

Registered Number 3331871

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**DIRECTORS' REPORT AND FINANCIAL STATEMENTS**  
**YEAR ENDED 31 DECEMBER 2008**

TUESDAY



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14/07/2009  
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**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC  
DIRECTORS' REPORT AND FINANCIAL STATEMENTS**

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**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**DIRECTORS AND COMPANY INFORMATION**

**DIRECTORS**

I G Stewart  
P A Curran

**SECRETARY**

A Lockwood

**REGISTERED OFFICE**

Premier House  
City Road  
CHESTER  
CH88 3AN

**AUDITORS**

KPMG Audit Plc  
1 The Embankment  
Neville Street  
LEEDS  
LS1 4DW

## **BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC DIRECTORS' REPORT**

The directors present their report and the audited financial statements for the year ended 31 December 2008.

### **BUSINESS REVIEW**

#### **Principal activity**

The principal activity of BOS (Shared Appreciation Mortgages) NO.3 PLC (the "Company") is to finance mortgage lending. In 1998 the Company issued £46.6m fixed rate notes (the "Notes"). The interest payable on the Notes is set at 4.50% per annum until February 2028. Thereafter, the interest rate applicable to the Notes is set at 5.50% per annum until 2073. The Notes are secured on the mortgage portfolio. The capital appreciation arising on the sale of a mortgage holder's property is shared between the mortgage holder and the Company as set out in the original loan agreement. The Company pays its entire share of the appreciation to the Note holders.

The activities of the Company are conducted primarily by reference to a series of transaction documents (the "Programme Documentation").

Movements in the mortgage book are disclosed in the notes to the financial statements.

#### **Business structure**

BOS (Shared Appreciation Mortgages) NO.3 PLC is a subsidiary undertaking of Bank of Scotland plc ("BOS") and HBOS plc.

### **RISK MANAGEMENT**

The majority of the Company's assets and liabilities have been classified as financial instruments in accordance with IAS 32 "Financial Instruments: Presentation".

The Company's financial instruments are principally a mortgage portfolio, cash and liquid resources, an embedded derivative, interest-bearing loans and borrowings and various other receivables and payables that arise directly from its operations. The principal purpose of these financial instruments is to raise finance for the Company's operations. It is, and has been throughout the year under review, the Company's policy that no trading in financial instruments is undertaken.

The principal risks arising from the Company's financial instruments are credit risk and interest rate risk. These and other risks which may affect the Company's performance are detailed below. Further analysis of the risks facing the Company on its financial instruments is provided in note 17.

#### **Credit Risk**

Credit risk arises on the individual loans within the mortgage loan portfolio which are in turn secured on the underlying UK residential properties. The performance of these loans is therefore influenced by the economic background and the UK housing market. However, the maximum loan-to-value of the original advances was 75% and the credit risk is considered to be low.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**DIRECTORS' REPORT (CONTINUED)**

**RISK MANAGEMENT (CONTINUED)**

**Credit Risk (continued)**

The extent to which the Company can meet its obligations to pay interest and ultimately repay the Notes will be dependent upon the receipt of funds earned on the mortgage portfolio and monies deposited in the Reserve Account with an external provider (see "Liquidity Risk"). To the extent that this income does not provide sufficient funds to cover the interest due on the Notes or the repayment of the Notes the Company has no claim on the assets of BOS.

The terms of the Mortgage Portfolio Agreement given by BOS in respect of the mortgages require BOS to repurchase any mortgage which is found to be in breach of warranty. BOS will repurchase any mortgages that are found or held not to be valid, binding and enforceable.

Although in such an event the total value of the outstanding loan and any accrued interest will be covered by BOS, the Note holder will not receive the benefit of any future payments of appreciation amounts or partial repayment of appreciation amounts in respect of the mortgages repurchased.

Shared appreciation is subject to the movement in the market value of the property which is dependent upon house price inflation ("HPI"). This may provide a return on the Notes below initial expectations. Any expected increase in value cannot be guaranteed.

**Interest Rate Risk**

Interest rate risk exists where assets and liabilities have interest rates set under a different basis or which reset at a different time. The Company minimises its exposure to interest rate risk by ensuring that the interest rate characteristics of assets and liabilities are similar. Both the mortgage portfolio and the Notes issued by the Company are exposed to fair value interest rate risk as they carry fixed interest rates.

**Liquidity Risk**

The Company holds a Reserve Account of £1,396,800 deposited with an external provider which, should it be needed, can be used to withdraw money to meet its obligations under the Notes. The Company has not drawn on this facility since inception.

**Operational Risk**

In accordance with the Programme Documentation the Company is bound to make payments to meet third party expenses.

The Company's operations are subject to periodic review by the Internal Audit function of HBOS plc.

**PERFORMANCE**

The Company's business will continue to unwind over the life of the mortgages issued as no further advances will be made. Cash is continuing to be collected.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**DIRECTORS' REPORT (CONTINUED)**

**PERFORMANCE (CONTINUED)**

The principal asset in the Company is a mortgage portfolio which is subject to an annual impairment review. The mortgage portfolio is subject to the economic factors relating to the housing market (see "Credit Risk" above). In 2008 the UK has experienced a significant reduction in activity in the housing market, together with a growth in mortgage arrears, as the effects of recession became more widespread. This trend has not significantly affected the Company's arrears levels (see note 17) and no impairment provision was deemed necessary as at 31 December 2008 or 31 December 2007.

Although UK interest rates have experienced significant volatility in 2008, the Company's net interest margin has not been adversely affected due to the fixing of rates in the original Programme Documentation. The underlying profits are determined by a margin earned between the interest received on the mortgages and the interest paid to the Note holders.

Under International Financial Reporting Standards ("IFRSs") an effective yield adjustment is made on interest receivable and interest payable. The expected life of the mortgages and Notes has been extended in 2008 to reflect actual payment experience. The net difference passed through the income statement for the year ended 31 December 2008 was £2,115 loss (31 December 2007: £7,404 loss).

The key performance indicators used by management in assessing the performance of the Company is the monitoring of actual interest cash flows against planned cash flows on the Notes. The Company's performance is addressed in the quarterly management accounts provided to the directors.

**OTHER INFORMATION**

The Company has employed no staff during the year ended 31 December 2008 or the previous year.

**RESULTS AND DIVIDEND**

No new mortgages were acquired or generated by the Company in the year and no new Notes were issued.

The profit after taxation for the year, prepared using IFRSs, amounted to £254,205 (2007: £240,287). A dividend of £140,000 was paid in the year (2007: £145,000).

**FUTURE DEVELOPMENTS**

No changes in the business of the Company are envisaged.

**SUPPLIER PAYMENT POLICY**

It is the Company's policy that payments to suppliers are made in accordance with those terms and conditions agreed between the Company and its suppliers.

The Company owed no amounts to trade creditors at 31 December 2008.

**DIRECTORS**

The directors who served during the year were as follows:

I G Stewart  
P A Curran

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**DIRECTORS' REPORT (CONTINUED)**

**GOING CONCERN**

As set out in the "Principles underlying Going Concern Assumption" of the Basis of Preparation section of the notes to the financial statements, the directors are satisfied that the Company 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.

**POST BALANCE SHEET EVENTS**

Details of post balance sheet events including the acquisition of HBOS plc by Lloyds TSB Group plc are given in note 20 to the financial statements.

**AUDIT INFORMATION**

The directors who held office at the date of approval of this Directors' Report confirm that, so far as they each are aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

By Order of the Board



A Lockwood  
Secretary

Premier House  
City Road  
CHESTER  
CH88 3AN

DATE: 18<sup>th</sup> March 2009

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**STATEMENT OF DIRECTORS' RESPONSIBILITIES**  
**IN RESPECT OF THE DIRECTORS' REPORT AND THE FINANCIAL STATEMENTS**

The directors are responsible for preparing the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with IFRSs as adopted by the EU and applicable law.

The financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position and the performance of the Company; 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 the Company financial statements, the directors are required to:

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



**INDEPENDENT AUDITORS' REPORT  
TO THE MEMBER OF BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**

We have audited the financial statements of BOS (Shared Appreciation Mortgages) NO. 3 PLC for the year ended 31 December 2008 which comprise the Income Statement, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Company's member, 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 Company's member 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 Company and the Company's member 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 financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU, are set out in the Statement of Directors' Responsibilities on page 7.

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

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, 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 the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

**Basis of audit opinion**

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

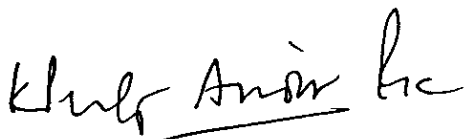
We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity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

**INDEPENDENT AUDITORS' REPORT  
TO THE MEMBER OF BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC  
(CONTINUED)**

**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 Company's affairs as at 31 December 2008 and of its profit for the year then ended; and
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.



KPMG Audit Plc  
Chartered Accountants  
Registered Auditor

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Neville Street  
LEEDS  
LS1 4DW

DATE: 18 March 2009

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**INCOME STATEMENT**  
**FOR THE YEAR ENDED 31 DECEMBER 2008**

|  | Notes | 2008<br>£      | 2007<br>£      |
|--|-------|----------------|----------------|
| Interest receivable and similar income         | 2     | 1,401,223      | 1,718,100      |
| Interest payable and similar charges           | 3     | (987,557)      | (1,335,800)    |
| <b>Net interest income</b>                     |       | <u>413,666</u> | <u>382,300</u> |
| Net fair value gains and losses on derivatives | 4     | -              | -              |
| Other operating income                         | 5     | 2,561          | 3,675          |
| Operating expenses                             | 6     | (60,547)       | (47,946)       |
| <b>Profit before tax for the year</b>          |       | <u>355,680</u> | <u>338,029</u> |
| Income tax expense                             | 7     | (101,475)      | (97,742)       |
| <b>Profit after tax for the year</b>           |       | <u>254,205</u> | <u>240,287</u> |
| <b>Profit attributable to equity holders</b>   |       | <u>254,205</u> | <u>240,287</u> |

The profit shown above is derived from continuing operations. The Company operates in a single business segment and all of the Company's activities are in the UK.


The statement of recognised income and expense has been omitted from the financial statements for the year ended 31 December 2008 as there was no income or expense recognised directly in equity in the current or preceding year.

The notes on pages 13 to 31 form part of these financial statements.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**BALANCE SHEET AS AT 31 DECEMBER 2008**

|                                       | Notes | 2008<br>£         | 2007<br>£         |
|---------------------------------------|-------|-------------------|-------------------|
| <b>Assets</b>                         |       |                   |                   |
| Mortgage portfolio                    | 8     | 17,720,413        | 18,081,415        |
| Shared appreciation rights receivable | 9     | 29,756,188        | 36,860,110        |
| <b>Total non-current assets</b>       |       | <b>47,476,601</b> | <b>54,941,525</b> |
| Other receivables                     | 10    | 1,541             | 1,130             |
| Cash and cash equivalents             | 11    | 2,570,732         | 2,572,646         |
| <b>Total current assets</b>           |       | <b>2,572,273</b>  | <b>2,573,776</b>  |
| <b>Total assets</b>                   |       | <b>50,048,874</b> | <b>57,515,301</b> |
| <b>Equity</b>                         |       |                   |                   |
| Called up share capital               |       | 50,001            | 50,001            |
| Retained earnings                     |       | 2,548,412         | 2,434,207         |
| <b>Total equity</b>                   | 12    | <b>2,598,413</b>  | <b>2,484,208</b>  |
| <b>Liabilities</b>                    |       |                   |                   |
| Interest-bearing loans and borrowings | 13    | 17,276,482        | 17,730,307        |
| Shared appreciation rights payable    | 14    | 29,756,188        | 36,860,110        |
| Deferred tax liability                | 15    | 44,913            | 51,330            |
| <b>Total non-current liabilities</b>  |       | <b>47,077,583</b> | <b>54,641,747</b> |
| Interest-bearing loans and borrowings | 13    | 57,397            | 21,945            |
| Other payables                        | 16    | 201,140           | 253,687           |
| Bank overdraft                        | 11    | 6,449             | 5,431             |
| Current tax liability                 | 7     | 107,892           | 108,283           |
| <b>Total current liabilities</b>      |       | <b>372,878</b>    | <b>389,346</b>    |
| <b>Total liabilities</b>              |       | <b>47,450,461</b> | <b>55,031,093</b> |
| <b>Total equity and liabilities</b>   |       | <b>50,048,874</b> | <b>57,515,301</b> |

These financial statements were approved by the Board of Directors on 18<sup>th</sup> March 2009

and were signed on its behalf by:  Director  
 Ian Gordon Stewart

The notes on pages 13 to 31 form part of these financial statements.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2008**

| Indirect Method  |       | 2008        | 2007        |
|--|-------|-------------|-------------|
|  | Notes | £           | £           |
| <b>Cash flows from operating activities</b>                            |       |             |             |
| Profit before tax for the year   |       | 355,680     | 338,029     |
| <i>Adjustments for:</i>  |       |             |             |
| Interest income  | 2     | (1,401,223) | (1,718,100) |
| Interest payable on Notes  | 3     | 972,604     | 1,283,463   |
| Amortisation of issue costs  | 3     | 14,953      | 52,337      |
| Shared appreciation income   | 5     | (675,935)   | (1,121,158) |
| Shared appreciation expense  | 5     | 675,935     | 1,121,158   |
|  |       | <hr/>       | <hr/>       |
| <b>Operating loss before changes in working capital and provisions</b> |       | (57,986)    | (44,271)    |
| Increase in other receivables  |       | (411)       | -           |
| Increase / (decrease) in other payables                                |       | 42,386      | (184,346)   |
|  |       | <hr/>       | <hr/>       |
| <b>Cash generated from operations</b>                                  |       | (16,011)    | (228,617)   |
| Income taxes paid  |       | (220,565)   | -           |
|  |       | <hr/>       | <hr/>       |
| <b>Net cash from operating activities</b>                              |       | (236,576)   | (228,617)   |
|  |       | <hr/>       | <hr/>       |
| <b>Cash flows from investing activities</b>                            |       |             |             |
| Mortgage interest received   |       | 1,138,942   | 1,174,121   |
| Bank interest received   |       | 153,780     | 164,227     |
| Repayment of mortgages   | 8     | 469,501     | 759,983     |
| Shared appreciation received   |       | 675,935     | 1,121,158   |
|  |       | <hr/>       | <hr/>       |
| <b>Net cash from investing activities</b>                              |       | 2,438,158   | 3,219,489   |
|  |       | <hr/>       | <hr/>       |
| <b>Cash flows from financing activities</b>                            |       |             |             |
| Interest paid on borrowings  |       | (863,921)   | (899,632)   |
| Repayment of borrowings  |       | (542,002)   | (779,241)   |
| Dividends paid   | 12    | (140,000)   | (145,000)   |
| Shared appreciation paid   |       | (658,591)   | (1,110,302) |
|  |       | <hr/>       | <hr/>       |
| <b>Net cash flows from financing activities</b>                        |       | (2,204,514) | (2,934,175) |
|  |       | <hr/>       | <hr/>       |
| Net (decrease) / increase in cash and cash equivalents                 |       | (2,932)     | 56,697      |
| Cash and cash equivalents at 1 January                                 |       | 2,567,215   | 2,510,518   |
|  |       | <hr/>       | <hr/>       |
| <b>Cash and cash equivalents at 31 December</b>                        | 11    | 2,564,283   | 2,567,215   |
|  |       | <hr/>       | <hr/>       |

As explained in the accounting policies in note 1, cash is distributed in accordance with the Programme Documentation.

The notes on pages 13 to 31 form part of these financial statements.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008**

**1. SIGNIFICANT ACCOUNTING POLICIES**

BOS (Shared Appreciation Mortgages) NO.3 PLC is a company domiciled in the United Kingdom.

**(a) Statement of compliance**

The financial statements for the year ended 31 December 2008 have been prepared in accordance with International Financial Reporting Standards (IFRSs) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) as adopted by the European Union. The standards applied by the Company are those endorsed by the European Union and effective at the date the financial statements are approved by the Board. However the Company has not utilised the "carve-out" provisions in respect of full fair value and portfolio hedging of core deposits in IAS39 'Financial Instruments: Recognition and Measurement' as adopted by the European Union. Consequently, the financial statements comply with International Financial Reporting Standards.

The accounting policies set out below have been applied consistently in respect of the financial years ended 31 December 2008 and 31 December 2007.

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

**(b) Basis of preparation**

**(b) (i) Basis of measurement**

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

The financial statements have been prepared on the historical cost basis (except that derivative financial instruments are stated at their fair value), and on a going concern basis.

**(b) (ii) Principles underlying the Going Concern Assumption**

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

In the context of this continued turbulence and uncertainty in the financial markets, combined with a deteriorating global economic outlook, HBOS plc has also taken steps to strengthen its capital position in order to provide a buffer against further shocks to the financial systems and to ensure that it remains competitive. On 15 January 2009, in conjunction with the takeover of HBOS plc by Lloyds TSB Group plc (Note 20), HBOS plc raised £11,345m (net after costs) in preference and ordinary share capital.

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

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**(b) Basis of preparation (continued)**

**(b) (ii) Principles underlying the Going Concern Assumption (continued)**

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

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

**(b) (iii) Critical Accounting Judgements and Estimates**

The preparation of the financial statements necessarily requires the exercise of judgement both in the application of accounting policies which are set out in the sections below and in the selection of assumptions used in the calculation of estimates. These judgements are reviewed on an ongoing basis and are continually evaluated based on historical experience and other factors. The most significantly affected components of the financial statements and associated critical judgements are as follows:

For the purpose of the effective yield calculation on the Notes, an average expected life has been calculated based on prepayment expectations for the mortgages. This is revised on a regular basis in light of actual redemption experience.

The value of the embedded derivative has been calculated by discounting future cash flows at an appropriate market rate. The valuation method is consistent with commonly used market techniques. All inputs into the valuation models are obtained from observable market data. No assumption for future HPI has been included as this is not considered to be practical.

**(c) Financial instruments**

The Company's financial instruments are principally a mortgage portfolio, cash and liquid resources, an embedded derivative, interest-bearing loans and borrowings and various other receivables and payables that arise directly from its operations.

The main purpose of these financial instruments is to raise finance for the Company's operations. These financial instruments are classified in accordance with the principles of IAS 39 as described below.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**(c) Financial instruments (continued)**

**(c)(i) Mortgage portfolio**

The Company's mortgage portfolio comprises mortgage loans with no fixed maturity date. The individual mortgage loans terminate on the earlier of the date of sale of the property or the death of the mortgage account holder.

Under IAS 39, the mortgage portfolio is classified within "loans and receivables". The initial measurement is at fair value (excluding amounts for the shared appreciation referred to in (c)(iv) below). Subsequent measurement is at amortised cost with revenue being recognised using the effective interest method. The discount arising on initial recognition is being amortised over the expected life of the mortgages.

At each reporting period end, the Company assesses whether there is any objective evidence that mortgage loans within the portfolio are impaired. The directors do not consider that a provision for impaired assets is currently required.

**(c)(ii) Cash and cash equivalents**

The Company held bank accounts with both an external provider and BOS. These accounts are held in the Company's name and meet the definition of cash and cash equivalents. The use of certain accounts is restricted by a detailed priority of payments set out in the Programme Documentation. As the cash can only be used to meet certain specific liabilities and is not available to be used with discretion, it is viewed as restricted cash.

These bank accounts are classified within "loans and receivables" in accordance with IAS 39. The initial measurement is at fair value. Subsequent measurement is at amortised cost with revenue being recognised using the effective interest method.

The Cash Flow Statement has been presented using the indirect method of preparation.

**(c)(iii) Interest-bearing loans and borrowings**

The Company's interest-bearing loans and borrowings comprise mortgage-backed fixed rate Notes that have been issued in the capital market.

Interest-bearing loans and borrowings are recognised initially at fair value less directly related incremental transaction costs. Subsequent to initial recognition, interest-bearing loans and borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

**(c)(iv) Embedded derivatives**

Certain derivatives are embedded within other non-derivative host financial instruments to create a hybrid instrument. Where the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host instrument, and where the hybrid instrument is not measured at fair value, the embedded derivative is separated from the host instrument with changes in fair value of the embedded derivative recognised in the income statement. Depending on the classification of the host instrument, the host is then measured in accordance with IAS 39.



**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**(c) Financial instruments (continued)**

**(c)(iv) Embedded derivatives (continued)**

The capital appreciation arising on the sale of a mortgage holder's property is shared between the mortgage holder and the Company as set out in the original loan agreement. The Company pays its entire share of the appreciation to the Note holders.

The economic characteristics and risks of the shared appreciation rights receivable and payable are not viewed as being closely related to those arising on the mortgages and Notes, respectively. The shared appreciation rights receivable and payable have therefore been valued separately from the mortgages and Notes using discounted cash flow techniques and taking account of current HPI. There is uncertainty regarding the timing of any future shared appreciation receipts and the directors do not consider that it is practical to include an estimate of future HPI in these valuations.

The resulting fair value movements of these embedded derivatives are recorded in net fair value gains and losses on derivatives in the income statement and the embedded derivatives are shown separately on the face of the balance sheet. The host instruments are valued at amortised cost, as noted above in (c)(i) and (c)(iii).

**(d) Fees and commissions**

Fees and commissions receivable for the continuing service of loans and advances are recognised on the basis of work done. Other fees are recognised when receivable.

**(e) Income tax**

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

Deferred tax is provided in full using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Temporary differences arising from the initial recognition of assets and liabilities that affects neither accounting nor taxable profit are not provided for. 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 that are enacted or substantially enacted at the balance sheet date.

The Company's tax charge is calculated on an IFRS basis and disclosed in accordance with IAS 12.

**(f) VAT**

Value Added Tax is not recoverable by the Company and is included with its related costs.

**(g) Dividends**

Dividends on the equity shares of the Company are recognised as a liability in the year in which they are paid.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**(h) Related parties**

In accordance with the provisions of IAS 24 "Related Party Disclosures", the Company has disclosed details of transactions with its related parties.

**(i) Other payables**

Other payables are stated at cost or at amortised cost if deemed to be a financial liability.

**(j) IFRS and IFRIC not yet applied**

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

IFRS 8 'Operating Segments' which is effective for periods commencing on or after 1 January 2009. This standard replaced IAS14 Segmental Reporting and its application will not have any impact upon the financial results of the Company as it does not change the recognition or measurement of transactions in the financial statements. The standard aligns the disclosure of operating segments in the financial statements with the internal reporting of segments to senior management. Adoption by the Company will not modify the measurement basis for segments and extend the disclosures for segment reporting in the financial statements.

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

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

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**2. INTEREST RECEIVABLE AND SIMILAR INCOME**

|                                  | 2008<br>£ | 2007<br>£ |
|----------------------------------|-----------|-----------|
| Mortgage interest from customers | 1,247,443 | 1,553,873 |
| Bank interest from BOS           | 32,798    | 35,899    |
| Bank interest                    | 120,982   | 128,328   |
|                                  | <hr/>     | <hr/>     |
|                                  | 1,401,223 | 1,718,100 |
|                                  | <hr/>     | <hr/>     |

Interest receivable and similar income is calculated using the effective interest method.

As the mortgage portfolio is not regarded as impaired the interest received on impaired assets is £ nil (2007: £ nil).

At the beginning of 2008, a review of the expected life of the mortgage pool was carried out which resulted in the effective yield adjustment being extended for a further ten years. This resulted in a reduction in mortgage interest from customers being recognised in the income statement for 2008.

**3. INTEREST PAYABLE AND SIMILAR CHARGES**

|                             | 2008<br>£ | 2007<br>£ |
|-----------------------------|-----------|-----------|
| Interest payable on Notes   | 972,604   | 1,283,463 |
| Amortisation of issue costs | 14,953    | 52,337    |
|                             | <hr/>     | <hr/>     |
|                             | 987,557   | 1,335,800 |
|                             | <hr/>     | <hr/>     |

Interest payable is calculated using the effective interest method

Following the review of the expected life of the mortgage pool as described in Note 2, both the effective yield adjustment on the Notes and the amortisation period of issue costs were extended by a further ten years. This resulted in a reduction in interest payable on Notes and amortisation of issue costs in the income statement for 2008.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**4. NET FAIR VALUE GAINS AND LOSSES ON DERIVATIVES**

|  | 2008<br>£   | 2007<br>£   |
|--|-------------|-------------|
| Fair value movement on shared appreciation rights receivable | (7,103,922) | 4,844,586   |
| Fair value movement on shared appreciation rights payable    | 7,103,922   | (4,844,586) |
|  | <u>-</u>    | <u>-</u>    |

**5. OTHER OPERATING INCOME**

|                                 | 2008<br>£    | 2007<br>£    |
|---------------------------------|--------------|--------------|
| Fees and commissions receivable | 2,486        | 3,590        |
| Shared appreciation receivable  | 675,935      | 1,121,158    |
| Shared appreciation payable     | (675,935)    | (1,121,158)  |
| Other income                    | 75           | 85           |
|                                 | <u>2,561</u> | <u>3,675</u> |

**6. OPERATING EXPENSES**

|                          | 2008<br>£     | 2007<br>£     |
|--------------------------|---------------|---------------|
| Bank administration fees | 33,507        | 35,122        |
| Trustees fee             | 5,438         | 4,203         |
| Legal fees               | 2,350         | 2,350         |
| Audit fees               | 4,281         | 5,011         |
| Other fees               | 14,971        | 1,260         |
|                          | <u>60,547</u> | <u>47,946</u> |

In the year ended 31 December 2008 and the comparative year the Company had no employees and none of the directors received any emoluments from the Company.

Audit fees relate to the statutory audit. Fees payable to the auditor and its associates for services other than the statutory audit are not disclosed since the consolidated accounts of HBOS plc, the ultimate controlling party, are required to disclose non-audit fees on a consolidated basis.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**7. INCOME TAX EXPENSE**

|  | <b>2008</b>    | <b>2007</b>    |
|--|----------------|----------------|
|  | <b>£</b>       | <b>£</b>       |
| <b>Current Tax</b>   |                |                |
| Corporation tax charge for the year at a rate of 28.5% (2007: 30%)                                       | 107,892        | 108,283        |
|  | <u>107,892</u> | <u>108,283</u> |
| <b>Deferred Tax</b>  |                |                |
| Deferred tax credit for the year at a rate of 28.5% (2007: 30%)  | (6,531)        | (6,874)        |
| Deferred tax change in tax rate – charge / (credit)  | 114            | (3,667)        |
|  | <u>101,475</u> | <u>97,742</u>  |
| <b>Total income tax expense in income statement</b>  | <b>101,475</b> | <b>97,742</b>  |
|  | <u>101,475</u> | <u>97,742</u>  |
| <b>Reconciliation of effective tax rate</b>  | <b>2008</b>    | <b>2007</b>    |
|  | <b>£</b>       | <b>£</b>       |
| The tax for the year is higher than the standard rate of corporation tax in the UK of 28.5% (2007: 30%). |                |                |
| Profit before tax  | 355,680        | 338,029        |
|  | <u>355,680</u> | <u>338,029</u> |
| Profit before tax multiplied by the standard rate of corporation tax in the UK of 28.5% (2007: 30%)      | 101,361        | 101,409        |
| Effects of:  |                |                |
| Deferred tax change in tax rate – charge / (credit)  | 114            | (3,667)        |
|  | <u>101,475</u> | <u>97,742</u>  |
| <b>Total income tax expense in income statement</b>  | <b>101,475</b> | <b>97,742</b>  |
|  | <u>101,475</u> | <u>97,742</u>  |

The current tax liability of £107,892 (2007: £108,283 liability) represents the amount of income tax payable in respect of the current year.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**8. MORTGAGE PORTFOLIO**

|                                  | 2008<br>£  | 2007<br>£  |
|----------------------------------|------------|------------|
| At 1 January                     | 18,081,415 | 18,461,646 |
| Mortgage redemptions in the year | (469,501)  | (759,983)  |
| Amortisation of discount         | 108,499    | 379,752    |
|                                  | <hr/>      | <hr/>      |
| At 31 December                   | 17,720,413 | 18,081,415 |
|                                  | <hr/>      | <hr/>      |

The mortgage loans advanced by the Company have no fixed maturity date but would terminate on the earlier of, the date of sale of the property, or the death of the mortgage account holder.

**9. SHARED APPRECIATION RIGHTS RECEIVABLE**

The right for the Company to receive a share of the capital appreciation arising on the individual mortgages, as set out in the original loan agreements, is classified as an embedded derivative, in accordance with the principles of IAS 39. The embedded derivative has been valued separately from the host contract using discounted cash flow techniques. No estimate has been made of the effect of future HPI as the directors consider that this is impractical.

The Company is contractually obliged to pay to the Note holders any amounts received from mortgage customers for the shared appreciation. A corresponding embedded derivative liability has therefore been recognised in the balance sheet (note 14).

**10. OTHER RECEIVABLES**

|               | 2008<br>£ | 2007<br>£ |
|---------------|-----------|-----------|
| Other debtors | 1,541     | 1,130     |
|               | <hr/>     | <hr/>     |

**11. CASH AND CASH EQUIVALENTS**

|                           | 2008<br>£ | 2007<br>£ |
|---------------------------|-----------|-----------|
| Bank balances             | 2,570,732 | 2,572,646 |
| Bank overdraft            | (6,449)   | (5,431)   |
|                           | <hr/>     | <hr/>     |
| Cash and cash equivalents | 2,564,283 | 2,567,215 |
|                           | <hr/>     | <hr/>     |

The Company held bank accounts with both an external provider and BOS. These accounts are held in the Company's name and meet the definition of cash and cash equivalents. The use of certain accounts is restricted by a detailed priority of payments set out in the Programme Documentation. As the cash can only be used to meet certain specific liabilities and is not available to be used with discretion, it is viewed as restricted cash.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**12. TOTAL EQUITY**

**Reconciliation of movement in capital and reserves**

|                                     | Share<br>Capital<br>£ | Retained<br>Earnings<br>£ | Total<br>Equity<br>£ |
|-------------------------------------|-----------------------|---------------------------|----------------------|
| Balance at 1 January 2008           | 50,001                | 2,434,207                 | 2,484,208            |
| Total recognised income and expense | -                     | 254,205                   | 254,205              |
| Dividends to shareholder            | -                     | (140,000)                 | (140,000)            |
|                                     | <hr/>                 | <hr/>                     | <hr/>                |
| Balance at 31 December 2008         | 50,001                | 2,548,412                 | 2,598,413            |
|                                     | <hr/>                 | <hr/>                     | <hr/>                |
|                                     | Share<br>Capital<br>£ | Retained<br>Earnings<br>£ | Total<br>Equity<br>£ |
| Balance at 1 January 2007           | 50,001                | 2,338,920                 | 2,388,921            |
| Total recognised income and expense | -                     | 240,287                   | 240,287              |
| Dividends to shareholder            | -                     | (145,000)                 | (145,000)            |
|                                     | <hr/>                 | <hr/>                     | <hr/>                |
| Balance at 31 December 2007         | 50,001                | 2,434,207                 | 2,484,208            |
|                                     | <hr/>                 | <hr/>                     | <hr/>                |

**Share capital**

|   | 2008<br>£ | 2007<br>£ |
|---|-----------|-----------|
| <b>Authorised</b>                         |           |           |
| 50,000 ordinary shares of £1 each         | 50,000    | 50,000    |
|   | <hr/>     | <hr/>     |
| 1 deferred share of £1                    | 1         | 1         |
|   | <hr/>     | <hr/>     |
| <b>Allotted, called up and fully paid</b> |           |           |
| 50,000 ordinary shares of £1 each         | 50,000    | 50,000    |
|   | <hr/>     | <hr/>     |
| 1 deferred share of £1                    | 1         | 1         |
|   | <hr/>     | <hr/>     |

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**12. TOTAL EQUITY (CONTINUED)**

The Company is a directly held subsidiary undertaking of BOS.

The £1 deferred share is held by Bankers Trustee Company Limited.

The holder of the ordinary shares is entitled to receive dividends as declared from time to time.

The deferred share carries no entitlement to any dividend or to any share in any surplus assets of the Company on a winding-up, other than the right to be repaid the amount of any paid up share capital thereon. The right to be repaid any paid-up share capital in the deferred share shall be deferred until after all paid-up share capital has been first repaid on all other classes of issued share capital in the Company.

The deferred share carries the right to receive notice of all general meetings of the Company but does not carry the right to attend, speak or vote at a general meeting unless a resolution is to be proposed abrogating, varying or modifying any of the rights or privileges of the holder of the deferred share, or for the winding up or administration of the Company under the Insolvency Act 1986, or for the entry by the Company with any other party into a merger, reconstruction, scheme of arrangement or amalgamation of or affecting the Company, in any of which cases such holder shall have the right to attend such general meeting and shall be entitled to speak and vote. Whenever the holder of the deferred share is entitled to vote at a general meeting, such holder shall have one vote and on a poll such number of votes as is equal to 34% of the number of votes attached to all other issued shares of the Company.

**Capital disclosures**

The Company is not subject to externally imposed capital requirements in either the current year or the prior year other than the minimum share capital required by the Companies Act with which it complies. The Company manages its ordinary share capital in order that there is sufficient capital, in the opinion of the directors, to support the transactions and level of business undertaken by the Company.

**13. INTEREST-BEARING LOANS AND BORROWINGS**

This note provides information about the contractual terms of the Company's interest-bearing loans and borrowings. For more information about the Company's exposure to interest rate risk and the fair value of its financial instruments, see note 17.

|  | 2008<br>£        | 2007<br>£        |
|--|------------------|------------------|
| <b>Non-current liabilities</b>           |                  |                  |
| Notes                                    | 17,455,924       | 17,887,318       |
| Deferred issue costs                     | (179,442)        | (157,011)        |
|  | <hr/> 17,276,482 | <hr/> 17,730,307 |
| <b>Current liabilities</b>               |                  |                  |
| Accrued interest payable to Note holders | 72,350           | 74,282           |
| Deferred issue costs                     | (14,953)         | (52,337)         |
|  | <hr/> 57,397     | <hr/> 21,945     |



**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**13. INTEREST-BEARING LOANS AND BORROWINGS (CONTINUED)**

The mortgage-backed fixed rate Notes are due in 2073. The interest rate applicable on the Notes up to and including the period ending 28 February 2028 is 4.50% per annum. Thereafter, the interest rate applicable to the Notes will be 5.50% per annum until 2073 when the Notes become due.

The Notes carry, in addition to interest, rights to receive certain amounts calculated by reference to the value of shared appreciation proceeds received from redeemed mortgages. The Notes are subject to mandatory part redemption from time to time based on the level of redeemed mortgages and can be redeemed in full, in certain circumstances, at the option of the Company. The Notes are secured on the mortgage portfolio and certain other assets of the Company.

**14. SHARED APPRECIATION RIGHTS PAYABLE**

The Company is contractually obliged to pay to the Note holders any amounts received from mortgage customers for the shared appreciation arising on the sale of the property. An embedded derivative liability has therefore been recognised in the balance sheet for the same value as the embedded derivative asset (note 9).

**15. DEFERRED TAX LIABILITY**

|  | 2008<br>£ | 2007<br>£ |
|--|-----------|-----------|
| At 1 January                           | 51,330    | 61,871    |
| Credit for year                        | (6,531)   | (6,874)   |
| Change in Tax Rate – charge / (credit) | 114       | (3,667)   |
|  | <hr/>     | <hr/>     |
| At 31 December                         | 44,913    | 51,330    |
|  | <hr/>     | <hr/>     |

The deferred tax liability was recognised for the fair value adjustments that arose on transition to IFRS and is being released to the income statement over a period of ten years from adoption.

**16. OTHER PAYABLES**

|                              | 2008<br>£ | 2007<br>£ |
|------------------------------|-----------|-----------|
| Shared appreciation payable  | 70,719    | 53,375    |
| Note redemptions payable     | 36,500    | -         |
| Accruals and deferred income | 91,106    | 88,030    |
| Amounts owed to BOS          | 2,815     | 112,282   |
|                              | <hr/>     | <hr/>     |
|                              | 201,140   | 253,687   |
|                              | <hr/>     | <hr/>     |

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**17. FINANCIAL INSTRUMENTS**

The majority of the Company's assets and liabilities have been classified as financial instruments in accordance with IAS 32 "Financial Instruments: Presentation".

The Company's financial instruments are principally a mortgage portfolio, cash and liquid resources, an embedded derivative, interest-bearing loans and borrowings and various other receivables and payables that arise directly from its operations.

The principal risks arising from the Company's financial instruments are credit risk and interest rate risk. Further detailed analysis of the risks facing the Company in relation to its financial instruments is provided below.

The Company's exposure to risk on its financial instruments and the management of such risk is largely determined at the inception of the securitisation transaction. The Company's activities and the role of each party to the transaction is clearly defined and documented.

**17(a) Credit risk**

Credit risk is the risk of financial loss arising from a customer's failure to settle financial obligations as they fall due.

Credit risk arises on the individual loans within the mortgage portfolio which are in turn secured on the underlying UK residential properties. The performance of these loans is therefore influenced by the economic background and the UK housing market. Mortgage loans are no longer offered by the Company.

The extent to which the Company can meet its obligations to pay interest and ultimately repay the Notes will be dependent upon the receipt of funds earned on the mortgage portfolio and monies deposited in the Reserve Account with an external provider (see "Liquidity Risk"). To the extent that this income does not provide sufficient funds to cover the interest due on the Notes or the repayment of the Notes the Company has no claim on the assets of BOS.

The terms of the Mortgage Portfolio Agreement given by BOS in respect of the mortgages require BOS, to repurchase any mortgage which is found to be in breach of warranty. BOS will repurchase any mortgages that are found or held not to be valid, binding and enforceable.

Although in such an event the total value of the outstanding loan and any accrued interest will be covered by BOS the Note holder will not receive the benefit of any future payments of appreciation amounts or partial repayment of appreciation amounts in respect of the mortgages repurchased.

In terms of the shared appreciation, in accordance with the Programme Documentation, amounts received by the Company from the borrower are required to be paid over to the Note holders.

In terms of arrears management, the Company has engaged BOS as servicer of the loans in the portfolio to help reduce the risk of loss. The servicer is required to monitor repayments on the mortgage loans in accordance with its usual credit policies.

The mortgage balances are monitored as part of the HBOS plc Group impairment process. At each reporting period end, the Company assesses whether there is any objective evidence that mortgage loans within the portfolio are impaired. All loans in the mortgage portfolio pay a fixed rate of interest of 5.75% or 5.95%.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**17. FINANCIAL INSTRUMENTS (CONTINUED)**

**17(a) Credit risk (continued)**

The total value of interest arrears at 31 December 2008 was £201,271 (2007: £162,872). All accounts in the mortgage portfolio had a maximum loan-to-value ratio of 75% and those accounts in interest arrears have a current loan-to-value ratio of less than 30% (2007: 25%). Credit risk is considered to be low. There are no properties in possession or bad debts within the Company. No impairment provision was deemed necessary at 31 December 2008 or 31 December 2007.

The maximum exposure to credit risk arising on the Company's financial assets at the reporting date is disclosed in the table below.

|                                       | Note | Carrying<br>amount<br>2008<br>£ | Maximum<br>exposure<br>2008<br>£ | Carrying<br>amount<br>2007<br>£ | Maximum<br>exposure<br>2007<br>£ |
|---------------------------------------|------|---------------------------------|----------------------------------|---------------------------------|----------------------------------|
| <b>Assets held at amortised cost:</b> |      |                                 |                                  |                                 |                                  |
| Mortgage portfolio                    | 8    | 17,720,413                      | 19,130,915                       | 18,081,415                      | 19,600,413                       |
| Cash and cash equivalents             | 11   | 2,570,732                       | 2,570,732                        | 2,572,646                       | 2,572,646                        |
| <b>Assets held at fair value:</b>     |      |                                 |                                  |                                 |                                  |
| Shared appreciation rights receivable | 9    | 29,756,188                      | 29,756,188                       | 36,860,110                      | 36,860,110                       |
| <b>Total Assets</b>                   |      | <u>50,047,333</u>               | <u>51,457,835</u>                | <u>57,514,171</u>               | <u>59,033,169</u>                |

**17(b) Market risk**

Market risk is defined as the potential loss in value or earnings of an organisation arising from changes in external market factors, such as interest rates.

The Company is exposed to market risk which comprises interest rate risk and is explained in more detail below.

Interest rate risk exists where assets and liabilities have interest rates set under a different basis or which reset at a different time. The Company minimises its exposure to interest rate risk by ensuring that the interest rate characteristics of assets and liabilities are similar. Both the mortgage portfolio and the Notes issued by the Company are exposed to fair value interest rate risk as they carry fixed interest rates.

At 31 December 2008, if interest rates had been 25 basis points higher or lower with all other variables held constant, the net effect on the Company's income statement would be insignificant. All items remain unaffected by interest rate changes except for interest earned on bank accounts but a 25 basis points change would not give rise to a significant impact on bank interest.

**BOS (SHARED APPRECIATION MORTGAGES) NO. 3 PLC**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 DECEMBER 2008 (CONTINUED)**

**17. FINANCIAL INSTRUMENTS (CONTINUED)**

**17(c) Liquidity risk**

Liquidity risk is the risk that the Company is not able to meet its financial obligations as they fall due or can do so only at an unacceptably high cost.

The extent to which the Company can meet its obligations to pay interest and ultimately repay the Notes will be dependent upon the receipt of funds earned on the mortgage portfolio and the monies deposited in the Reserve Account with an external provider. £1,396,800 has been placed on deposit to assist the Company should it not be able to meet its obligations under the Notes. The reliance on this facility is therefore dependent upon the creditworthiness of an external provider. To the extent that this income does not provide sufficient funds to cover the interest due on the Notes or the repayment of the Notes the Company has no claim on the assets of BOS. The Company has not drawn on this facility since inception.

The liquidity tables reflect the undiscounted cash payments which will fall due if the structure continues until the earliest contractual maturity date as set out in the Programme Documentation. The Note repayment profile mirrors the repayment of the mortgages, and based on current modelling assumptions, it is not anticipated that any mortgages will still be outstanding beyond the step-up date of February 2028.

| 2008                        | Carrying<br>amount         | Contractual<br>repayment<br>value          | Not later<br>than one<br>month          | Later than<br>one month<br>not later<br>than three<br>months            | Later than<br>three<br>months but<br>not later<br>than one<br>year<br>£              | Later than<br>one year<br>and not<br>later than<br>five years<br>£             | Later than<br>five years<br>£          |
|-----------------------------|----------------------------|--|---|---|--|--|--|
|                             | £                          | £  | £                                       | £   | £  | £  | £                                      |
| <b>Principal</b>            |                            |  |   |   |  |  |  |
| Notes                       | 17,455,924                 | 18,930,411                                 | -                                       | -   | -  | -  | 18,930,411                             |
| Shared appreciation payable | 29,756,188                 | 28,994,476                                 | -                                       | -   | -  | -  | 28,994,476                             |
| Other payables              | 201,140                    | 201,140                                    | 59,840                                  | 141,300   | -  | -  | -                                      |
| <b>Interest payable</b>     |                            |  |   |   |  |  |  |
| Interest payable on Notes   | 72,350                     | 16,194,838                                 | -                                       | 214,718   | 637,151  | 3,409,808  | 11,933,161                             |
|                             | <u>47,485,602</u>          | <u>64,320,865</u>                          | <u>59,840</u>                           | <u>356,018</u>  | <u>637,151</u>   | <u>3,409,808</u>   | <u>59,858,048</u>                      |
| <b>2007</b>                 | <b>Carrying<br/>amount</b> | <b>Contractual<br/>repayment<br/>value</b> | <b>Not later<br/>than one<br/>month</b> | <b>Later than<br/>one month<br/>not later<br/>than three<br/>months</b> | <b>Later than<br/>three<br/>months but<br/>not later<br/>than one<br/>year<br/>£</b> | <b>Later than<br/>one year<br/>and not<br/>later than<br/>five years<br/>£</b> | <b>Later than<br/>five years<br/>£</b> |
|                             | £                          | £  | £                                       | £   | £  | £  | £                                      |
| <b>Principal</b>            |                            |  |   |   |  |  |  |
| Notes                       | 17,887,318                 | 19,435,914                                 | -                                       | -   | -  | -  | 19,435,914                             |
| Shared appreciation payable | 36,860,110                 | 36,744,007                                 | -                                       | -   | -  | -  | 36,744,007                             |
| Other payables              | 253,687                    | 253,687                                    | 84,716                                  | 56,689  | 112,282  | -  | -                                      |
| <b>Interest payable</b>     |                            |  |   |   |  |  |  |
| Interest payable on Notes   | 74,282                     | 17,633,699                                 | -                                       | 220,451   | 654,165  | 3,498,465  | 13,260,618                             |
|                             | <u>55,075,397</u>          | <u>74,067,307</u>                          | <u>84,716</u>                           | <u>277,140</u>  | <u>766,447</u>   | <u>3,498,465</u>   | <u>69,440,539</u>                      |

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**17. FINANCIAL INSTRUMENTS (CONTINUED)**

**17(d) Fair values**

The fair values of the Company's financial instruments, together with the carrying amounts shown in the balance sheet are as follows:

|   | Note | Carrying<br>amount<br>2008<br>£ | Fair<br>value<br>2008<br>£ | Carrying<br>amount<br>2007<br>£ | Fair<br>value<br>2007<br>£ |
|---|------|---------------------------------|----------------------------|---------------------------------|----------------------------|
| <b>Loans and receivables at amortised cost</b>  |      |                                 |                            |                                 |                            |
| Mortgage portfolio                              | 8    | 17,720,413                      | 20,639,414                 | 18,081,415                      | 19,717,775                 |
| Cash and cash equivalents                       | 11   | 2,570,732                       | 2,570,732                  | 2,572,646                       | 2,572,646                  |
| <b>Financial assets held at fair value</b>      |      |                                 |                            |                                 |                            |
| Shared appreciation rights receivable           | 9    | 29,756,188                      | 29,756,188                 | 36,860,110                      | 36,860,110                 |
| <b>Financial liabilities at amortised cost</b>  |      |                                 |                            |                                 |                            |
| Interest-bearing loans and borrowings           | 13   | (17,333,879)                    | (19,295,254)               | (17,752,252)                    | (18,854,697)               |
| Bank overdraft                                  | 11   | (6,449)                         | (6,449)                    | (5,431)                         | (5,431)                    |
| Other payables                                  | 16   | (201,140)                       | (201,140)                  | (253,687)                       | (253,687)                  |
| <b>Financial liabilities held at fair value</b> |      |                                 |                            |                                 |                            |
| Shared appreciation rights payable              | 14   | (29,756,188)                    | (29,756,188)               | (36,860,110)                    | (36,860,110)               |
|   |      | <u>2,749,677</u>                | <u>3,707,303</u>           | <u>2,642,691</u>                | <u>3,176,606</u>           |
| Unrecognised gain                               |      |                                 | 2,919,001                  |                                 | 1,636,360                  |
| Unrecognised loss                               |      |                                 | (1,961,375)                |                                 | (1,102,445)                |
|   |      |                                 | <u>957,626</u>             |                                 | <u>533,915</u>             |

**Estimation of fair values**

The following comments summarise the main methods and assumptions used in estimating the fair value of financial instruments that are reflected in the table above.

The fair value of the mortgage portfolio, shared appreciation rights receivable, shared appreciation rights payable and interest-bearing loans and borrowings have been calculated by discounting future cash flows at an appropriate market rate. The valuation method is consistent with commonly used market techniques. All inputs into the valuation models are obtained from observable market data.

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**17. FINANCIAL INSTRUMENTS (CONTINUED)**

**17(d) Fair values (continued)**

**Estimation of fair values (continued)**

These calculations do not necessarily represent the fair value that could be obtained for the instruments if they were to be sold.

Cash and cash equivalents, other payables and the bank overdraft are recognised on an amortised cost basis that is considered to be a close approximation to fair value.

The sensitivity to a 1% change in fair value of the Company's financial assets and liabilities amounts to £37,073 (2007: £31,766).

**18. RELATED PARTIES**

The Company is a subsidiary undertaking of BOS and HBOS plc. The Company receives bank interest from BOS, its immediate parent undertaking. BOS administers the mortgage portfolio on behalf of the Company, for which quarterly service fees are paid. In 2008, a dividend of £140,000 (2007: £145,000) was paid to BOS. The Company's transactions with related parties are summarised below.

|  | <b>HBOS plc<br/>and<br/>subsidiaries<br/>2008<br/>£</b> | <b>HBOS plc<br/>and<br/>subsidiaries<br/>2007<br/>£</b> |
|--|---|---|
| <b>Income Statement</b>                |   |   |
| Interest receivable and similar income | 32,798  | 35,899  |
| Operating expenses                     | (33,507)  | (35,122)  |
| <b>Balance Sheet</b>                   |   |   |
| <b>Equity</b>                          |   |   |
| Dividends paid                         | (140,000)   | (145,000)   |
| <b>Assets</b>                          |   |   |
| Cash and cash equivalents              | 890,846   | 904,864   |
| <b>Liabilities</b>                     |   |   |
| Other payables                         | (2,815)   | (115,221)   |
| Bank overdraft                         | (6,449)   | (5,431)   |

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**19. PARENT UNDERTAKINGS**

As at 31 December 2008 the Company's immediate parent company was Bank of Scotland plc. The company regarded by the directors as the ultimate parent company at 31 December 2008 was HBOS plc, a limited liability company incorporated and domiciled in Scotland, which was also the parent undertaking of the largest group of undertakings for which group accounts are drawn up and of which the Company is a member. Bank of Scotland plc was the parent undertaking of the smallest such group of undertakings. Copies of the annual report and accounts of HBOS plc for the year ended 31 December 2008 may be obtained from HBOS plc's registered office at The Mound, Edinburgh, EH1 1YZ.

From 16 January 2009, BOS (Shared Appreciation Mortgages) NO.3 PLC's ultimate parent undertaking and controlling party is Lloyds Banking Group plc (formerly Lloyds TSB Group) which is incorporated in Scotland. Lloyds Banking Group plc will produce consolidated accounts for the year ended 31 December 2009. Copies of the annual report and accounts of Lloyds TSB Group plc for the year ended 31 December 2008 may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN.

**20. POST BALANCE SHEET EVENTS**

On 18 September 2008, with the support of the UK Government, the boards of HBOS plc ('HBOS') and Lloyds TSB Group plc ('Lloyds TSB') announced that they had reached agreement on the terms of the recommended acquisition of HBOS by Lloyds TSB. The terms of the acquisition were subsequently amended, as announced on 13 October 2008, at the same time as the announcement of the participation by HBOS and Lloyds TSB in the Government's action plan to recapitalise some of the major UK banks. The acquisition was to be implemented by means of a scheme of arrangement with a separate scheme of arrangement in relation to preference shares, under sections 895 to 899 of the Companies Act 2006.

On 12 January 2009 the Court of Session in Edinburgh, Scotland made an order sanctioning the scheme of arrangement for the acquisition and the preference share scheme of arrangement. The last day of trading in HBOS ordinary and preference shares was 14 January 2009.

On 15 January 2009 HBOS raised £11.5bn of capital (before costs and expenses) through an issue of £8.5bn of new ordinary shares under a placing with HM Treasury subject to clawback by existing shareholders, and an issue to HM Treasury of £3bn of new preference shares. Lloyds TSB raised £4.5bn (before costs and expenses) through an issue of £3.5bn of new ordinary shares under a placing with HM Treasury subject to clawback by existing shareholders, and an issue to HM Treasury of £1bn of new preference shares.

On 16 January 2009 the Lloyds TSB acquisition of HBOS completed following final court approval and Lloyds TSB was renamed Lloyds Banking Group plc. The exchange of HBOS shares for Lloyds Banking Group shares took place at an exchange ratio of 0.605 of a new Lloyds Banking Group share for every one HBOS share held. As a result, the UK Government through HM Treasury owned approximately 43.4% of the enlarged ordinary share capital of Lloyds Banking Group. In addition, each class of preference share issued by HBOS, including the preference shares issued to HM Treasury in the capital raising was replaced with an equal number of new Lloyds Banking Group preference shares.

HBOS ordinary and preference shares were de-listed from the Official List of the UK Listing Authority and admission to trading on the London Stock Exchange was cancelled on 19 January 2009 when trading in the new Lloyds Banking Group shares commenced.

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**20. POST BALANCE SHEET EVENTS (CONTINUED)**

On 7 March 2009, the Company's ultimate parent undertaking, Lloyds Banking Group plc ("LBG"), announced its intention to participate in the Government's Asset Protection Scheme. LBG intends to participate in the Scheme in respect of assets and exposures on its consolidated balance sheet with an aggregate book value of approximately £250bn and will pay a fee to HM Treasury of £15.6bn which will be amortised over an estimated 7 year period. The proceeds of this fee will be applied by HM Treasury in subscribing for an issue of "B" shares of LBG, carrying a dividend of the greater of 7 per cent per annum and 125 per cent of the dividend on ordinary shares.

LBG has also agreed to replace the £4bn of preference shares held by HM Treasury with new ordinary shares which will be offered to eligible LBG shareholders pro rata to their existing shareholdings at a fixed price of 38.43 pence per ordinary share. These new ordinary shares will be offered to shareholders and new investors on the same basis as the Placing and Open Offer in November 2008. The ordinary share offer is fully underwritten by HM Treasury on substantially the same fee basis as the Placing and Open Offer conducted in November 2008.

Participation in the Scheme and the replacement of the preference shares is subject to approval by eligible LBG shareholders.