consolidated Income Statement

For the year ended 31 December 2005

	Notes	2005 £ million	2004 £ million
Interest receivable		**18,054**	15,072
Interest payable		**(14,255)**	(12,092)
Net interest income		**3,799**	2,980
Fees and commission income		**727**	1,241
Fees and commission expense		**(132)**	(215)
Net earned premiums on insurance contracts		**16**	
Net trading income	1	**214**	208
Other operating income		**1,106**	754
Net operating income (all from continuing operations)	1	**5,730**	4,968
Change in investment contract liabilities		**(11)**	
Net claims incurred on insurance contracts		**(1)**	(1)
Net change in insurance contract liabilities		**(6)**	
Administrative expenses	2	**(1,710)**	(1,536)
Depreciation and amortisation			
Property and equipment	18	**(57)**	(56)
Operating lease assets	20	**(505)**	(381)
Intangible assets other than goodwill	17	**(43)**	(40)
		(605)	(477)
Goodwill impairment	17		(6)
Operating expenses		**(2,333)**	(2,020)
Impairment losses on loans and advances	13	**(851)**	(729)
Impairment on investment securities		**(51)**	(24)
Operating profit (all from continuing operations)		**2,495**	2,195
Share of operating profits of jointly controlled entities		**41**	43
Share of profits of other associated undertakings		**10**	68
Non-operating income			13
Profit before taxation		**2,546**	2,319
Tax on profit	8	**(678)**	(661)
Profit after taxation		**1,868**	1,658
Attributable to:			
Shareholders (including certain non-equity interests in 2004)		**1,845**	1,586
Minority interests (equity)		**23**	9
(non-equity)			63
		1,868	1,658

Details of dividends are set out in Note 31.

The statement of accounting policies on pages 31 to 35 and the notes on pages 47 to 97 form part of these accounts.

Consolidated Balance Sheet

As at 31 December 2005

	Notes	2005 £ million	2004 £ million
Assets			
Cash and balance at central banks		**1,384**	1,276
Items in course of collection		**603**	611
Financial assets held for trading	10	**41,766**	
Derivative assets	35	**9,711**	
Treasury bills and other eligible bills	9		4,327
Loans and advances to banks	11	**90,247**	68,555
Loans and advances to customers		**177,766**	163,836
Less: non-returnable finance			(4,170)
	12	**177,766**	159,666
Investment securities	14	**42,782**	57,786
Interests in jointly controlled entities	15	**205**	79
Interests in associated undertakings	15	**169**	159
Goodwill and other intangible fixed assets	17	**521**	498
Property and equipment	18	**487**	454
Investment properties	19	**37**	34
Operating lease assets	20	**1,884**	1,832
Deferred tax asset	22	**119**	
Other assets	21	**3,131**	7,721
Prepayments and accrued income		**498**	2,470
Total Assets		**371,310**	305,468
Liabilities			
Deposits by banks	23	**87,379**	76,539
Customer accounts	24	**100,299**	96,017
Financial liabilities held for trading	10	**25,007**	
Derivative liabilities	35	**8,562**	
Notes in circulation		**830**	721
Insurance contract liabilities		**17**	
Investment contract liabilities		**98**	
Current tax liabilities		**169**	303
Deferred tax liabilities	22		10
Other liabilities	25	**2,191**	8,619
Accruals and deferred income		**1,587**	2,781
Net post retirement benefit liabilities	6	**827**	659
Other provisions	27	**40**	25
Debt securities in issue	26	**126,487**	103,780
Other borrowed funds	28	**8,341**	6,422
Total Liabilities		**361,834**	295,876

The statement of accounting policies on pages 31 to 35 and the notes on pages 47 to 97 form part of these accounts.

Consolidated Balance Sheet (continued)

	Notes	2005 £ million	2004 £ million
Shareholders' Equity			
Issued share capital*	29	**459**	810
Share premium	30	**2,951**	2,951
Other reserves	30	**328**	(5)
Retained earnings	30	**5,705**	4,950
Shareholders' Equity (excluding minority interests)*	30	**9,443**	8,706
Minority interests (equity)	30	**33**	23
Shareholders' Equity (including minority interests)*		**9,476**	8,729
Minority and other interests (non-equity)			863
Total Shareholders' Equity		**9,476**	9,592
Total Liabilities and Shareholders' Equity		**371,310**	305,468

* Includes certain non-equity interests in 2004

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 profit attributable to shareholders, £1,137 million (2004 - £1,188 million) is dealt with in the accounts of the Bank.

Approved by the Board on 28 February 2006 and signed on its behalf by:

Lord Stevenson	A J Hobson	J R Crosby	P A Hodkinson
Governor	Chairman of Audit Committee	Director	Director

Bank Balance Sheet

As at 31 December 2005

	Notes	2005 £ million	2004 £ million
Assets			
Cash and balance at central banks		**1,007**	1,004
Items in course of collection		**546**	611
Derivative assets	35	**30**	
Loans and advances to banks	11	**44,921**	30,945
Loans and advances to customers		**104,736**	100,931
Less: non-returnable finance			(4,091)
	12	**104,736**	96,840
Investment securities	14	**365**	344
Interests in jointly controlled entities	15	**2**	2
Interests in associated undertakings	15	**67**	72
Interests in group undertakings	16	**1,921**	1,942
Goodwill and other intangible fixed assets	17	**147**	135
Property and equipment	18	**277**	293
Deferred tax asset	22	**464**	296
Other assets		**432**	205
Prepayments and accrued income		**243**	788
Total Assets		**155,158**	133,477
Liabilities			
Deposits by banks	23	**70,957**	62,889
Customer accounts	24	**66,383**	53,113
Derivative liabilities	35	**36**	
Debt securities in issue	26	**1,065**	1,161
Notes in circulation		**830**	721
Current tax liabilities		**97**	165
Other liabilities	25	**692**	1,209
Accruals and deferred income		**633**	480
Net post retirement benefit liabilities	6	**814**	631
Other provisions	27	**2**	6
Other borrowed funds	28	**6,843**	6,075
Total Liabilities		**148,352**	126,450

The statement of accounting policies on pages 31 to 35 and the notes on pages 47 to 97 form part of these accounts.

Bank Balance Sheet (continued)

	Notes	2005 £ million	2004 £ million
Shareholders' Equity			
Issued share capital*	29	**410**	810
Share premium account	30	**2,951**	2,951
Other reserves	30	**59**	85
Profit and loss account	30	**3,386**	3,181
Shareholders' Equity (excluding minority interests)*	30	**6,806**	7,027
Total Liabilities and Shareholders' Equity		**155,158**	133,477

* Includes certain non-equity interests in 2004

Approved by the Board on 28 February 2006 and signed on its behalf by:

Lord Stevenson	A J Hobson	J R Crosby	P A Hodkinson
Governor	Chairman of Audit Committee	Director	Director

Consolidated Statement of Recognised Income and Expense

For the year ended 31 December 2005

	2005	2004
	£ million	£ million
Net actuarial losses from defined benefit plans and other movements (net of tax)	**(167)**	(58)
Income and expense recognised directly in equity	**(4)**	(3)
Available for sale investments		
Change in fair value (net of tax)	**132**	
Net gains transferred to the income statement (net of tax)	**(119)**	
Cash flow hedges		
Effective portion of changes in fair value taken to equity (net of tax)	**16**	
Net losses transferred to the income statement (net of tax)	**34**	
Net expense recognised directly in equity	**(108)**	(61)
Profit after taxation	**1,868**	1,658
Total recognised income and expense	**1,760**	1,597
Effect of adopting IAS32/39 and IFRS4 (net of tax) at 1 January 2005		
Share capital	**(354)**	
Cash flow hedge reserve	**93**	
Available for sale reserve	**168**	
Other reserves	**16**	
Retained earnings	**(436)**	
Minority interests (equity)	**(7)**	
Minority and other interests (non-equity)	**(863)**	
	(1,383)	
	377	1,597
Attributable to:		
Bank shareholders (including certain non-equity interests in 2004)	**367**	1,525
Minority interests	**10**	72
	377	1,597

Bank Statement of Recognised Income and Expense

For the year ended 31 December 2005

	2005 £ million	2004 £ million
Net actuarial gains and losses from defined benefit plans and other movements (net of tax)	**(168)**	(66)
Income and expense recognised directly in equity	**(7)**	32
Available for sale investments		
Change in fair value (net of tax)	**(7)**	
Cash flow hedges		
Effective portion of changes in fair value taken to equity (net of tax)	**(7)**	
Net income recognised directly in equity	**(189)**	(34)
Profit after taxation	**1,137**	1,188
Total recognised income and expense	**948**	1,154
Effect of adopting IAS32/39 and IFRS4 (net of tax) at 1 January 2005		
Share capital	**(400)**	
Available for sale reserve	**11**	
Other reserves	**(16)**	
Retained earnings	**(280)**	
	(685)	1,154
Attributable to:		
Shareholders (including certain non-equity interests in 2004)	**(685)**	1,154

Consolidated Cash Flow Statement

For the year ended 31 December 2005

	2005 £ million	2004 £ million
Profit before tax	**2,546**	2,319
Adjustments for:		
Impairment losses on loans and advances	**851**	729
Depreciation and amortisation	**605**	484
Amortisation of discounts on debt securities	**(10)**	(11)
Movement in derivatives held for trading	**(2,466)**	
Interest on other borrowed funds	**498**	357
Pension charge for defined benefit schemes	**96**	162
Profit on sale of investment securities	**(172)**	(105)
Other provisions charged	**18**	31
Provision utilised	**(5)**	(28)
Provision against investment securities	**66**	24
Exchange differences	**(2,658)**	1,327
Other non-cash items	**(37)**	(142)
Net change in operating assets	**(25,312)**	(66,531)
Net change in operating liabilities	**49,608**	59,124
Net cash flows from operating activities before tax	**23, 628**	(2,260)
Income taxes paid	**(813)**	(636)
Cash flows from operating activities	**22,815**	(2,896)
Cash flows from investing activities	**(3,823)**	(9,941)
Cash flows from financing activities	**(703)**	2
Net increase in cash and cash equivalents	**18,289**	(12,835)
Opening cash and cash equivalents	**50,707**	63,542
Closing cash and cash equivalents	**68,996**	50,707

The statement of accounting policies on pages 31 to 35 and the notes on pages 47 to 97 form part of these accounts.

Analysis of Cash and Cash Equivalents

	2005 £ million	2004 £ million
Cash and balances at central banks	**283**	622
Loans and advances to other banks – repayable in less than 3 months	**26,947**	28,243
Short term investments	**41,766**	21,842
Closing cash and cash equivalents	**68,996**	50,707
Investing activities		
Sale and maturity of investment securities	**25,160**	17,208
Purchase of investment securities	**(28,024)**	(26,712)
Sale of operating lease assets	**584**	621
Purchase of operating lease assets	**(1,138)**	(990)
Sale of other intangible assets	**13**	16
Capitalisation of other intangible assets	**(77)**	(46)
Sale of property and equipment	**42**	37
Purchase of property and equipment	**(129)**	(71)
Cash contribution to defined benefit pension schemes	**(166)**	(52)
Sale of investment properties	**14**	2
Purchase of investment properties	**(17)**	(1)
Investment in subsidiary undertakings		(22)
Investment in jointly controlled entities and associated undertakings	**(137)**	(18)
Disposal of jointly controlled entities and associated undertakings	**14**	26
Dividends received from jointly controlled entities	**30**	42
Dividends received from associated undertakings	**8**	19
Cash flows from investment activities	**(3,823)**	(9,941)
Financing activities		
Issue of other borrowed funds	**353**	1,061
Minority interest acquired	**4**	
Repayments of other borrowed funds	**(75)**	(168)
Equity dividends paid	**(487)**	(444)
Preference dividends paid		(37)
Dividends paid to minority shareholders in subsidiary undertakings	**(3)**	(47)
Interest on other borrowed funds relating to servicing of finance	**(495)**	(363)
Cash flows from financing activities	**(703)**	2

Bank Cash Flow Statement

For the year ended 31 December 2005

	2005 £ million	2004 £ million
Profit before tax	**1,560**	1,535
Adjustments for:		
Impairment losses on loans and advances	**598**	653
Depreciation and amortisation	**68**	70
Movement in derivatives held for trading	**(22)**	
Interest on other borrowed funds	**394**	323
Pension charge for defined benefit schemes	**94**	140
Profit on sale of investment securities	**(6)**	(42)
Other provisions charged		20
Provision utilised	**(4)**	(23)
Provision against investment securities	**12**	9
Exchange differences	**46**	(13)
Other non-cash items	**(14)**	(122)
Non operating income		12
Net change in operating assets	**(4,570)**	(9,493)
Net change in operating liabilities	**20,293**	19,409
Net cash flows from operating activities before tax	**18,449**	12,478
Income taxes paid	**(470)**	(347)
Cash flows from operating activities	**17,979**	12,131
Cash flows from investing activities	**(211)**	234
Cash flows from financing activities	**(651)**	2
Net increase in cash and cash equivalents	**17,117**	12,367
Opening cash and cash equivalents	**27,878**	15,511
Closing cash and cash equivalents	**44,995**	27,878

The statement of accounting policies on pages 31 to 35 and the notes on pages 47 to 99 form part of these accounts.

Analysis of Cash and Cash Equivalents

	2005 £ million	2004 £ million
Cash and balances at central banks	**186**	355
Loans and advances to other banks – repayable in less than 3 months	**44,809**	27,523
Closing cash and cash equivalents	**44,995**	27,878
Investing activities		
Sale and maturity of investment securities	**152**	535
Purchase of investment securities	**(174)**	(225)
Sale of other intangible assets	**10**	15
Capitalisation of other intangible assets	**(57)**	(40)
Sale of property and equipment	**20**	28
Purchase of property and equipment	**(37)**	(42)
Cash contribution to defined benefit pension schemes	**(151)**	(39)
Disposal in subsidiary undertakings	**21**	3
Investment in jointly controlled entities and associated undertakings		(2)
Disposal of jointly controlled entities and associated undertakings	**5**	1
Cash flows from investment activities	**(211)**	234
Financing activities		
Issue of other borrowed funds	**300**	980
Repayments of other borrowed funds	**(75)**	(168)
Equity dividends paid	**(484)**	(444)
Preference dividends paid		(37)
Interest on other borrowed funds relating to servicing of finance	**(392)**	(329)
Cash flows from financing activities	**(651)**	2

Notes to the Accounts

1. Net Operating Income

	2005 £ million	2004 £ million
Included within net operating income is the following:		
Net trading income which includes the following:		
Equity and commodity instruments and related derivatives	**22**	
Interest bearing securities and related derivatives	**114**	136
Foreign exchange and related derivatives	**78**	72
	214	208

	2005 £ million	2004 £ million
Dividend income on financial investments designated as:		
Available for sale	**125**	
Loans and receivables	**5**	
Dividend income from equity shares		13
Realised gains less losses on sale of financial instruments designated as:		
Available for sale	**168**	
Loans and receivables	**4**	
Profit on sale of investment securities		105

2. Administrative Expenses

	Notes	2005 £ million	2004 £ million
Administrative expenses includes:			
HBOS merger integration costs			23
Tax effect			(7)
			16
Administrative expenses also include:			
Staff costs	3	**1,051**	876
Accommodation, repairs and maintenance		**135**	121
Technology		**32**	55
Marketing and communication		**133**	125

3. Staff

During 2005 HBOS plc became the employer for most UK based employees in the group. Consequently, the Bank has no employees. Staff and related costs are recharged from HBOS plc.

	2005 Number	2004 Number
The average number of persons recharged to the Group during the year was:		
Full time	**19,704**	17,883
Part time	**3,662**	3,471
	23,366	21,354

Notes to the Accounts (Continued)

	2005	2004
	£ million	£ million
The aggregate remuneration payable included within administrative expenses to those employees comprises:		
Wages and salaries	**850**	687
Social security costs	**60**	64
Other pension costs	**107**	104
Expense arising from share based payments (note 7)	**34**	21
Staff costs charged to administrative expenses	**1,051**	876

4. Directors' Remuneration

The Directors of Bank of Scotland during the year were also Directors of HBOS plc. No Director received emoluments for qualifying services to Bank of Scotland in the year ended 31 December 2005 or the comparative period. Full details of the Directors' remuneration are disclosed in the 2005 HBOS plc Annual Report and Accounts within the "Report of the Board in relation to remuneration policy and practice".

5. Auditors' Remuneration

The aggregate remuneration of KPMG Audit Plc and its associates for audit and other services (excluding VAT and any overseas equivalent thereof) is analysed below.

			2005			2004
	Within UK	**Outwith UK**	**Total**	Within UK	Outwith UK	Total
Group	**£ million**	**£ million**	**£ million**	£ million	£ million	£ million
Audit services						
Statutory audits	**1.6**	**0.9**	**2.5**	1.9	0.7	2.6
Audit-related regulatory reporting	**0.4**	**0.2**	**0.6**	1.1	0.2	1.3
Total audit services	**2.0**	**1.1**	**3.1**	3.0	0.9	3.9
Further assurance services						
International Financial Reporting Standards project				0.5	0.1	0.6
Other further assurance services	**0.2**		**0.2**	0.2		0.2
Total further assurance services	**0.2**		**0.2**	0.7	0.1	0.8
Tax services						
Compliance services		**0.3**	**0.3**		0.2	0.2
Advisory services		**0.3**	**0.3**		0.2	0.2
Total tax services		**0.6**	**0.6**		0.4	0.4
Other services	**0.4**	**0.5**	**0.9**	0.2	0.1	0.3
Total non-audit services	**0.6**	**1.1**	**1.7**	0.9	0.6	1.5
Total	**2.6**	**2.2**	**4.8**	3.9	1.5	5.4

In respect of the Bank, statutory audit fees were £0.5 million (2004 - £0.2 million) and other fees were £0.6 million (2004 - £1.9 million). All fees are within the UK.

Notes to the Accounts (Continued)

6. Post Retirement Benefits

The group operates a number of employee benefit plans in its various countries of operation. In addition to the share based payment employee benefits detailed in note 7 the group operates pension schemes on a defined benefit basis as well as a defined contribution pension plan. These plans have been accounted for under IAS 19 covering employee benefits. IAS 19 requires disclosure of certain information about the plans as follows:

Defined contribution post employment benefit plans

The group provides several defined contribution schemes, including the HBOS Group Money Purchase Scheme. This scheme is open to new employees as the principal defined benefit schemes are closed to new members. It is funded by contributions from employees and the group. Normal employee contributions are made at rates of 2 per cent to 5 per cent and group contributions can range between 3 per cent to 8 per cent. These arrangements are due to change in April 2006. The expense of defined contribution plans for the year ended 31 December 2005 is £18 million (2004 - £16 million).

Defined benefit post employment benefit plans

The group provides various pension plans that operate on a defined benefit basis. The principal defined benefit pension scheme is the Bank of Scotland 1976 Pension Scheme ('The Scheme'), which is a funded scheme.

The assets of The Scheme are held in trust funds which are independent of the group's own assets. In determining the level of contributions required to be made to The Scheme and the relevant charges to the group's income statement, the group has been advised by independent actuaries. The most recently published formal valuation of the Scheme was carried out on 31 December 2004. The financial assumptions are derived based upon the economic conditions prevailing at the date of valuation.

The amount included in the balance sheet arising from the group's obligations in respect of its defined benefit plans is as follows:

	The Scheme 2005 £ million	The Scheme 2004 £ million
Defined benefit obligation	**(2,723)**	(2,122)
Fair value of assets	**1,909**	1,491
Net Post Retirement Benefit Liabilities	**(814)**	(631)
Movements in the net post retirement benefit liabilities were as follows:		
As at 1 January	**(631)**	(530)
Pension expense	**(88)**	(94)
Employer contributions	**159**	59
Actuarial losses	**(254)**	(66)
At 31 December	**(814)**	(631)
Movements in the defined benefit obligation were as follows:		
At 1 January	**2,122**	1,900
Current service cost	**85**	84
Contributions by plan participants	**4**	5
Interest cost	**114**	105
Benefits paid	**(58)**	(60)
Actuarial losses	**455**	82
Past service cost	**1**	6
At 31 December	**2,723**	2,122
Movements in the fair value of plan assets were as follows:		
At 1 January	**1,491**	1,373
Actual return on plan assets	**313**	114
Employer contributions	**159**	59
Plan participant contributions	**4**	5
Benefits paid	**(58)**	(60)
At 31 December	**1,909**	1,491

Notes to the Accounts (Continued)

	The Scheme 2005 £ million	The Scheme 2004 £ million
Included within the fair value of plan assets at 31 December were the following:		
Equity instruments	**1,315**	1,142
Bonds	**199**	60
Fixed interest gilts	**238**	234
Property occupied by the company	**105**	43
Other assets	**52**	12
Total value of assets	**1,909**	1,491
The actual rate of return is calculated as follows:		
Expected return on plan assets	**112**	101
Actuarial gain on plan assets	**201**	13
Actual return on plan assets	**313**	114
The history of experience adjustments is as follows:		
Defined benefit obligation	**(2,723)**	(2,122)
Fair value of plan assets	**1,909**	1,491
Funded status	**(814)**	(631)
Experience adjustments on plan liabilities		
Amounts (£ million)	**66**	18
Percentage of scheme liabilities (%)	**2**	1
Experience adjustments on plan assets		
Amounts (£ million)	**(201)**	(13)
Percentage of plan assets (%)	**11**	1

The actuarial losses of £455 million that arose following the actuarial valuation of the group's defined benefit obligations in 2005, arose principally from the change in the discount rate assumption. The discount rate is based on an average yield from dated AA corporate bonds which fell significantly in 2005.

The expense recognised in the income statement for the year ending 31 December is comprised as follows:	**The Scheme 2005 £ million**	The Scheme 2004 £ million
Service cost	**85**	84
Interest cost	**114**	105
Expected return on assets	**(112)**	(101)
Other/past service cost	**1**	6
Total pension expense	**88**	94

The group's policy for recognising actuarial gains and losses is to take them directly to reserves in the period in which they are incurred. In respect of The Scheme, a loss of £168 million (net of tax) was recognised in the Statement of Recognised Income and Expense in the year (2004 - loss £66 million). Cumulative actuarial gains and losses recognised in the statement of Recognised Income and Expense at 31 December 2005 amount to a loss of £234 million (net of tax) (2004 – loss £66 million net of tax).

Notes to the Accounts (Continued)

Summary of assumptions and membership data

The following assumptions and data have been used:			The Scheme
	2006	2005	2004
Actuarial assumptions at beginning of the year			
Discount rate (%)	4.85	5.45	5.6
Expected rate of return on plan assets (%)	7	7.5	7.5
Salary increases* (%)	3.3	3.8	3.8
Pension increases (%)	2.8	2.8	2.8
Life expectancy at age 60 (years)			
Retired members			
Males		23	23
Females		26	26
Non-retired members			
Males		24	24
Females		27	27
Active members			
Number		13,493	14,749
Covered annual payroll (£ million)		336.3	351.0
Average age		44	44
Average service (years)		12	11
Deferred members			
Number		9,966	9,190
Average age		46	46
Retired members			
Number		5,897	5,508
Total annual pensions (£ million)		56	53
Average age		65	65

* In addition to the general assumed rate of salary increases, there is a separate assumed salary scale of increases due to promotions and increasing seniority.

Notes to the Accounts (Continued)

7. Share-based Payments

The profit of the company is stated after charging an amount of £32 million (2004 - £21 million) in respect of services received by the group which have been settled by way of share-based payment arrangements. This does not include £2m in 2005 in relation to national insurance and income tax costs that are borne by the group.

All staff providing services to the company are employed by the ultimate parent undertaking, HBOS plc, in whose shares settlement is made. The amount charged is recharged on a proportionate basis from HBOS plc. Details of the share-based payment schemes within the group are included on an aggregated basis in the HBOS plc consolidated financial statements.

8. Taxation

	2005	2004
	£ million	£ million
Current tax		
Corporation tax charge at 30% (2004 – 30%)	**568**	554
Relief for overseas taxation	**(36)**	(23)
Overseas taxation	**147**	127
	679	658
Deferred taxation	**(1)**	3
Total income tax on profit	**678**	661

The tax assessed in the year is lower than the standard rate of corporation tax in the UK (30 per cent). The differences are explained below:

	2005	2004
	£ million	£ million
Profit before taxation	**2,546**	2,319
Profit multiplied by the standard rate of corporation tax in the UK of 30% (2004 - 30%)	**764**	696
Effects of:		
(Income)/Expenses not deductible for tax purposes	**(24)**	10
Net effect of differing tax rates overseas	**(8)**	(9)
Book gains covered by capital losses/ indexation	**(36)**	(2)
Deductible interest on innovative tier 1 capital		(10)
Amounts written off fixed asset investments	**12**	14
Adjustments in respect of previous periods	**(24)**	(32)
Other	**(6)**	(6)
Total income tax on profit	**678**	661
Current tax recognised directly in equity:		
Relating to equity securities available for sale	**8**	
Deferred tax recognised directly in equity:		
Relating to equity securities available for sale	**(3)**	
Relating to cash flow hedging	**24**	
Relating to post employment benefit obligations	**(72)**	(20)
	(51)	(20)

Notes to the Accounts (Continued)

9. Treasury Bills and Other Eligible Bills

Group	2004	
	Book value	Fair value
	£ million	£ million
Investment securities		
Treasury bills and similar securities	2,850	2,849
Other eligible bills	855	855
	3,705	3,704
Other securities		
Treasury bills and similar securities	499	499
Other eligible bills	123	123
	622	622
	4,327	4,326

No treasury bills and other eligible bills were held for investment purposes at 31 December 2005.

In 2004 treasury bills and other eligible bills classified as ‘investment securities’ were measured at amortised cost and those classified as ‘other securities’ were measured at fair value. These ‘other securities’ relate solely to those securities held for trading and following the adoption of IAS 39 on 1 January 2005, these securities were reclassified to financial assets held for trading (note 10).

10. Financial Instruments Held for Trading

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

Group	**2005**
	£ million
Financial assets held for trading	
Debt securities	**24,692**
Treasury bills and other eligible instruments	**4,660**
Loans and advances to banks	**9,271**
Loans and advances to customers	**3,135**
Other assets	**8**
Total	**41,766**
Financial liabilities held for trading	
Debt securities in issue	**406**
Deposits by banks	**2,875**
Customer accounts	**21,509**
Other liabilities	**217**
Total	**25,007**

A maturity analysis of financial instruments held for trading is included in note 43.

Notes to the Accounts (Continued)

11. Loans and Advances to Banks

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Loans and advances to banks	**90,247**	68,555	**44,921**	30,945
Included in the above are loans to:				
Subsidiary undertakings			**41,692**	30,636
Fellow subsidiary undertakings	**78,115**	52,698	**2,940**	18

The maturity analysis of Loans and Advances to Banks is shown in note 43.

12. Loans and Advances to Customers

The Bank's lending exposure before deduction of impairment provisions or taking account of collateral is analysed below. For 2004, the gross amounts are also stated after deduction of non-returnable finance and before the deduction of interest in suspense.

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Gross loans and advances to customers	**179,403**	165,385	**105,963**	102,046
Non-returnable finance		(4,170)		(4,091)
	179,403	161,215	**105,963**	97,955
Less: Impairment provisions (note 13)	**(1,637)**	(1,411)	**(1,227)**	(1,016)
Interest in suspense		(138)		(99)
Net loans and advances to customers	**177,766**	159,666	**104,736**	96,840
Included in the above are loans to:				
Subsidiary undertakings			**4,679**	2,381
Fellow subsidiary undertakings	**21,465**	3,013	**51**	3,013
Ultimate parent undertaking	**61**	7	**61**	7
Jointly controlled entities and associated undertakings	**8,310**	6,940	**5,539**	4,564

At 31 December 2005 loans and advances to customers designated as loans and receivables under IAS 39 are measured at amortised cost on the balance sheet. Those loans and advances that are subject to fair value hedge designation have been adjusted to reflect the fair value for the risk being hedged.

The fair value of Loans and Advances to Customers is disclosed in note 37. A maturity analysis of Loans and Advances to Customers is shown in note 43.

Notes to the Accounts (Continued)

The group's lending exposure before impairment provisions and before taking account of collateral is analysed below. For 2004 the group's lending exposure is after deduction of non-returnable finance and before the deduction of impairment provisions and interest in suspense.

	2005	2004
	£ million	£ million
Agriculture, forestry and fishing	**1,315**	1,326
Energy	**1,675**	1,244
Manufacturing industry	**6,333**	6,182
Construction and property	**34,784**	29,380
Hotels, restaurants and wholesale and retail trade	**12,567**	10,258
Transport, storage and communication	**2,983**	2,928
Financial	**29,585**	31,859
Other services	**17,938**	16,785
Individuals		
Home mortgages	**47,285**	40,949
Other personal lending	**11,452**	10,742
Overseas residents	**13,486**	9,562
	179,403	161,215

Loans and advances to customers which have been securitised through special purpose vehicles are shown below.

					2004
		Gross assets Securitised		Non-returnable finance	
	Assets Securitised	Group £ million	Bank £ million	Group £ million	Bank £ million
Swan Trust Mortgages	Mortgages	79		79	
Mound Financing (No. 1) PLC	Mortgages	617	617	616	616
Mound Financing (No 2) PLC	Mortgages	525	525	524	524
Melrose Financing No. 1 plc	Corporate loans	900	900	693	693
Mound Financing (No. 3) PLC	Mortgages	2,261	2,261	2,258	2,258
		4,382	4,303	4,170	4,091

The presentation format of the 2004 comparatives in the above table have been prepared under previous GAAP. The loans and advances which were securitised and met the criteria set out in FRS 5 'Reporting the Substance of Transactions' as issued by the ASB were shown net of non-returnable finance ('linked presentation').

Under IFRS, prior to the adoption of IAS 39 at 1 January 2005, such presentation was permitted for 2004 only. From 1 January 2005 the non-returnable finance, primarily floating rate notes, is classified within debt securities in issue, with the related securitised customer advances remaining in loans and advances to customers.

For 2005 loans and advances to customers include advances of £10,083 million (2004 – £6,160 million) the majority of which have been sold by subsidiary undertakings of the Bank to bankruptcy remote special purpose vehicles, funded by the issue of commercial paper on terms whereby the rewards and some of the risks of the portfolio have been retained by the subsidiary. Accordingly, all these advances have been retained on the group's balance sheet with the commercial paper being included within debt securities in issue (note 26). The 2004 comparatives include those advances which did not qualify for linked presentation.

Notes to the Accounts (Continued)

Group loans and advances to customers include finance leases analysed as follows:

	2005	2004
	£ million	£ million
Gross investment in finance receivables		
Within one year	**2,803**	2,775
Between one and five years	**3,982**	3,878
More than five years	**880**	1,053
	7,665	7,706
Less unearned finance income	**(1,185)**	(1,172)
Present value of minimum lease payments	**6,480**	6,534
Analysed as		
Within one year	**2,417**	2,367
Between one and five years	**3,379**	3,338
More than five years	**684**	829
Finance lease receivables	**6,480**	6,534

At 31 December 2005 total unguaranteed residual values accrued to the benefit of the lessor amounted to £57 million (2004 - £64 million). At 31 December 2005 total accumulated allowance for uncollectable minimum lease payments receivable amounted to £28 million (2004 - £31 million).

Bank of Scotland's principal leasing activities are in property leasing and instalment credit and are transacted through its subsidiary undertakings.

13. Impairment losses on loans and advances

		Group		**Bank**
	2005	**2004**	**2005**	**2004**
	£ million	**£ million**	**£ million**	**£ million**
At 1 January	**1,551**	1,408	**1,184**	1,002
New impairment provisions less releases	**897**	756	**648**	665
Amounts written off	**(774)**	(796)	**(554)**	(654)
Acquisitions and transfers	**7**	50		6
Discount unwind on impaired:				
Loans and advances to customers	**(54)**		**(50)**	
Exchange movements	**10**	(7)	**(1)**	(3)
Cumulative provisions as at 31 December	**1,637**	1,411	**1,227**	1,016
New impairment provisions less releases	**897**	756	**648**	665
Recoveries of amounts previously written off	**(46)**	(27)	**(50)**	(14)
Net charge to Income Statement	**851**	729	**598**	651

Notes to the Accounts (Continued)

14. Investment Securities

Group				**2005**		2004
	At fair value through income statement	**Available for sale**	**Loans and receivables**	**Total**	Amortised cost	Market value
	£ million	**£ million**	**£ million**	**£ million**	£ million	£ million
Listed						
Debt securities		**22,047**		**22,047**	29,543	28,963
Equity securities	**1**	**36**		**37**	30	28
Total listed	**1**	**22,083**		**22,084**	29,573	28,991
Unlisted						
Debt securities	**11**	**19,112**	**779**	**19,902**	28,049	28,803
Equity securities	**105**	**691**		**796**	164	262
Total unlisted	**116**	**19,803**	**779**	**20,698**	28,213	29,065
Total investment securities	**117**	**41,886**	**779**	**42,782**	57,786	58,056
Comprising:						
Debt securities	**11**	**41,159**	**779**	**41,949**	57,592	57,766
Equity securities	**106**	**727**		**833**	194	290
Bank						
Listed						
Debt securities		**24**		**24**	19	21
Equity securities		**7**		**7**		1
Total listed		**31**		**31**	19	22
Unlisted						
Debt securities			**324**	**324**	297	298
Equity securities		**10**		**10**	28	30
Total unlisted		**10**	**324**	**334**	325	328
Total investment securities		**41**	**324**	**365**	344	350
Comprising:						
Debt securities		**24**	**324**	**348**	316	319
Equity securities		**17**		**17**	28	31

Investment securities held at fair value through the income statement and as available for sale are recorded at fair value. Investment securities designated as loans and receivables are recorded at amortised cost. The fair value of investment securities is disclosed in note 37 and a maturity analysis of investment securities is included in note 43.

The fair value movements during the year are £4 million and £186 million respectively for securities held at fair value through the income statement and available for sale. Within the fair value movement for available for sale is £34 million relating to assets subject to fair value hedging.

Of the investment securities held by the Bank that are designated as available for sale the fair value movement during the year is £3 million.

Notes to the Accounts (Continued)

In keeping with normal market practice, the group enters into securities lending transactions and repurchase agreements, whereby cash and securities are temporarily received or transferred as collateral. Debt securities with a value of £1,827 million (2004 - £1,702 million) for the group were subject to agreement to repurchase, where the transferee obtains the right to pledge or sell the asset they receive. Debt securities also include securities pledged as collateral as part of securities lending transactions amounting to £11,787 million (2004 - £10,666 million).

Securities held as collateral under reverse repurchase agreements amounted to £46,918 million. These are not recognised as assets and are therefore not included above. Of this amount the group had resold or repledged £38,466 million as collateral for its own transactions. Debt securities include asset backed securities of £19,497 million (2004 - £14,507 million) which are held in bankruptcy remote special purpose vehicles, funded by the issue of commercial paper on terms whereby some of the rewards and risks of the portfolio have been retained by the group. The commercial paper is included within debt securities in issue (note 26).

15. Interests in Jointly Controlled Entities and Associated Undertakings

					Group	Bank
	Acquired book value	**Equity adjustments**	**Share of net tangible assets**	**Goodwill**	**Book value**	**Cost**
Interests in jointly controlled entities	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
At 31 December 2004	**118**	**(41)**	**77**	**2**	**79**	**2**
Change in accounting policy		**2**	**2**		**2**	
At 1 January 2005	**118**	**(39)**	**79**	**2**	**81**	**2**
Acquisitions and subscriptions of capital	**121**		**121**		**121**	
Disposals	**(6)**		**(6)**		**(6)**	
Equity accounting adjustments		**9**	**9**		**9**	
At 31 December 2005	**233**	**(30)**	**203**	**2**	**205**	**2**

The group's unrecognised share of losses for the year was £22 million (2004 - £18 million) and £53 million (2004 - £37 million) on a cumulative basis. For those entities subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The share of losses on a cumulative basis are net of those unrecognised profits.

The following amounts are included in the group's share of jointly controlled entities all of which are unlisted.

	Profit after tax	**Current assets**	**Non-current assets**	**Current liabilities**	**Non-current liabilities**	**Equity**
	£ million	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
2005	**41**	**1,414**	**3,304**	**(1,669)**	**(2,844)**	**205**
2004	43	1,245	2,917	(1,464)	(2,575)	123

			Group	Bank
	Acquired book value	**Equity adjustments**	**Book value**	**Cost**
Interests in associated undertakings	**£ million**	**£ million**	**£ million**	**£ million**
At 31 December 2004	**106**	**53**	**159**	**72**
Change in accounting policy		**1**	**1**	
At 1 January 2005	**106**	**54**	**160**	**72**
Acquisitions and subscriptions of capital	**16**		**16**	
Disposals	**(8)**		**(8)**	**(5)**
Equity accounting adjustments		**1**	**1**	
At 31 December 2005	**114**	**55**	**169**	**67**

The group's unrecognised share of losses for the year was £1 million (2004 - nil) and £ nil (2004 - £1 million) on a cumulative basis. For those entities subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The share of losses on a cumulative basis are net of those unrecognised profits.

All the interests in associated undertakings are unlisted.

Notes to the Accounts (Continued)

Main Jointly Controlled Entities and Associated Undertakings

Incorporated in the UK	Nature of Business	Issued Share and Loan Capital		Group's Interest	Statutory accounts made up to	Principal area of operation
Jointly controlled entities:						
AA Personal Finance Limited	Finance	ordinary	£3,000,002	50.0%*	December 2005*	UK
NFU Mutual Finance Limited	Finance	ordinary	£500,002	50.0%*	December 2005*	UK
RFS Limited	Finance	ordinary	£6,000,006	50.0%*	December 2005*	UK
Associated undertaking:						
Sainsbury's Bank plc	Banking	ordinary	£140,000,000	45.0%	March 2005~	UK
		loan	£100,000,000	45.0%		

* Held by subsidiary undertakings.

~ The accounts of Sainsbury's Bank plc have been equity accounted in the group's consolidated accounts on the basis of accounts prepared for the year to 31 December 2005.

16. Interests in Group Undertakings

	Banks £ million	**Others £ million**	**Total £ million**
At cost at 1 January 2005	863	1,079	1,942
Exchange translation		(21)	(21)
At cost at 31 December 2005	**863**	**1,058**	**1,921**

The main subsidiary undertakings are as follows:

	Bank's interest in ordinary share capital and voting rights	Principal business	Incorporated
HBOS Treasury Services PLC	100%	Banking	UK
HBOS Australia Pty Ltd and subsidiaries including Bank of Western Australia Ltd	100%	Banking	Australia
Bank of Scotland (Ireland) Ltd	100%	Banking	Ireland
CAPITAL BANK plc	~ 100%	Banking and personal finance	UK

~ Bank of Scotland holds 100 per cent of the issued preference share capital.

Notes to the Accounts (Continued)

17. Goodwill and other Intangible Fixed Assets

2005				Group			Bank
	Goodwill £ million	Software £ million	Purchased value in-force investment contracts £ million	Total £ million	Goodwill £ million	Software £ million	Total £ million
Cost							
At 1 January 2005	**413**	**212**		**625**	**66**	**172**	**238**
Exchange translation	**(1)**	**2**		**1**			
Acquired through business combination	**(2)**		**2**				
Additions		**78**		**78**		**57**	**57**
Disposals		**(15)**		**(15)**		**(12)**	**(12)**
At 31 December 2005	**410**	**277**	**2**	**689**	**66**	**217**	**283**
Amortisation							
At 1 January 2005		**127**		**127**		**103**	**103**
Exchange translation		**1**		**1**			
Amortisation charge in year		**43**		**43**		**35**	**35**
Disposals		**(3)**		**(3)**		**(2)**	**(2)**
At 31 December 2005		**168**		**168**		**136**	**136**
Carrying value at 31 December 2005	**410**	**109**	**2**	**521**	**66**	**81**	**147**

2004			Group			Bank
	Goodwill £ million	Software £ million	Total £ million	Goodwill £ million	Software £ million	Total £ million
Cost						
At 1 January 2004	469		469	73		73
Transition to IFRS	(47)	184	137	(3)	150	147
Opening balance restated	422	184	606	70	150	220
Exchange translation	(8)	(1)	(9)			
Impairment losses	(6)		(6)	(4)		(4)
Additions	7	46	53		37	37
Disposals	(2)	(17)	(19)		(15)	(15)
At 31 December 2004	413	212	625	66	172	238
Amortisation						
At 1 January 2004	47		47	3		3
Transition to IFRS	(47)	91	44	(3)	72	69
Opening balance restated		91	91		72	72
Amortisation charge in year		40	40		34	34
Disposals		(4)	(4)		(3)	(3)
At 31 December 2004		127	127		103	103
Carrying value at 31 December 2004	413	85	498	66	69	135

Notes to the Accounts (Continued)

Goodwill impairment testing

Goodwill has arisen on the acquisition of companies and other businesses. It is subject to a six monthly impairment review by comparing the 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. 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 represents the actual company or business acquired.

Goodwill can be aligned on a divisional basis as follows:

	2005	2004
	£ million	£ million
Retail	**70**	70
Corporate	**42**	42
International	**298**	301
Total	**410**	413

The recoverable amount of each cash-generating unit is based upon value in use calculations. The calculations use cash flow projections based upon the five year business plan with cash flows thereafter being extrapolated using growth rates in the range of 2.25 - 2.50 per cent reflecting the long-term nature of the businesses concerned and the long term trend in growth rate of the respective economies. The pre-tax discount rates used in discounting projected cash flows lie in the range of 10.0 - 12.2 per cent.

Notes to the Accounts (Continued)

18. Property and Equipment

2005			**Group**			**Bank**
	Property	**Equipment**	**Total**	**Property**	**Equipment**	**Total**
	£ million	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
Cost						
At 1 January 2005	**325**	**586**	**911**	**203**	**358**	**561**
Exchange translation	**2**	**4**	**6**			
Additions	**70**	**59**	**129**	**19**	**18**	**37**
Disposals	**(18)**	**(70)**	**(88)**	**(14)**	**(14)**	**(28)**
At 31 December 2005	**379**	**579**	**958**	**208**	**362**	**570**
Depreciation						
At 1 January 2005	**56**	**401**	**457**	**30**	**238**	**268**
Exchange translation		**3**	**3**			
Depreciation charge in year	**14**	**43**	**57**	**9**	**24**	**33**
Disposals	**(3)**	**(43)**	**(46)**	**(1)**	**(7)**	**(8)**
At 31 December 2005	**67**	**404**	**471**	**38**	**255**	**293**
Carrying value at 31 December 2005	**312**	**175**	**487**	**170**	**107**	**277**

2004			Group			Bank
	Property	Equipment	Total	Property	Equipment	Total
	£ million	£ million	£ million	£ million	£ million	£ million
Cost						
At 1 January 2004	344	739	1,083	220	484	704
Transition to IFRS	(30)	(154)	(184)	(30)	(120)	(150)
Opening balance restated	314	585	899	190	364	554
Exchange translation	(1)	(4)	(5)			
Additions	23	51	74	18	24	42
Disposals	(11)	(46)	(57)	(5)	(30)	(35)
At 31 December 2004	325	586	911	203	358	561
Depreciation						
At 1 January 2004	56	455	511	33	282	315
Transition to IFRS	(16)	(75)	(91)	(16)	(56)	(72)
Opening balance restated	40	380	420	17	226	243
Depreciation charge in year	20	36	56	13	19	32
Disposals	(4)	(15)	(19)		(7)	(7)
At 31 December 2004	56	401	457	30	238	268
Carrying value at 31 December 2004	269	185	454	173	120	293

Included within group property and equipment are assets in the course of construction amounting to £38 million (2004 - £53 million) which are not depreciated until the assets are brought into use.

Notes to the Accounts (Continued)

19. Investment Properties

Group	**2005** **£ million**	2004 £ million
At 1 January	**34**	
Transition to IFRS		35
Opening balance restated	**34**	35
Additions	**17**	1
Disposals	**(14)**	(2)
At 31 December	**37**	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.

Rental income amounted to £4 million (2004 - £4 million) and expenses £1 million (2004 - £2 million) in respect of the above properties.

20. Operating Lease Assets

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

Group **2005**	**Cost** **£ million**	**Depreciation** **£ million**	**Carrying value** **£ million**
At 1 January 2005	**2,655**	**(823)**	**1,832**
Exchange translation	**3**		**3**
Additions	**1,138**		**1,138**
Disposals	**(860)**	**276**	**(584)**
Depreciation charge for the year		**(505)**	**(505)**
At 31 December 2005	**2,936**	**(1,052)**	**1,884**

2004	Cost £ million	Depreciation £ million	Carrying value £ million
At 1 January 2004	2,428	(704)	1,724
Exchange translation	(1)		(1)
Additions	1,112		1,112
Disposals	(884)	262	(622)
Depreciation charge for the year		(381)	(381)
At 31 December 2004	2,655	(823)	1,832

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

	2005 **£ million**	2004 £ million
One year or less	**568**	528
Later than one year and not later than five years	**521**	395
Over five years	**90**	47
	1,179	970

Notes to the Accounts (Continued)

21. Other Assets

Group	**2005 £ million**	2004 £ million
Positive market values of trading derivative contracts		6,176
Other assets	3,131	1,545
	3,131	7,721

Other assets includes £581 million (2004 - £517 million) due by HBOS plc.

22. Deferred Tax

Group	**2005 £ million**	2004 £ million
Deferred tax liabilities	**566**	502
Deferred tax assets	**(685)**	(492)
Net position	**(119)**	10
At 1 January	**10**	253
Transition to IFRS	**(40)**	(169)
Opening balance restated	**(30)**	84
Charge to income for the year (note 8)	**(1)**	3
Charge to equity for the year (note 8)	**(51)**	(20)
Other movements	**(37)**	(57)
At 31 December	**(119)**	10

Analysed as follows

Deferred tax liabilities	**Capital allowances on assets leased to customers £ million**	**Capital allowances on other assets £ million**	**Available for sale investments £ million**	**Cash flow hedges £ million**	**Other £ million**	**Total £ million**
At 1 January	**451**	**(1)**			**52**	**502**
Transition to IFRS			**68**	**39**		**107**
Opening balance restated	**451**	**(1)**	**68**	**39**	**52**	**609**
Charge to income for the year	**(53)**	**9**			**17**	**(27)**
Charge to equity for the year			**(3)**	**24**		**21**
Other movements	**(55)**				**18**	**(37)**
At 31 December	**343**	**8**	**65**	**63**	**87**	**566**

Deferred tax assets	**Employees benefits £ million**	**Provisions £ million**	**Effective interest rate adjustment £ million**	**Other £ million**	**Total £ million**
At 1 January	**(194)**	**(163)**		**(135)**	**(492)**
Transition to IFRS		**(18)**	**(100)**	**(29)**	**(147)**
Opening balance restated	**(194)**	**(181)**	**(100)**	**(164)**	**(639)**
Charge to income for the year	**14**	**(7)**		**19**	**26**
Charge to equity for the year	**(72)**				**(72)**
At 31 December	**(252)**	**(188)**	**(100)**	**(145)**	**(685)**

At 31 December 2005, a deferred tax liability of £91 million (2004 - £84 million) relating to an investment in a subsidiary has not been recognised because the group controls whether the liability will be incurred and is satisfied that it will not be incurred in the forseeable future.

Notes to the Accounts (Continued)

Bank	2005	2004
	£ million	£ million
Deferred tax liabilities	**22**	19
Deferred tax assets	**(486)**	(315)
Net position	**(464)**	(296)

At 1 January	**(296)**	(145)
Transition to IFRS	**(104)**	(128)
Opening balance restated	**(400)**	(273)
Charge to income for the year	**21**	(3)
Charge to equity for the year	**(85)**	(20)
At 31 December	**(464)**	(296)

Analysed as follows

Deferred tax liabilities	**Capital allowances on other assets**	**Available for sale investments**	**Other**	**Total**
	£ million	**£ million**	**£ million**	**£ million**
At 1 January	**3**		**16**	**19**
Transition to IFRS		**1**	**14**	**15**
Opening balance restated	**3**	**1**	**30**	**34**
Charge to income for the year	**(4)**		**5**	**1**
Charge to equity for the year		**1**	**(14)**	**(13)**
At 31 December	**(1)**	**2**	**21**	**22**

Deferred tax assets	**Employee benefits**	**Provisions**	**Effective interest rate adjustment**	**Other**	**Total**
	£ million	**£ million**	**£ million**	**£ million**	**£ million**
At 1 January	**(193)**	**(102)**		**(20)**	**(315)**
Transition to IFRS		**(26)**	**(93)**		**(119)**
Opening balance restated	**(193)**	**(128)**	**(93)**	**(20)**	**(434)**
Charge to income for the year	**18**			**2**	**20**
Charge to equity for the year	**(72)**				**(72)**
At 31 December	**(247)**	**(128)**	**(93)**	**(18)**	**(486)**

23. Deposits by Banks

		Group		Bank
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Deposits by banks	**87,379**	76,539	**70,957**	62,889
Included in the above are loans to:				
Subsidiary undertakings			**64,181**	57,187
Fellow subsidiary undertakings	**56,665**	39,871	**4,307**	3,131
Other associated undertakings	**830**	135	**7**	14

Notes to the Accounts (Continued)

24. Customer Accounts

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Customer accounts	**100,299**	96,017	**66,383**	53,113
Included in the above are loans to:				
Subsidiary undertakings			**2,304**	592
Fellow subsidiary undertakings	**18,628**	20,380	**2,525**	3,131
Ultimate parent undertaking	**233**	97	**233**	97
Other associated undertakings and joint ventures	**185**	180	**185**	180

25. Other Liabilities

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Negative market values of trading derivative contracts		6,564		
Other liabilities	**2,191**	2,055	**692**	1,209
	2,191	8,619	**692**	1,209

26. Debt Securities in Issue

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Bonds and medium term notes	**51,016**	41,513	**1,065**	1,083
Other debt securities	**75,471**	62,267		78
Total debt securities in issue	**126,487**	103,780	**1,065**	1,161

The group issues debt securities to securitise loans and advances and certain other assets of the group, principally through special purpose vehicles. At 31 December 2005 such debt securities in issue amounted to £29,091 million (2004 - £21,040 million).

All debt securities in issue are measured at amortised cost with the exception of those which are subject to a fair value hedging relationship, such as debt securities relating to securitisation and covered bonds, which are measured at fair value in respect of the risk being hedged and certain securities designated at fair value through the income statement amounting to £1,243 million. A maturity analysis of debt securities in issue is included in note 43.

Notes to the Accounts (Continued)

27. Other Provisions

Group	Merger integration provision £ million	Other provisions £ million	Total provisions £ million
At 1 January 2005	**4**	**21**	**25**
Exchange translation		**2**	**2**
Additional provision in the year		**18**	**18**
Utilised in year	**(4)**	**(1)**	**(5)**
At 31 December 2005		**40**	**40**

Bank	Merger integration provision £ million	Other provisions £ million	Total provisions £ million
At 1 January 2005	**4**	**2**	**6**
Utilised in year	**(4)**		**(4)**
At 31 December 2005		**2**	**2**

Other provisions include property related costs on surplus leased space and provisions for long-term and annual leave.

Notes to the Accounts (Continued)

28. Other Borrowed Funds

Other borrowed funds		Group		Bank
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Preference shares	**412**		**412**	
Preferred securities	**845**			
Subordinated liabilities				
Dated	**4,353**	3,807	**3,410**	3,105
Undated	**2,731**	2,615	**3,021**	2,970
	8,341	6,422	**6,843**	6,075

Preference shares		Group		Bank
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
9 1/4% non-cumulative irredeemable preference shares	**300**	300	**300**	300
9 3/4% non-cumulative irredeemable preference shares	**100**	100	**100**	100
Accrued interest	**12**		**12**	
	412	400*	**412**	400*

* Classified within the 2004 balance sheet as issued share capital.

Following the adoption of IAS 32 from 1 January 2005 the 9 1/4 per cent and 9 3/4 per cent non-cumulative irredeemable preference shares above were reclassified from shareholders equity to other borrowed funds. In line with this reclassification for the year ended 31 December 2005 the preference dividend of £37 million has been charged to interest payable within the income statement. The corresponding amount for 2004 of £37 million has been charged directly to the retained earnings reserve.

Preferred securities		Group
	2005	2004
	£ million	£ million
£250 million preferred securities	**250**	250
£150 million preferred securities	**150**	150
£4 million preferred securities	**4**	
A$1,025 million redeemable preference shares	**436**	415
Accrued interest	**5**	21
	845	836*

* Classified within the 2004 balance sheet as minority and other interests (non-equity).

Following the adoption of IAS 32 from 1 January 2005 the above preferred securities for 2004 were reclassified from minority and other interests (non-equity) to other borrowed funds.

Notes to the Accounts (Continued)

Subordinated liabilities		Group		Bank
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Dated loan capital				
US$150 million 8.85% notes 2006	**87**	78	**87**	78
£60 million 9.00% instruments 2006	**60**	60		
€500 million 5.50% instruments 2009	**343**	353	**343**	353
US$500 million notes 2010	**290**	258	**290**	258
£75 million floating rate notes 2010		75		75
US$150 million notes 2011	**87**	78	**87**	78
€7 million floating rate notes 2011	**5**	5		
€12.8 million 6.25% instruments 2012	**9**	9		
€325 million 6.125% notes 2013	**223**	229	**223**	229
€1,000 million subordinated callable fixed/floating rate instruments 2013	**686**	705	**686**	705
£250 million 6.375% instruments 2019	**250**	250	**250**	250
€750 million 5.5% notes 2012	**515**	529	**515**	529
US$450 million subordinated floating rate notes 2012	**262**	232	**262**	232
A$75 million callable notes 2012	**32**	30		
US$1,000 million 4.25% subordinated guaranteed notes 2013	**580**	517		
£330 million floating rate subordinated notes 2011	**330**	330	**330**	330
£300 million floating rate subordinated notes 2011 (1)	**300**		**300**	
A$200 million instruments 2014	**85**	81		
A$125 million instruments 2015 (2)	**53**			
Fair value hedge adjustments	**116**			
Accrued interest	**50**		**47**	
Unamortised premiums, discounts and issue costs	**(10)**	(12)	**(10)**	(12)
	4,353	3,807	**3,410**	3,105

No repayment, for whatever reason, of dated loan capital prior to its stated maturity and no purchase by the relevant undertaking of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the relevant company, 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 company 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.

(1) On 31 May 2005, £300 million 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 85 bps.

(2) On 28 October 2005, a subsidiary of the bank issued A$ 125 million instruments 2015, at par to its ultimate parent undertaking HBOS plc. These instruments bear interest at the three month Australian bank rate plus 85 bps

Notes to the Accounts (Continued)

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Undated loan capital				
US$300 million reset notes	**174**	155	**174**	155
£200 million perpetual notes	**200**	200	**200**	200
£300 million perpetual regulatory tier one securities	**300**	300	**300**	300
€500 million instruments	**343**	353	**343**	353
US$250 million floating rate primary capital notes	**145**	129	**145**	129
£150 million instruments	**150**	150	**150**	150
£150 million instruments	**150**	150	**150**	150
JPY 17 billion instruments	**84**	86	**84**	86
£100 million instruments	**100**	100	**100**	100
JPY 9 billion instruments	**44**	45		
£300 million instruments	**300**	300	**300**	300
£250 million perpetual preferred notes			**250**	250
£150 million perpetual preferred notes			**150**	150
£150 million floating rate subordinated notes	**150**	150	**150**	150
£500 million floating rate subordinated notes	**500**	500	**500**	500
Fair value hedge adjustments	**68**			
Accrued interest	**26**		**28**	
Unamortised premiums, discounts and issue costs	**(3)**	(3)	**(3)**	(3)
	2,731	2,615	**3,021**	2,970

No exercise of any redemption option or purchase by the relevant company of any of its undated loan capital may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary undertaking, 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 undertaking 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.

A maturity analysis of other borrowings is included in note 43.

29. Share Capital

	Group		Bank	
	Ordinary shares	Preference shares	Ordinary shares	Preference shares
Allotted, called up and fully paid	£ million	£ million	£ million	£ million
At 1 January 2004 and 31 December 2004	410	400	410	400
Change in accounting policy		(354)		(400)
At 1 January 2005 – restated	410	46	410	
Exchange movement		3		
As at 31 December 2005	**410**	**49**	**410**	

£300 million 9 1/4 per cent and £100 million 9 3/4 per cent non-cumulative irredeemable preference shares of £1 each classified as share capital at 31 December 2004, were reclassified as other borrowed funds (note 28) following the adoption of IAS 39 on 1 January 2005.

A$115 million redeemable preference shares which are held by HBOS plc, the group's parent undertaking, were reclassified as share capital from preferred securities following the adoption of IAS 39 on 1 January 2005.

Notes to the Accounts (Continued)

Authorised Share Capital

At 31 December 2005 the authorised share capital comprises:

Ordinary Shares - 1,785 million Ordinary shares of 25 pence each (2004 – 1,785 million)

Preference Shares - 150,000 7.754 per cent, non-cumulative perpetual preference shares of £10 each (2004 – 150,000), 250,000 8.117 per cent non-cumulative perpetual preference shares of £10 each (2004 – 250,000), 375,000,000 9.25 per cent non-cumulative irredeemable preference shares of £1 each (2004 – 375,000,000), 125,000,000 9.75 per cent non-cumulative irredeemable preference shares of £1 each (2004 – 125,000,000).

30. Reconciliation of Shareholders' Equity

2005	**Share capital**	**Share premium**	**Cash flow hedge reserve**	**Available for sale reserve**	**Other reserves**	**Retained earnings**	**Minority interests**	**Total**
Group	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
At 31 December 2004	**810**	**2,951**			**(5)**	**4,950**	**886**	**9,592**
Changes in accounting policy (note 50)	**(354)**		**93**	**168**	**16**	**(436)**	**(870)**	**(1,383)**
At 1 January 2005 restated	**456**	**2,951**	**93**	**168**	**11**	**4,514**	**16**	**8,209**
Changes in equity for 2005								
Income and expense recognised directly in equity	**3**				**(7)**			**(4)**
Actuarial loss from retirement benefit plan						**(167)**		**(167)**
Available for sale investments								
Net change in fair value				**132**				**132**
Net gains transferred to income statement				**(119)**				**(119)**
Cash flow hedges								
Effective portion of changes in fair value taken to equity			**16**					**16**
Net losses transferred to income statement			**34**					**34**
Profit after tax						**1,845**	**23**	**1,868**
Total recognised income and expense	**3**		**50**	**13**	**(7)**	**1,678**	**23**	**1,760**
Dividends paid in 2005						**(487)**		**(487)**
Other net movements in minority interests							**(6)**	**(6)**
At 31 December 2005	**459**	**2,951**	**143**	**181**	**4**	**5,705**	**33**	**9,476**
Bank								
At 31 December 2004	**810**	**2,951**			**85**	**3,181**		**7,027**
Changes in accounting policy	**(400)**			**11**	**(16)**	**(280)**		**(685)**
At 1 January 2005 restated	**410**	**2,951**		**11**	**69**	**2,901**		**6,342**
Changes in equity for 2005								
Income and expense recognised directly in equity					**(7)**			**(7)**
Actuarial loss from retirement benefit plan						**(168)**		**(168)**
Available for sale investments								
Net change in fair value				**(7)**				(7)
Cash flow hedges								
Effective portion of changes in fair value taken to equity			**(7)**					**(7)**
Profit after tax						**1,137**		**1,137**
Total recognised income and expense			**(7)**	**(7)**	**(7)**	**969**		**948**
Dividends paid in 2005						**(484)**		**(484)**
At 31 December 2005	**410**	**2,951**	**(7)**	**4**	**62**	**3,386**		**6,806**

The £280 million equity impact in the Bank in respect of the change in accounting policy has a corresponding decrease in assets of £280 million. The change in accounting policy arises from the introduction of IAS32, IAS 39 and IFRS 4 at 1 January 2005. The impact of these changes is explained in note 52.

Notes to the Accounts (Continued)

2004	Share capital	Share premium	Other reserves	Retained earnings	Minority interests	Total
Group	£ million	£ million	£ million	£ million	£ million	£ million
At 31 December 2003	810	2,951	(2)	4,008	844	8,611
Transition to IFRS (note 50)				(105)		(105)
At 1 January 2004 restated	810	2,951	(2)	3,903	844	8,506
Changes in equity for 2004						
Income and expense recognised directly in equity			(3)			(3)
Actuarial loss from retirement benefit plans and other movements				(58)		(58)
Profit after tax				1,586	72	1,658
Total recognised income and expense			(3)	1,528	72	1,597
Other net movements in minority interests					(30)	(30)
Dividends paid in 2004				(481)		(481)
At 31 December 2004	810	2,951	(5)	4,950	886	9,592
Bank						
At 31 December 2003	810	2,951	53	2,567		6,381
Transition to IFRS				(27)		(27)
At 1 January 2004 restated	810	2,951	53	2,540		6,354
Changes in equity for 2004						
Income and expense recognised directly in equity			32			32
Actuarial loss from retirement benefit plans and other movements				(66)		(66)
Profit after tax				1,188		1,188
Total recognised income and expense			32	1,122		1,154
Dividends paid in 2004				(481)		(481)
At 31 December 2004	810	2,951	85	3,181		7,027

Under IFRS the Bank does not recognise ordinary dividends receivable or payable after the balance sheet date unless they have been irrevocably declared. In addition the Bank's transition to IFRS includes leasing, post employment obligations and deferred tax adjustments as explained in note 52. The adjustment of £27 million to equity has a corresponding increase in liabilities of £11 million and a reduction in assets of £8 million.

31. Dividends

After the balance sheet date a dividend of £467 million was proposed by the Directors, but has not been provided for. Ordinary and preference dividends are charged to reserves only when the company has a contractual obligation to pay.

The following dividends have been charged to retained earnings during the year:

		2005	2004
		£ million	£ million
Preference dividends	Paid	3	25
	Payable		12
		3	37
Ordinary dividends			
Interim dividend		230	127
Final dividend		254	254
		484	381
		487	418

Notes to the Accounts (Continued)

32. Commitments and Contingencies

The contract amounts noted below indicate the volume of business outstanding at the balance sheet date in respect of contingent liabilities and commitments undertaken for customers. They do not reflect the underlying credit and other risks, which are significantly lower.

	2005 Contract amount £ million	2004 Contract amount £ million
Group		
Contingent Liabilities		
Acceptances and endorsements	**23**	75
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	**4,728**	3,842
	4,751	3,917
Commitments		
Other commitments		
Short-term trade related transactions	**117**	129
Undrawn formal standby facilities, credit lines and commitments to lend		
- up to and including one year	**28,492**	25,939
- over one year	**17,464**	15,189
	46,073	41,257
Bank		
Contingent Liabilities		
Acceptances and endorsements	**8**	55
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	**25,075**	20,442
	25,083	20,497
Amounts included above in respect of guarantees to subsidiary undertakings	**20,692**	16,881
Commitments		
Other commitments		
Short-term trade related transactions	**103**	114
Undrawn formal standby facilities, credit lines and commitments to lend		
- up to and including one year	**19,635**	17,322
- over one year	**16,077**	13,618
	35,815	31,054
Amounts included above in respect of commitments to subsidiary undertakings	**203**	104

Notes to the Accounts (Continued)

33. Operating Leases

	Group		Bank	
	2005	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million
Non cancellable operating lease rentals are payable as follows:				
Within one year	**58**	62	**33**	37
Between one and five years	**191**	190	**112**	108
After five years	**390**	398	**256**	260
	639	650	**401**	405

34. Capital and Other Commitments

	Group	
	2005	2004
	£ million	£ million
Commitments in respect of capital expenditure on property and equipment that is authorised but not provided for in the accounts, for which contracts have been entered into	5	13
Commitments for which contracts have been placed in relation to operating leased assets	10	3
Other financial commitments		1
Included in other liabilities are net obligations under finance leases payable as follows:		
Within one year	1	28
Between one and five years	1	2

Notes to the Accounts (Continued)

35. Derivatives

The group uses interest rate swaps, forward foreign exchange contracts 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 being adopted by the group is to utilise a combination of the macro cash flow, micro fair value and net investment hedge approaches. Some derivatives held for trading are held for economic hedging purposes. Where these do not meet the criteria for hedge accounting as defined under IAS 39 they are accounted for in the same way as derivatives held for trading.

The group has entered into derivative contracts as noted below. The notional principal amounts represent the value of the contract to which the derivative relates and are provided to assist with comparing to the financial instruments held on the balance sheet.

2005	Group			Bank		
	Notional principal amount	Year end fair value Asset	Year end fair value Liability	Notional principal amount	Year end fair value Asset	Year end fair value Liability
Derivatives held for hedging	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
Derivatives designated as fair value hedges						
Interest rate swaps	33,846	1,197	579			
Forward foreign exchange	1,244		2			
Cross currency swaps	40,306	668	792			
Options	840		5			
	76,236	1,865	1,378			
Derivatives designated as cash flow hedges						
Interest rate swaps	140,358	1,480	1,197			
Cross currency swaps	22,439	299	8			
Forward rate agreements	47,440	40	3	884	10	12
Futures	36,896	11	17			
	247,133	1,830	1,225	884	10	12
Total derivatives held for hedging	323,369	3,695	2,603	884	10	12

Notes to the Accounts (Continued)

The group's trading derivative transactions are either customer driven and generally matched or are carried out for proprietary purposes within limits approved by the Board.

Where a derivative does not qualify for hedge accounting, it is classified below as held for trading.

2005	**Group**			**Bank**		
	Notional principal amount	**Year end fair value**		**Notional principal amount**	**Year end fair value**	
		Asset	**Liability**		**Asset**	**Liability**
Derivatives held for trading	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
Exchange rate related contracts						
Forward foreign exchange	**52,353**	**707**	**534**			
Cross currency swaps	**12,730**	**125**	**229**			
Options	**1,016**	**7**	**38**			
	66,099	**839**	**801**			
Interest rate related contracts						
Interest rate swaps	**336,990**	**3,856**	**4,261**	**6,443**	**20**	**24**
Forward rate agreements	**123,912**	**28**	**31**			
Options	**42,224**	**142**	**116**			
Futures	**46,433**	**170**	**176**			
	549,559	**4,196**	**4,584**	**6,443**	**20**	**24**
Equity/index and commodity related contracts						
Options and swaps	**4,112**	**981**	**574**			
Total derivatives held for trading	**619,770**	**6,016**	**5,959**	**6,443**	**20**	**24**
Total derivatives	**943,139**	**9,711**	**8,562**	**7,327**	**30**	**36**

Notes On The Accounts (continued)

In line with the requirements of IFRS 1 'First time adoption of International Financial Reporting Standards' the following derivative table for 2004 has been disclosed as reported under the previous GAAP.

2004	Group			Bank		
	Notional principal amount	Year end fair value Asset	Liability	Notional principal amount	Year end fair value Asset	Liability
	£ million	£ million	£ million	£ million	£ million	£ million
Group						
Non trading						
Exchange rate related contracts						
Forward foreign exchange	703	36	159			
Cross currency swaps	56,447	854	1,992			
	57,150	890	2,151			
Interest rate related contracts						
Interest rate swaps	39,178	744	348	4,851	1	5
Options	197					
Forward rate agreements	141					
	39,516	744	348	4,851	1	5
Equity and commodity related contracts						
Options and swaps	41			16		
Total non trading derivatives	96,707	1,634	2,499	4,867	1	5
Trading						
Exchange rate related contracts						
Forward foreign exchange	66,127	1,089	1,853	961	20	20
Cross currency swaps	1,495	41	133			
Options	936	9	9			
	68,558	1,139	1,995	961	20	20
Interest rate related contracts						
Interest rate swaps	399,979	4,604	4,135			
Forward rate agreements	76,773	18	18			
Options	62,538	132	119			
Futures	20,765	5	34			
	560,055	4,759	4,306			
Equity and commodity related contracts						
Options and swaps	1,827	222	146			
Total trading derivatives	630,440	6,120	6,447	961	20	20
Total group derivatives	727,147	7,754	8,946	5,828	21	25

Notes to the Accounts (Continued)

The residual maturity of ‘over the counter’ (‘OTC’) and non-margined exchange traded contracts was as follows:

2004 Group	Notional principal amount £ million	Replacement cost £ million
Contracts maturing:		
Within one year	301,947	1,902
Between one and five years	242,836	2,208
After five years	161,598	3,639
	706,381	7,749

Credit Risk Analyses

Counterparties of the Bank and group’s derivatives transactions are primarily financial institutions. An institutional and geographical analysis of replacement cost, based on the location of the office writing the business, is shown below:

2004	Group £ million	Bank £ million
Institutional		
Financial institutions	6,428	10
Non-financial institutions	1,321	11
	7,749	21
Geographical		
UK	7,606	21
Rest of world	143	
	7,749	21

The group’s objectives and policies in managing the risks that arise in connection with the use of financial instruments are set out on page 9 of the Risk Management section of the Business and Financial Review.

Notes to the Accounts (Continued)

36. Hedges

In line with the requirements of IFRS 1 'First time adoption of International Financial Reporting Standards' the following hedging table for 2004 has been disclosed as reported under the previous GAAP.

Gains and losses on instruments used for hedging are not recognised until the exposure that is being hedged is itself recognised. Unrecognised gains and losses on instruments used for hedging, and the movements therein, are as follows:

2004 Group	Gains £ million	Losses £ million	Total Net Gains/(Losses) £ million
Unrecognised gains and losses on hedges at 1 January 2004	1,753	2,754	(1,001)
Gains and losses arising in previous years that were recognised in the year ended 31 December 2004	845	3,100	(2,255)
Gains and losses arising before 1 January 2004 that were not recognised in the year ended 31 December 2004	908	(346)	1,254
Gains and losses arising in the year ended 31 December 2004 that were not recognised in that year	398	2,585	(2,187)
Unrecognised gains and losses on hedges at 31 December 2004	1,306	2,239	(933)
of which:			
Gains and losses expected to be recognised in the year ending 31 December 2005	413	1,130	(717)
Gains and losses expected to be recognised after 31 December 2005	893	1,109	(216)

37. Fair Value of Financial Instruments

The fair values of financial instruments are based on market prices where available, or are estimated using other valuation techniques. Where they are short term in nature or reprice frequently, fair value approximates to carrying value. The classification adopted by the group is shown in the following table:

2005	**At fair value through income statement**		**Available for sale**		**Loans and receivables**	
	Carrying amount £ million	**Fair value £ million**	**Carrying amount £ million**	**Fair value £ million**	**Carrying amount £ million**	**Fair value £ million**
Assets						
Financial assets held for trading	**41,766**	**41,766**				
Derivative assets	**9,711**	**9,711**				
Loans and advances to banks					**90,247**	**91,158**
Loans and advances to customers					**177,766**	**179,839**
Investment securities	**117**	**117**	**41,886**	**41,886**	**779**	**1,163**
Total financial assets	**51,594**	**51,594**	**41,886**	**41,886**	**268,792**	**272,160**

Notes to the Accounts (Continued)

2005	At fair value through income statement		Financial liabilities at amortised cost	
	Carrying amount £ million	Fair value £ million	Carrying amount £ million	Fair value £ million
Liabilities				
Deposits by banks			**87,379**	**88,270**
Customer accounts			**100,299**	**101,259**
Financial liabilities held for trading	**25,007**	**25,007**		
Derivative liabilities	**8,562**	**8,562**		
Debt securities in issue	**1,243**	**1,243**	**125,244**	**125,375**
Other borrowed funds	**120**	**120**	**8,221**	**9,133**
Total financial liabilities	**34,932**	**34,932**	**321,143**	**324,037**

The fair value information presented does not represent the fair value of the group as going concern at 31 December 2005.

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

- Financial assets and liabilities at fair value through profit and loss

The fair values of quoted investments in active markets are based on current bid prices. Where there is no active market, fair value is established using valuation techniques. Where current prices are not available, the price of the most recent transaction provides evidence of the current fair value, adjusted for changes in economic circumstances. Valuation techniques also include the use of recent market transactions, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

- Derivatives

Derivative fair values are determined by 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 to customers

The fair value of loans and advances is estimated by discounting anticipated cash flows, including interest, at a current market rate of interest.

- Loans and advances to banks and deposits by banks

The fair value of floating rate placements and overnight deposits is equal to carrying value. The fair value of fixed interest bearing deposits is based on cash flows discounted using current money market interest rates for debts with similar maturity and credit risk characteristics.

- Cash, balances at central banks and items in course of collection

The carrying amount of such monetary assets reflects fair value.

- Customer deposits and borrowings

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

- Investment securities

Fair value is based on market prices or broker/dealer valuations. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

- Debt Securities in issue

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.

In line with the requirements of IFRS 1 ‘First time adoption of International Financial Reporting Standards’ the following fair value of financial assets and financial liabilities table for 2004 has been disclosed as previously reported under the previous GAAP.

For the table below the fair values of financial assets and financial liabilities are based on market prices where available, or are estimated using other valuation techniques. Where they are short term in nature or reprice frequently, fair value approximates to carrying value.

Notes to the Accounts (Continued)

Derivatives held for trading purposes as disclosed in note 35 are carried at fair values. Derivatives held for non-trading purposes are accounted for in the same way as the underlying transaction being hedged. Fair values are based on market prices where available, or are estimated using other valuation techniques.

The following table shows the carrying amount and the fair value of financial assets and liabilities analysed between trading and non trading:

2004		Assets		Liabilities
Group	Carrying amount £ million	Fair value £ million	Carrying amount £ million	Fair value £ million
Non trading				
Treasury bills and other eligible bills	3,705	3,704		
Debt securities	36,240	36,444		
Equity shares	208	326		
Debt securities in issue			103,051	104,039
Dated loan capital			3,807	4,091
Undated loan capital			2,615	2,816
Minority and other interests (non equity)			863	932
Derivatives	464	1,634	396	2,499
Total non trading	40,617	42,108	110,732	114,377
Trading				
Treasury bills and other eligible bills	622	622		
Loans and advances to banks	2,513	2,513		
Loans and advances to customers	1,776	1,776		
Debt securities	21,220	21,220		
Other assets	62	62		
Debt securities in issue			729	729
Deposits by banks			5,206	5,206
Customer accounts			9,481	9,481
Other liabilities			107	107
Derivatives	6,120	6,120	6,447	6,447
Total trading	32,313	32,313	21,970	21,970

Fair values in respect of non trading financial assets and liabilities are disclosed only where there is a liquid and active market.

38. Effective Interest Rates

	2005 Yield %
Assets	
Treasury bills and other eligible bills	**4.7**
Loans and advances to banks	**4.5**
Loans and advances to customers	**6.9**
Investment securities	**3.4**
Liabilities	
Deposits by banks	**4.5**
Customer accounts	**4.4**
Debt securities in issue	**3.6**
Other borrowed funds	**6.5**

The above figures do not take account of derivative interest rate hedging and so may not reflect economic margins earned.

Notes to the Accounts (Continued)

39. Interest Rate Sensitivity Gap

The table below summarises the repricing profiles of the group's assets and liabilities.

As at 31 December 2005	Up to 1 months £ million	1 to 3 months £ million	3 to 12 months £ million	1 to 2 years £ million	2 to 3 years £ million	3 to 4 years £ million	4 to 5 years £ million	Over 5 years £ million	Non interest bearing Items £ million
Assets									
Loans and advances to banks	20,049	8,188	11,642	23,661	15,537	3,848	3,191	3,708	423
Loans and advances to customers	114,915	26,751	12,551	8,298	5,051	2,022	2,300	5,771	107
Investment securities	20,714	14,210		187	131	319	241	6,483	497
Other assets, prepayments and accrued income		585							8,453
	155,678	49,734	24,193	32,146	20,719	6,189	5,732	15,962	9,480
Liabilities									
Deposits by banks	51,012	13,797	12,426	1,765	3,737	1,609	348	1,978	707
Customer accounts	66,237	15,052	4,401	1,176	765	33	747	11,478	409
Debt securities in issue	28,389	57,667	18,463	3,077	2,789	4,220	4,522	6,331	1,030
Other borrowed funds	345	2,117	386	175	688	351	298	3,771	210
Other liabilities, accruals and deferred income									5,759
Minority interests & shareholders' funds									9,476
Internal funding of trading book	(13,944)	(2,686)	(1,237)		(41)				
	132,039	85,947	34,439	6,193	7,938	6,213	5,915	23,558	17,591
	23,639	(36,213)	(10,246)	25,953	12,781	(24)	(183)	(7,596)	(8,111)
Net hedging derivatives	1,296	8,652	9,030	(24,002)	(12,166)	2,237	1,362	13,591	
Total interest rate sensitivity gap	24,935	(27,561)	(1,216)	1,951	615	2,213	1,179	5,995	(8,111)
Cumulative interest rate sensitivity gap	24,935	(2,626)	(3,842)	(1,891)	(1,276)	937	2,116	8,111	

Excluded from the above table are the carrying amounts of derivative financial instruments and financial assets and liabilities held for trading. The notional principal amounts associated with those derivatives which have been used to reduce the group's exposure to interest rate movements, have been shown as part of net hedging derivatives. This includes derivatives held for economic hedging purposes which are not in formal hedge accounting relationships. The estimated potential loss arising from the group's exposure to interest rate risk from the group's trading activities and its policy of measures and controls is shown in note 40.

Assets and liabilities associated with policyholders funds have not been included in the above table. This is on the basis that the underlying interest rate risks inherent in the net assets of the funds are matched by the policyholder liabilities, limiting the impact of these risks on the group results.

Notes to the Accounts (Continued)

In line with the requirements of IFRS 1 'First time adoption of International Financial Reporting Standards' the following interest rate sensitivity gap table for 2004 has been disclosed as previously reported under the previous GAAP.

As at 31 December 2004	Up to 3 months	3 to 6 months	6 to 12 months	1 to 5 years	Over 5 years	Non-interest Bearing	Trading	Total
	£ million	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Assets								
Treasury bills and other eligible bills	2,871	834					622	4,327
Loans and advances to banks	28,448	2,928	9,070	22,189	3,144	263	2,513	68,555
Loans and advances to customers	129,392	5,333	4,791	13,000	5,329	149	1,776	159,770
Debt securities and equity shares	30,172	2,506	215	738	1,486	1,331	21,220	57,668
Other assets	9				516	14,507	62	15,094
	190,892	11,601	14,076	35,927	10,475	16,250	26,193	305,414
Liabilities								
Deposits by banks	51,579	4,550	6,655	6,699	1,850		5,206	76,539
Customer accounts	71,244	1,077	1,307	1,416	10,393	1,099	9,481	96,017
Debt securities in issue	80,015	4,686	4,842	5,576	7,932		729	103,780
Other liabilities						12,741	107	12,848
Subordinated liabilities	1,749	138		811	3,738	(14)		6,422
Minority interests & shareholders' funds					860	8,948		9,808
Internal funding of trading business	(11,082)	(413)	125	365	335		10,670	
	193,505	10,038	12,929	14,867	25,108	22,774	26,193	305,414
On-balance sheet gap	(2,613)	1,563	1,147	21,060	(14,633)	(6,524)		
Non trading derivatives	(2,190)	1,038	(186)	(14,916)	16,254			
Net interest rate repricing gap at 31 December 2004	(4,803)	2,601	961	6,144	1,621	(6,524)		
Cumulative gap at 31 December 2004	(4,803)	(2,202)	(1,241)	4,903	6,524			

40. Trading Value at Risk

The group's Value at Risk ("VaR") methodology of estimating potential losses arising from the group's exposure to market risk is explained on page 13 of the Risk Management report. The group's trading market risk exposure for the year ended 31 December 2005 is analysed below.

	Exposure							
			Average		Highest		Lowest	
	As at 31 December	As at 31 December						
	2005	2004	**2005**	2004	**2005**	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million	**£ million**	£ million	**£ million**	£ million
Total value at risk	**5.7**	5.1	**6.1**	5.6	**8.8**	9.4	**3.7**	3.6
Included in the above								
Value at risk relating to interest rates	**1.4**	1.3	**1.9**	2.4	**3.7**	5.5	**0.6**	0.9
Value at risk relating to foreign exchange	**0.3**	0.1	**0.6**	0.9	**2.5**	2.6	**0.1**	0.1

Interest rate risk relating to the trading book is managed using interest rate sensitivity methods to principally measure exposure and set limits. This methodology calculates the present value impact of a one basis point parallel movement in interest rates on the outstanding interest rate risk positions. For all significant exposures VaR has been calculated on a daily basis.

Notes to the Accounts (Continued)

41. Non Trading Currency Exposure

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

			2005			2004
Functional currency of the operation	**Net investments in overseas operations £ million**	**Borrowing taken out to hedge the net investments £ million**	**Remaining structural currency exposure £ million**	Net investments in overseas operations £ million	Borrowing taken out to hedge the net investments £ million	Remaining structural currency exposure £ million
US Dollar	**161**	**161**		90	49	41
Euro	**569**	**569**		522	522	
Australian Dollar	**1,345**	**1,341**	**4**	1,119	1,099	20
Other	**10**		**10**	11		11
Total	**2,085**	**2,071**	**14**	1,742	1,670	72

As at 31 December 2005 and 31 December 2004 there were 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 group's foreign exchange exposures is set out on page 13 of the Risk Management report.

42. Assets and Liabilities in Foreign Currencies

		Group		Bank
	2005 £ million	2004 £ million	**2005 £ million**	2004 £ million
The aggregate amounts of assets and liabilities denominated in currencies other than sterling were:				
Assets	**180,991**	97,791	**16,037**	21,251
Liabilities	**203,935**	104,708	**10,079**	21,499

The above figures do not reflect the group exposure to foreign exchange, which is significantly lower as it is hedged by off-balance sheet instruments.

Notes to the Accounts (Continued)

43. Maturity Analysis of Assets and Liabilities

The table below breaks down the group's assets and liabilities by remaining contractual maturity. The maturity profile for those assets and liabilities defined as 'financial' have been determined in accordance with groupings that are considered most appropriate for those particular assets and liabilities. The remaining assets and liabilities have been split between those considered to be current and non current.

As at 31 December 2005	Up to 1 month £ million	1 to 3 months £ million	3 to 12 months £ million	1 to 5 years £ million	Over 5 years £ million	Policyholder Funds* £ million	Total £ million
Assets							
Cash and balances with central banks	**1,376**		**8**				**1,384**
Items in the course of collection	**603**						**603**
Financial assets held for trading	**14,992**	**10,251**	**6,504**	**1,826**	**8,193**		**41,766**
Derivative assets	**331**	**599**	**843**	**2,344**	**5,594**		**9,711**
Loans and advances to banks	**20,166**	**6,919**	**11,877**	**45,674**	**5,611**		**90,247**
Loans and advances to customers	**25,874**	**48,984**	**10,017**	**26,673**	**66,218**		**177,766**
Investment securities	**510**	**225**	**1,669**	**7,251**	**33,029**	**98**	**42,782**
Total financial assets	**63,852**	**66,978**	**30,918**	**83,768**	**118,645**	**98**	**364,259**
Liabilities							
Deposits by banks	**38,450**	**14,155**	**12,566**	**11,439**	**10,769**		**87,379**
Financial liabilities held for trading	**13,727**	**5,106**	**6,021**	**153**			**25,007**
Customer accounts	**68,292**	**7,396**	**3,704**	**4,815**	**16,092**		**100,299**
Derivative liabilities	**221**	**834**	**778**	**2,297**	**4,432**		**8,562**
Insurance contract liabilities	**17**						**17**
Investment contract liabilities						**98**	**98**
Debt securities in issue	**19,290**	**38,322**	**22,405**	**31,848**	**14,622**		**126,487**
Other borrowed funds	**16**	**49**	**170**	**674**	**7,432**		**8,341**
Total financial liabilities	**140,013**	**65,862**	**45,644**	**51,226**	**53,347**	**98**	**356,190**

* Policyholder funds include the unit linked and with profit funds where the liquidity risks is for the account of the policyholder and has no direct impact on the shareholder's balance sheet and accordingly, these assets and liabilities have been excluded from the above analysis.

Of the £7 billion remaining assets £4 billion is considered to be current. Similarly of the £6 billion remaining liabilities £5 billion is considered to be current.

Notes to the Accounts (Continued)

Maturity Analysis of Assets and Liabilities 2004.

The table below breaks down the group's assets and liabilities by remaining contractual maturity. The maturity profile for those assets and liabilities defined as 'financial' have been determined in accordance with groupings that are considered most appropriate for those particular assets and liabilities. The remaining assets and liabilities have been split between those considered to be current and non-current.

As at 31 December 2004	Up to 1 month £'000	1 to 3 months £'000	3 to 12 months £'000	1 Year to 5 years £'000	Over 5 years £'000	Total £'000
Assets						
Cash and balances with central banks	1,276					1,276
Items in the course of collection	611					611
Treasury bills and other eligible bills	1,435	1,936	956			4,327
Loans and advances to banks	22,098	6,277	12,408	23,248	4,524	68,555
Loans and advances to customers	33,297	32,785	9,363	25,031	59,190	159,666
Investment securities	7,542	7,685	6,761	8,052	27,746	57,786
Total financial assets	66,259	48,683	29,488	56,331	91,460	292,221
Liabilities						
Deposits by banks	35,234	12,658	11,321	8,656	8,670	76,539
Customer accounts	65,880	11,784	3,920	2,421	12,012	96,017
Debt securities in issue	19,255	35,448	14,839	25,532	8,706	103,780
Other borrowed funds				491	5,931	6,422
Total financial liabilities	120,369	59,890	30,080	37,100	35,319	282,758

Of the £13 billion remaining assets £10 billion is considered to be current. Similarly of the £13 billion remaining liabilities £12 billion is considered to be current.

44. Related Party Transactions

The ultimate parent of the group is HBOS plc. A number of banking transactions are entered into with its subsidiaries in the normal course of business. These include loans, deposits and foreign currency transactions. The balances held due and by HBOS plc subsidiaries are shown within the notes to the accounts. The interest income received and paid is £4,522 million (2004 - £2,345 million) and is £2,128 million (2004 - £1,531 million) respectively. HBOS plc is the principal employer of the group and staff costs amounting to £826 million were recharged to the group.

In the year ended 31 December 2005, Bank of Scotland group provided both administration and processing services to Sainsbury's Bank plc. The amounts in respect of administration and processing services payable to Bank of Scotland group during the year were £37 million (2004 − £34 million), of which £23 million was outstanding at the year end (2004 − £21 million).

45. Transactions with Key Management Personnel

For the purposes of IAS 24 'Related party disclosures', 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.

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 Bank of Scotland and its subsidiaries. These product relationships 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 benefit in kind are declared to HM Revenue & Customs and taxed accordingly.

Key management personnel and members of their close families have undertaken transactions with Bank of Scotland and its subsidiary undertakings, jointly controlled entities and associated undertakings in the normal course of business, details of which are given below. The group's policy in relation to lending to related parties and other product offerings is disclosed in the HBOS Group accounts of HBOS plc, the ultimate parent undertaking of Bank of Scotland.

Notes to the Accounts (Continued)

Transactions with Key Management Personnel

Mortgages, credit cards and term loans	Number of key management personnel	£'000
At 1 January 2004 or date of appointment, if later	8	1,783
Amounts advanced during the year	7	1,697
Interest charged	4	90
Amounts repaid during the year	4	(106)
Upon resignation of office	2	(2)
At 31 December 2004	6	3,462
Interest charged	4	164
Amounts repaid during the year	4	(1,083)
Upon resignation of office	2	(85)
At 31 December 2005	**4**	**2,458**

Bank, cheque or current accounts	Number of key management personnel	Credit balances £'000	Debit balances £'000	Net balances £'000
At 1 January 2004 or date of appointment, if later	5	1,977	(173)	1,804
Net movement during the year	6	(853)	113	(740)
Upon resignation of office	1	(308)		(308)
At 31 December 2004	5	816	(60)	756
Balance outstanding at date of appointment	1	16		16
Net movement during the year	9	278	(17)	261
Upon resignation of office	2	(118)		(118)
At 31 December 2005	**7**	**992**	**(77)**	**915**

Savings and deposit accounts	Number of key management personnel	£'000
At 1 January 2004 or date of appointment, if later	4	643
Amounts deposited during the year	1	399
Interest credited	4	15
Amounts withdrawn during the year	2	(292)
Upon resignation of office	1	(10)
At 31 December 2004	3	755
Balance outstanding at date of appointment	1	105
Amounts deposited during the year	2	1,225
Interest credited	3	14
Amounts withdrawn during the year	2	(888)
Upon resignation of office	2	(294)
At 31 December 2005	**2**	**917**

Life assurance and investment contracts	Number of key management personnel	£'000
At 1 January 2004 or date of appointment, if later	2	2,023
Premiums paid/amounts invested during the year	2	52
Other movements including investment returns	2	23
Upon resignation of office	1	(1,794)
Total sum insured/value of investment at 31 December 2004	1	304
Premiums paid/amounts invested during the year	1	1,231
Other movements including investment returns	1	298
Total sum insured/value of investment at 31 December 2005	**1**	**1,833**

Notes to the Accounts (Continued)

46. Segmental Analysis

Business Sector

Following an internal reorganisation, from 1 January 2005, the group reported throughout the year through five divisions (Retail, Corporate, Insurance & Investment, International and Treasury & Asset Management), plus Group Items. 2004 figures have been restated to reflect the new structure.

2005	Retail	Corporate	Insurance & Investment	International	Treasury & Asset Management	Group Items	Total
	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Net interest income	911	1,689	2	1,016	181		3,799
Net fees and commission income	188	278	15	137	(23)		595
Net trading income	3	12		3	196		214
Other operating income	38	986		83	15		1,122
Net operating income	1,140	2,965	17	1,239	369		5,730
Administrative expenses	(347)	(650)		(443)	(131)	(139)	(1,710)
Depreciation and amortisation	(16)	(506)		(44)	(2)	(37)	(605)
Other operating expenses				(18)			(18)
Operating expenses	(363)	(1,156)		(505)	(133)	(176)	(2,333)
Impairment	(245)	(474)		(183)			(902)
Operating profit/(loss)	532	1,335	17	551	236	(176)	2,495
Share of profits/(losses) of jointly controlled entities and associated under-takings	7	46		(2)			51
Profit/(loss) before tax	539	1,381	17	549	236	(176)	2,546
Total assets	45,582	79,453	2	45,635	200,659	(21)	371,310
Included in total assets:							
Interests in jointly controlled entities and associates undertakings	56	304	1	13			374
Total liabilities	44,087	74,779	2	43,504	199,483	(21)	361,834
Capital expenditure		1		77	2	49	129

Notes to the Accounts (Continued)

2004	Retail	Corporate	Insurance & Investment	International	Treasury & Asset Management	Group Items	Total
	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Net interest income	928	1,278		604	170		2,980
Net fees and commission income	204	607	31	211	(27)		1,026
Net trading income					208		208
Other operating income	50	635		45	24		754
Net operating income	1,182	2,520	31	860	375		4,968
Administrative expenses	(387)	(637)		(318)	(116)	(78)	(1,536)
Depreciation and amortisation	(17)	(385)		(34)		(41)	(477)
Goodwill impairment						(6)	(6)
Other operating expenses				(1)			(1)
Operating expenses	(404)	(1,022)		(353)	(116)	(125)	(2,020)
Impairment	(177)	(393)	1	(184)			(753)
Operating profit	601	1,105	32	323	259	(125)	2,195
Share of profits and losses of jointly controlled entities and associated undertakings	33	65		13			111
Non-operating income	13						13
Profit/(loss) before tax	647	1,170	32	336	259	(125)	2,319
Total assets	41,822	73,680	13	35,499	154,464	(10)	305,468
Included in total assets:-							
Interests in jointly controlled entities and associated undertakings	41	219		(22)			238
Total liabilities	39,899	69,088	13	33,274	153,612	(10)	295,876
Capital expenditure		4		11		59	74

Notes to the Accounts (Continued)

Geographical

The table below analyses the group results and assets by the geographical area in which the business is generated. The geographical analysis is prepared in accordance with the location of the relevant company or branch.

Group	UK		Rest of world		Total	
	2005	2004	**2005**	2004	**2005**	2004
	£ million	£ million	**£ million**	£ million	**£ million**	£ million
Net interest income	**2,806**	2,458	**993**	522	**3,799**	2,980
Net fees and commissions income	**457**	828	**138**	198	**595**	1,026
Net trading income	**212**	189	**2**	19	**214**	208
Other operating income	**1,052**	682	**70**	72	**1,122**	754
Net operating income	**4,527**	4,157	**1,203**	811	**5,730**	4,968
Administrative expenses	**(1,253)**	(1,372)	**(457)**	(165)	**(1,710)**	(1,537)
Depreciation and amortisation	**(575)**	(456)	**(30)**	(21)	**(605)**	(477)
Goodwill impairment		(6)				(6)
Other operating expenses			**(18)**		**(18)**	
Operating expenses	**(1,828)**	(1,834)	**(505)**	(186)	**(2,333)**	(2,020)
Impairment	**(726)**	(571)	**(176)**	(182)	**(902)**	(753)
Operating profit	**1,973**	1,752	**522**	443	**2,495**	2,195
Share of profits of joint controlled entities and associated undertakings	**53**	109	**(2)**	2	**51**	111
Non-operating income		13				13
Profit before tax	**2,026**	1,874	**520**	445	**2,546**	2,319
Total assets	**309,075**	265,862	**62,235**	39,606	**371,310**	305,468
Included in total assets are interests in jointly controlled entities and associated undertakings	**365**	244	**9**	(6)	**374**	238
Total liabilities	**303,088**	251,865	**58,746**	44,011	**361,834**	295,876
Capital expenditure	**49**	61	**80**	13	**129**	74

47. Ultimate Parent Undertaking

HBOS plc is the ultimate parent undertaking of Bank of Scotland group. Copies of the Annual Report and Accounts of HBOS plc may be obtained from its head office at The Mound, Edinburgh, EH1 1YZ.

48. Explanation of transition to IFRS

As stated in the ‘Statement of Compliance’ within the Accounting Policies on page 31, these are the group’s first consolidated financial statements prepared in accordance with IFRS.

In preparing the opening IFRS Balance Sheet, the group has adjusted amounts previously reported in financial statements prepared in accordance with previous GAAP. An explanation of how the transition from this previous GAAP to IFRS’s has affected the group’s financial position, financial performance and cash flows is set out in notes 49 to 52. Details of the Bank’s transitional adjustments are shown in note 30.

Notes to the Accounts (Continued)

49. Reconciliation of UK GAAP Balance Sheet to IFRS

The reconciliation below explains the restatement of the group balance sheet at 31 December 2004 from UK GAAP to IFRS. The restated IFRS balance sheet excludes the application of IAS 32, IAS 39 and IFRS4.

			IFRS adjustments		
As at 31 December 2004	Note 52	UK GAAP £ million	Reclassification £ million	Adjustment to equity £ million	IFRS £ million
Assets					
Cash and balances at central banks		1,276			1,276
Items in course of collection		611			611
Treasury bills and other eligible bills		4,327			4,327
Loans and advances to banks		68,555			68,555
Loans and advances to customers	A, D	163,940	(31)	(73)	163,836
Less: Non-returnable finance		(4,170)			(4,170)
		159,770	(31)	(73)	159,666
Investment securities					
Debt securities	B	57,460	132		57,592
Equity shares	B	208	(14)		194
Interests in jointly controlled entities	B	144	(96)	31	79
Interests in associated undertakings	B	169	(22)	12	159
Goodwill and other intangible assets	C	391	85	22	498
Property and equipment	C	539	(85)		454
Investment properties	D		34		34
Operating lease assets	A	1,883		(51)	1,832
Other assets		7,724		(3)	7,721
Prepayments and accrued income		2,473	(3)		2,470
Total assets		305,530		(62)	305,468
Liabilities					
Deposits by banks		76,539			76,539
Customer accounts		96,017			96,017
Notes in circulation		721			721
Net post retirement benefit liability	F		74	585	659
Current tax liabilities		303			303
Deferred tax liabilities	A	212		(202)	10
Dividends payable	E	266		(253)	13
Other liabilities		8,602		4	8,606
Accruals and deferred income		2,761		20	2,781
Other provisions		99	(74)		25
Debt securities in issue		103,780			103,780
Subordinated liabilities		6,422			6,422
Total liabilities		295,722		154	295,876

Notes to the Accounts (Continued)

As at 31 December 2004	Note 52	UK GAAP £ million	IFRS adjustments Reclassification £ million	IFRS adjustments Adjustment to equity £ million	IFRS £ million
Shareholders' Equity					
Issued share capital		810			810
Share premium		2,951			2,951
Other reserves	D	(11)		6	(5)
Profit and loss account	A,C,F	5,172		(222)	4,950
Shareholders' equity (excluding minority interests)		8,922		(216)	8,706
Minority interests (equity)		23			23
Minority and other interests (non-equity)		863			863
		9,808		(216)	9,592
Total liabilities and equity		305,530		(62)	305,468

Reconciliation of equity

	At 31 Dec 2003 and 1 Jan 2004	Movement in year ended 31 Dec 2004				At 31 Dec 2004
	Equity £ million	Share capital and share premium £ million	Retained profits £ million	Other reserves £ million	Minority interests £ million	Equity £ million
Under UK GAAP	8,611		1,164	(9)	42	9,808
IFRS adjustments:						
Leasing	(144)		20			(124)
Goodwill			22			22
Associates and jointly controlled entities	31		12			43
Post employment obligations	(474)		(111)			(585)
Dividends	317		(64)			253
Deferred Tax	169		33			202
Other	(4)		(29)	6		(27)
	(105)		(117)	6		(216)
Under IFRS	8,506		1,047	(3)	42	9,592

Notes to the Accounts (Continued)

50. Reconciliation of IFRS Balance Sheet Transition from 31 December 2004 to 1 January 2005

The balance sheet below explains the restatement of the balance sheet at 31 December 2004 to include the application of IAS 32/39 and IFRS 4 as at 1 January 2005.

			IFRS adjustments		
		As at 31 Dec 2004	Reclassification	Adjustment to equity	As at 1 Jan 2005
	Note 52	£ million	£ million	£ million	£ million
Assets					
Cash and balances at central banks		1,276			1,276
Items in course of collection		611			611
Financial assets held for trading	G		27,200		27,200
Derivative assets	I		7,087	1,311	8,398
Treasury bills and other eligible bills	G	4,327	(623)		3,704
Loans and advances to banks	G	68,555	(2,513)		66,042
Loans and advances to customers	G	163,836	(1,776)	(288)	161,772
Less: Non-returnable finance	H	(4,170)	4,170		
		159,666	2,394	(288)	161,772
Investment securities					
Debt securities	G	57,592	(21,656)	144	36,080
Equity shares	G	194	437	119	750
Interests in jointly controlled entities		79		2	81
Interests in associated undertakings		159		1	160
Goodwill and other intangible assets		498			498
Property and equipment		454			454
Investment properties		34			34
Operating lease assets		1,832			1,832
Other assets	H,I	7,721	(6,240)		1,481
Prepayments and accrued income	H,I	2,470	(426)	(16)	2,028
Total assets		305,468	5,660	1,273	312,401
Liabilities					
Deposits by banks	G	76,539	(5,580)		70,959
Customer accounts	G	96,017	(9,481)		86,536
Financial liabilities held for trading	G		16,528		16,528
Derivative liabilities	I		7,423	2,191	9,614
Notes in circulation		721			721
Net post retirement benefit liability		659			659
Current tax liabilities		303			303
Deferred tax liabilities		10		(40)	(30)
Dividends payable	J	13	(13)		
Other liabilities	G,J	8,606	(6,673)	(184)	1,749
Accruals and deferred income		2,781		(24)	2,757
Other provisions		25			25
Debt securities in issue	G	103,780	3,441	(688)	106,533
Other borrowing	J		1,232		1,232
Subordinated liabilities	J	6,422		184	6,606
Total liabilities		295,876	6,877	1,439	304,192

Notes to the Accounts (Continued)

			IFRS Adjustments		
		As at 31 Dec 2004	Reclassification	Adjustment to Equity	As at 1 Jan 2005
	Note 52	£ million	£ million	£ million	£ million
Shareholders' Equity					
Issued share capital	J	810	(354)		456
Share premium		2,951			2,951
Other reserves	G	(5)		277	272
Profit and loss account	G.H,I	4,950		(436)	4,514
Shareholders' equity (excluding minority interests)		8,706	(354)	(159)	8,193
Minority interests (equity)	J	23		(7)	16
Minority and other interests (non-equity)		863	(863)		
		9,592	(1,217)	(166)	8,209
Total liabilities and equity		305,468	5,660	1,273	312,401

Reconciliation of equity

	Equity
	£ million
Under IFRS At 31 Dec 2004	9,592
IFRS adjustment:	
Fair value adjustments for available for sale securities	168
Loan fees, cost recognition and interest on an effective yield basis	(164)
Loan impairment provisioning	(140)
Hedging and derivatives	(31)
Other	8
	(159)
Movement in minority interest (equity)	(7)
Reclassification of preference shares	(354)
Reclassification of minority interest (non equity)	(863)
	(1,383)
Under IFRS as at 1 January 2005	8,209

Notes to the Accounts (Continued)

51. Reconciliation of UK GAAP Profit and Loss to IFRS Income Statement for the year ended 31 December 2004

Year ended 31 December 2004	Note 52	UK GAAP year ended 31 Dec 2004 £ million	IFRS Adjustments £ million	IFRS year ended 31 Dec 2004 £ million
Net interest income	A	3,016	(36)	2,980
Non interest income	A	1,955	33	1,988
Net operating income		4,971	(3)	4,968
Operating expenses	A,F	(2,002)	(18)	(2,020)
Impairment on investment securities		(24)		(24)
Operating profit before provisions		2,945	(21)	2,924
Impairment losses on loans and advances		(729)		(729)
Share of profits of associates and jointly controlled entities	B	92	19	111
Non operating income		13		13
Profit before tax		2,321	(2)	2,319
Tax on profit	A	(668)	7	(661)
Profit after taxation		1,653	5	1,658

Explanation of material adjustments to the cashflow statement for 2005 and 2004

Cash and cash equivalents under IFRS consist of cash and balances with central banks that are freely available and non-equity investments with a maturity of three months or less from the date of acquisition. Under UK GAAP cash and cash equivalents consist of cash and balances with central banks and loans and advances to banks repayable on demand. There are no other significant changes to the cashflow statement for 2005 and 2004 on transition to IFRS.

52. Notes to the analysis of the Income Statement, Balance Sheet and Equity Impact

Detailed below are supplementary notes that provide explanations of the income statement, balance sheet reclassifications and equity impact to reserves as a result of the transition to IFRS. The explanations have been split between excluding and including IAS 32, IAS 39 and IFRS 4 to support the respective balance sheets in notes 49 and 50.

IFRS Adjustments – Excluding IAS 32, IAS 39 and IFRS 4

(A) Leasing

Finance Leases

Under the UK GAAP the group held finance lease assets on the balance sheet within loans and advances to customers at an amount equal to the net investment in the lease after making provisions for items such as bad and doubtful rentals receivable. The total gross earnings under a finance lease were allocated to accounting periods to give a constant periodic rate of return to the lessor's net cash investment outstanding in respect of the lease. Under IFRS the total gross earnings are allocated to accounting periods using an actuarial pre tax method to give a constant rate of return on the net investment.

Operating Leases

For operating leases, rental income continues to be recognised on a straight-line basis. However, the calculation of the depreciation on operating lease assets has changed from a post tax actuarial method to a straight-line pre tax basis. This is to ensure that the depreciation profile matches that of similar assets for use by the group

(B) Interests in Jointly Controlled Entities ("JCEs") and Associates

Interests in JCEs and associates follow the provisions of IAS 28 and IAS 31 respectively using the equity accounting method.

Jointly controlled entities

Under UK GAAP, interests in JCEs were accounted for using the equity accounting method. Under IFRS, the group continues to account for jointly controlled entities using the equity accounting method. IFRS requires investments in debt securities issued by the JCEs to be disclosed separately from the underlying carrying value of these entities. This results in a reclassification of debt securities to investment securities. In addition under IFRS losses should be restricted to a level that reflects an obligation to fund such losses, whereas under UK GAAP losses were taken beyond this level.

Associates

The definition of an associate differs under IFRS from that of UK GAAP and therefore the scope of what can and cannot be included has changed. In addition under UK GAAP, the carrying value of associates includes any preference shares or loan stock held by the group relating to those entities. Following the introduction of IFRS these debt securities are disclosed separately from the underlying carrying value of these entities. This results in a reclassification from associates to debt securities.

(C) Goodwill and Other Intangible Assets

Under UK GAAP, goodwill was capitalised and amortised by equal instalments over its estimated useful life, not exceeding 20 year. Goodwill was subject to an impairment review when a change in circumstances indicated the carrying amount may not be recoverable. Under IFRS, impairment reviews for intangible assets are undertaken six monthly. Goodwill amortisation under IFRS is prohibited. Software development costs are capitilised in line with our accounting policy and reclassified to Goodwill and Other Intangible assets. Amortisation is carried out on the same basis as under UK GAAP.

(D) Investment Properties

IFRS requires the separate identification of investment properties. The changes resulting from certain subsidiaries that have been funded for the purpose of property development. At a consolidated level under UK GAAP the costs of property development have been treated as loans and advances to customers as the substance of the transaction is that of lending. However under IFRS the classification of the transaction must follow the treatment within the individual subsidiaries and therefore requires a reclassification from loans and advances to customers.

(E) Dividends Paid and Payable

Under UK GAAP, dividends were recognised in the period to which they related.

Under IFRS ordinary dividends paid in the year are not included on the income statement, but are recognised directly in the retained earnings reserve.

In addition, under IFRS the group does not recognise ordinary dividends that have been declared or proposed after the balance sheet date. The liability for outstanding distributions on preference securities at the balance sheet date is due to the group's contractual obligation to pay distributions due on these preference securities.

(F) Net Post Retirement Benefit Liability

Under UK GAAP, the cost of providing retirement pension and related benefits was charged against profits on a systematic basis over employee service lives.

Under the IAS 19, defined benefit pension schemes and other post-retirement benefit plans are recognised in the balance sheet and represent the present value of the defined benefit obligation.

Actuarial gains and losses will be recognised in full in the period they arise within the Statement of Recognised Income and Expenses ("SORIE"). In addition the basis on which certain assets are valued is also different to FRS 17, which values assets based on a mid price basis while IAS 19 (via IAS 39) requires all assets to be valued on a bid price basis as of 1 January 2005. The group has elected to recognise all cumulative actuarial gains and losses for all group defined benefit schemes in opening equity at 1 January 2004 on transition to IFRS.

IFRS Adjustments – Including IAS 32, IAS 39 and IFRS 4

(G) Investment Securities Reclassification

Under UK GAAP, debt securities and other fixed interest securities held for trading were included at market value with gains or losses included in dealing profits. Debt securities and other fixed interest securities held for the longer term and equity securities were included at cost less amounts written off. Gains or losses on disposal and income are recognised in other operation income as they arise. Equity shares held for investment were stated at cost less amounts written off. Income from listed equity share was credited to other operating income on the ex-dividend date for listed equity and on the equivalent date for unlisted equity.

Under IFRS, both equity shares and debt securities are included within investment securities.

IAS 39 established specific categories into which all financial assets and liabilities must be classified. The classification of financial instruments dictates how these assets and liabilities are subsequently measured in the financial statements. There are four categories of financial assets: Assets at fair value through profit and loss, available for sale, loans and receivables and held to maturity.

Assets at fair value through the income statement

These assets are carried at fair value with changes in fair value taken to the income statement. This category includes assets held for trading where they are held for the purpose of selling in the near term or as investments that are held to meet insurance policyholder liabilities.

Available-for-sale financial assets ("AFS")

These are any non-derivative financial assets designated on initial recognition as available for sale. AFS assets are measured at fair value in the balance sheet. Fair value changes on AFS assets are recognised directly in equity, through the SORIE, except for interest on AFS assets (which is recongised in income on an effective interest rate basis), impairment losses, and (for interest-bearing AFS debt instruments) foreign exchange gains or losses. The cumulative gain or loss that was recognised in equity is recognised in the income statement when an available-for-sale financial asset is derecognised.

Loans and receivables

These are non-derivative financial assets with fixed or determinable payments, originated or acquired, that are not quoted in an active market, not held for trading, and not designated on initial recognition as assets at fair value through the income statement or as available-for-sale. Investment debt securities that are not quoted on an active market are categorised as loans and receivables.

Held-to-maturity investment

The group has no investment securities designated under this category.

(H) Loans and Advances

Under UK GAAP loans and advances were held at cost less provisions.

Under IFRS loans and advances are held at amortised cost with revenue recognised on an effective interest rate basis.

The non-returnable finance on securitised customer advances that met the criteria for linked presentation in accordance with the UK Reporting Standard FRS 5 'Reporting the substance of transactions' are now classed as debt securities in issue, from 1 January 2005.

The opening IFRS adjustment to reserves in respect of impairment reflects the net impact of moving to a narrower interpretation of an incurred loss model which recognises recoverable cash flows applying a discount rate based on the loan's effective interest rate.

(I) Derivatives/Hedge Accounting

Hedging the group's exposures to interest rate and foreign exchange rate risk is undertaken in the normal course of business by using derivatives. This activity is principally carried out in Treasury within a risk management framework of limits, practices and procedures set and overseen by the HBOS Group Market Risk Committee.

Under UK GAAP, derivatives were held off-balance sheet.

IAS 39 will now require the fair value of all derivatives to be recorded on the balance sheet with any movements in value taken to the income statement as they arise. Given that fair values will fluctuate, these movements will create volatility in reserves and the income statement. Only in circumstances where hedge accounting for derivatives is employed will the income statement be protected from this volatility.

The hedge accounting strategy being adopted by the group is to utilise a combination of both the macro cash flow and micro fair value approaches. In the case of the macro cash flow approach, the hedging derivative is measured at fair value with any movement taken to reserves. In these circumstances, no fair value accounting entries are required of the hedged loans or deposits. This approach gives rise to volatility in reserves, but protects the income statement to the extent the hedge is effective.

In addition, the group will also use the micro fair value approach, which requires that the hedging derivative is measured at fair value with movements recognised in the income statements, rather than reserves. The designated hedged item is also adjusted by the change in fair value in relation to the risk being hedged and that change is recognised through the income statement. Therefore, if the hedge is fully effective, postings to the income statement will be equal and opposite.

(J) Reclassification of Funding Instruments

There is a classification switch of certain funding instruments historically shown within capital and reserves, to other borrowed funds. This arises because the IFRS definition of debt includes instruments with a contractual obligation to pay interest or principal.

The most significant balance sheet reclassifications are in respect of non-equity minority interests including innovative tier 1 securities, historically shown under capital and reserves, are now reclassified as liabilities and disclosed within other borrowed funds on the face of the balance sheet. Non equity preference shares previously shown under capital and reserves but have been reclassified as liabilities and disclosed as other borrowings.