# Bank of Scotland
# Report and Accounts

for the year ended 31 December 2002

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# BUSINESS AND FINANCIAL REVIEW – INTRODUCTION

## Business Sector Analysis of Results

The business sector profit and loss accounts of the Bank of Scotland Group presented below exclude the impact of exceptional items.

The business sectors reported have been aligned with those of the HBOS Group and comprise:

- Retail Banking
- Insurance & Investment
- Business Banking
- Corporate Banking
- Treasury
- BankWest

Comparative numbers have been restated where appropriate to reflect the effect of business transfers between divisions and prior year adjustments in respect of the implementation of FRS 19 Deferred Tax and UITF 33 Obligations in Capital Instruments.

# BUSINESS AND FINANCIAL REVIEW – RETAIL BANKING AND INSURANCE & INVESTMENT

## Retail Banking

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Net interest income | 796 | 582 |
| Non-interest income | 187 | 181 |
| Operating income | 983 | 763 |
| Operating expenses* | (547) | (499) |
| Operating profit before provisions | 436 | 264 |
| Provisions for bad & doubtful debts | (149) | (135) |
| Share of profits in joint ventures | 32 | 26 |
| Pre-tax profit* | 319 | 155 |
| Advances to Customers | £33.2bn | £23.3bn |
| Net interest margin (2001 annualised) | 2.82% | 3.27% |
| Cost:income ratio* | 55.6% | 65.4% |

* Excluding exceptional items.

Bank of Scotland has a long tradition of serving mainstream consumers, being a well established financial services brand, operating across the entire range of financial services distribution channels.

2002 has been a year of strong sales and profit growth for the division. Our commitment to deliver value, simplicity and transparency to consumers is driving very good bottom line growth with profits before tax and exceptionals, based on annualised 2001, 73% higher at £319 million.

Strong advances growth, up 42%, more than offset a decline in margin resulting in an increase of 15% (annualised) in net interest income at £796 million. Non-interest income of £187million was 13% lower than the annualised figure for 2001. Based on an annualised 2001, operating expenses fell some 8%, primarily reflecting cost savings generated through synergies following the merger with Halifax plc. The cost:income ratio improved to 55.6%.

The bad debt provision charge for the year was £149m, 7% lower than the annualised charge for the 10 month period to December 2001. Closing provisions as a percentage of year end advances decreased from 2.0% at the end of 2001 to 1.5% at the end of 2002.

## Insurance & Investment

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 £m |
|---|---|---|
| Net interest income | 1 | 9 |
| Non-interest income | 94 | 147 |
| Operating income | 95 | 156 |
| Operating expenses* | (8) | (20) |
| Claims payable | – | (15) |
| Pre-tax profit* | 87 | 121 |

* Excluding exceptional items.

On 1 January 2002, HBOS Insurance & Investment Group Ltd, a subsidiary of Halifax Group plc, acquired CHH Holdings plc and its subsidiary undertakings from Bank of Scotland Group at net asset value. The business of CHH Holdings Group is credit protection insurance and life assurance. The results for the remainder of the Insurance and Investment division within Bank of Scotland are noted in the table above.

## BUSINESS AND FINANCIAL REVIEW – BUSINESS BANKING

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Net interest income | 603 | 458 |
| Non-interest income | 559 | 401 |
| Operating income | 1,162 | 859 |
| Operating expenses* | (776) | (541) |
| Operating profit before provisions | 386 | 318 |
| Provisions for bad & doubtful debts | (157) | (105) |
| Share of profits in joint ventures | 7 | 5 |
| Profit on disposal of business | 25 | – |
| Pre-tax profit* | 261 | 218 |
| Advances to Customers | £22.5bn | £18.2bn |
| Net interest margin (2001 annualised) | 3.04% | 3.04% |
| Cost:income ratio** | 56.5% | 52.6% |

* Excluding exceptional items.

** Cost:income ratio has been calculated excluding exceptional items and after netting operating lease depreciation against operating lease income.

Business Banking provides a full range of banking services to businesses with a turnover up to £10 million a year. The Division also encompasses asset finance activities including vehicle management and contract hire. In addition, the Division has successful and rapidly growing businesses in Ireland and Australia.

Good progress has been made in a year where the planned focus has been to establish infrastructure for expansion in England and Wales. The sales momentum has delivered strong lending growth of 24% whilst the introduction of the payment of interest on current accounts has contributed to deposit growth up 15%.

Profit before tax including profit on disposal of the merchant services business, was stable at £261 million.

Operating income rose 13% (2001 – annualised) to £1,162 million, driven by strong new account growth, well ahead of plan across the division. During 2002, 42,000 new current accounts were opened. The motor finance operation also increased its market share of new customers.

Operating expenses increased by 20% (2001 – annualised) with the principal increases being staff and IT expansion related.

Provisions for bad and doubtful debts charged in the year were £157 million and, as a percentage of average customer lending was 0.77% compared to 0.71% (annualised ) for 2001.

The Division has enjoyed significant growth, but this has not been at the expense of credit quality. The Division continues to have a well spread portfolio of advances, and significant exposures are regularly stress tested.

# BUSINESS AND FINANCIAL REVIEW – CORPORATE BANKING

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Net interest income | 678 | 421 |
| Non-interest income | 340 | 221 |
| Operating income | 1,018 | 642 |
| Operating expenses* | (168) | (107) |
| Operating profit before provisions | 850 | 535 |
| Provisions for bad & doubtful debts | (295) | (174) |
| Share of profits in joint ventures | 1 | 6 |
| Pre-tax profit* | 556 | 367 |
| Advances to Customers | £37.2bn | £29.2bn |
| Net interest margin (2001 annualised) | 2.04% | 2.01% |
| Cost:income ratio* | 16.5% | 16.7% |

* Excluding exceptional items.

Operating from 22 Corporate Banking locations in the UK and 13 overseas, Corporate Banking provides a full range of banking products and services to businesses with an annual turnover of more than £10 million. The Division continues to examine the merits of selectively expanding its overseas network of offices. With Madrid having opened in 2002, it believes there are real opportunities to further export its UK expertise, particularly to Europe but also to the North American and Australian marketplaces which it knows well and where it has a proven track record.

Corporate Banking's ability to create innovative customised added value solutions which help build and sustain long-term profitable relationships, through good times and bad, continues to deliver impressive results. Controlled growth, increased returns, improved efficiency and a dedicated focus on credit quality, has resulted in a profit before tax up 27% (2001 – annualised) on the prior period, notwithstanding a challenging economic backdrop.

Operating income advanced by 33% (2001 – annualised) to £1,018 million underpinned by a solid mix of increased activity across the existing customer base as well as a continued good flow of attractive new business. Net interest income rose by 35% (2001 – annualised) compared to a 27% growth in lending, reflecting a further improvement in margins. The upward trend in margins evident since the beginning of 2001 has continued, with the overall net margin increasing from 2.01% to 2.04% over the last twelve months.

Non-interest income also continued to grow strongly, up 29% (2001 – annualised) to £340 million, with significant increases in fees and commissions again well spread across all areas. Investment gains totalled £23 million for the year and picked up significantly in the second half. This was achieved in a difficult exit environment where prospective buyers appeared thin on the ground.

Operating expenses rose by 32% (2001 – annualised) resulting in only a small improvement in the cost:income ratio from 16.7% to 16.5%. Investment over the last two years has given the Division necessary skills and infrastructure to take full advantage of the increased opportunities which the merger provided.

Against an uncertain economic backdrop, the Division's overall credit quality has remained stable, albeit certain sectors are clearly suffering more than others. It's specialised teams dedictated to working proactively with those customers experiencing problems continue to help mitigate the impact of non-performing loans.

The Division is committed to improving all aspects of its risk management. All individual credits are reviewed on an ongoing basis, whilst regular research and reviews of business sectors are undertaken to assist in the credit underwriting processes. The Division operates a sectoral "traffic light" system where the Division's risk appetite across 90 different sectors is re-assessed and updated on a monthly basis. A higher level of lending sign-off is required for those sectors flagged as red where risk is considered to have increased.

The lower share of profits of joint ventures and associates reflects the initial start up costs of a number of significant new joint ventures entered into during the course of 2002.

The continuing economic slowdown has inevitably resulted in an increase in provisions. This is not considered in any way unexpected or disappointing at this stage of the economic cycle. Whilst the Division cannot expect to be immune from the difficulties being seen in certain sectors, it has largely avoided the worst of the high profile corporate collapses seen in the last eighteen months.

## BUSINESS AND FINANCIAL REVIEW – TREASURY

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 £m |
|---|---|---|
| Net interest income | 149 | 67 |
| Non-interest income | 85 | 56 |
| Operating income | 234 | 123 |
| Operating expenses* | (67) | (30) |
| Operating profit before provisions | 167 | 93 |
| Provisions for bad and doubtful debts | (4) | |
| Pre-tax profit* | 163 | 93 |
| Net interest margin excluding trading assets (2001 – annualised) | 0.16% | 0.17% |
| Cost:income ratio* | 28.6% | 24.4% |

* Excluding exceptional items.

The Company's principal activities include the provision of wholesale multi-currency funding and the management of liquidity and the Treasury investment portfolio for the HBOS Group. The Company also manages the market risk arising from the HBOS Group's retail business and corporate operations, as well as leading the HBOS Group's debt capital issuance and asset securitisations in the UK. Trading transactions are undertaken to accommodate customer and HBOS Group requirements, whilst proprietary activity is maintained within approved limits.

Since the merger of Bank of Scotland and Halifax plc in September 2001, focus has been on successfully integrating the Halifax and Bank of Scotland treasury operations and infrastructure. Substantially all of the Halifax business was successfully combined in Bank of Scotland Treasury Services PLC from June 2002 using the banking business transfer provisions of part VII of the Financial Services and Markets Act 2000. Re-branded in June, HBOS Treasury Services plc is a single integrated business which blends together the strengths of both the Bank of Scotland and Halifax treasury businesses. Within the Bank of Scotland Group it sits as a wholly owned and fully guaranteed subsidiary of Bank of Scotland. Capital resources within the subsidiary were augmented to accommodate the combined business.

For Treasury, 2002 was a year of major achievement. Financial performance was very strong, with pre-tax profits before exceptional items of £163 million.

Net interest income was £149 million. Revenue growth was primarily driven from increased funding of the HBOS lending books, with net interest margin excluding trading assets remaining stable.

Overall operating expenses were £67 million. This includes higher performance related bonus accruals resulting from strong trading performance.

## BUSINESS AND FINANCIAL REVIEW – BANKWEST

| | Year ended 31 December 2002 A$m | 10 months ended 31 December 2001 A$m |
|---|---|---|
| Net interest income* | 416 | 348 |
| Non-interest income | 239 | 188 |
| Operating income | 655 | 536 |
| Operating expenses | (404) | (327) |
| Operating profit before provisions | 251 | 209 |
| Provisions for bad & doubtful debts | (38) | (17) |
| Profit before tax | 213 | 192 |
| Total lending to customers** | A$20.4bn | A$18.8bn |
| Net interest margin (2001 – annualised)* | 2.13% | 2.19% |
| Cost:income ratio* | 60.7% | 59.8% |

* Including income representing the fully tax equivalent gross up of A$11 million (10 months ended December 2001 A$11 million).

** After securitisation.

The above table has been prepared under Australian GAAP, as reported by BankWest. The figures reported under the 'Financial Review' section on page 7 reflect the sterling equivalent under UK GAAP.

BankWest's total operating income for the 12 months to 31 December 2002 increased 2% on an annualised basis when compared to the results for the 10 months ended 31 December 2001. This was achieved in an environment of continued competitive pressure and a steeply increasing interest rate yield curve in the first half of the year. The slight increase in net interest income was a result of the combined effect of high volumes at low margins in the strong housing sector, and subdued growth in business credit, albeit at higher margins.

Non-interest income increased 7%, compared with the 2001 annualised comparative, representing a significant increase in customer fees and commissions in Consumer Solutions, offset to a degree by a reduction in software consulting and maintenance income.

Operating expenses increased by 4% over the annualised comparative period. There was an increase in personnel expenses reflecting inflationary pressures and the creation of a bigger sales network to support the Bank's small business initiative, which was launched during the year.

The combined charge for specific and general provisions was A$38 million. Net impaired assets as a percentage of total lending to customers were 0.8% (2001 – 0.7%). An increase in the specific provisions charge and a higher ratio of net impaired assets to total lending reflects the impact of a difficult business lending environment.

Highlights of the year were the continuing strong growth in housing lending which increased by 22.8% to A$11.5 billion before securitisation and growth in retail deposits of 16.9% to A$10.4 billion. A low level of business investment early in the year constrained business lending growth.

# BUSINESS AND FINANCIAL REVIEW – FINANCIAL REVIEW AND RISK MANAGEMENT

## Overview of Results

Group profit before tax and exceptional items amounts to £1,373 million (period ended 31 December 2001 – £922million) and is derived as follows:

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Group profit before tax | 1,296 | 807 |
| Add back: | | |
| Merger costs | | 25 |
| Exceptional items | 77 | 90 |
| Group profit before tax and exceptional items | 1,373 | 922 |

On a divisional basis, Group profit before tax and exceptional items is made up as follows:

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Retail Banking | 319 | 155 |
| Insurance & Investment | 87 | 121 |
| Business Banking | 261 | 218 |
| Corporate Banking | 556 | 367 |
| Treasury | 163 | 93 |
| BankWest | 75 | 67 |
| Group items* | (88) | (99) |
| | 1,373 | 922 |

* Group items comprise costs incurred in the management of the Group as a whole and the amortisation of goodwill.

Group net interest income in the year of £2,375 million is up from strong asset led growth. Net interest margins decreased to 1.87% mainly reflecting the impact of higher volumes of low margin business through treasury, following the integration of the Halifax and Bank of Scotland treasury operations and the impact of interest on current accounts. Excluding trading assets the margin is 2.11%, down from an annualised 2.34% for the period to December 2001. The increase in trading assets in 2002 arises as a consequence of the treasury integration. Future reporting will focus on average interest earning assets excluding trading assets.

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Interest receivable | 10,085 | 6,161 |
| Interest payable | (7,710) | (4,500) |
| Net interest income | 2,375 | 1,661 |
| **Average balances** | | |
| Interest earning assets: | | |
| – Loans and advances | 97,674 | 75,934 |
| – Securities and other liquid assets | 29,567 | 8,897 |
| | 127,241 | 84,831 |
| Trading assets | 14,952 | – |
| | 112,289 | 84,831 |
| Net interest margin ** | 1.87% | 2.34% |
| Net interest margin excluding trading assets** | 2.11% | 2.34% |

** Net interest margin was annualised for period ended 31 December 2001.

Non-interest income amounted to £1,376 million for the year compared with £1,081 million for the period to 31 December 2001.

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 £m |
|---|---|---|
| Net fees and commissions receivable | 800 | 548 |
| Operating lease rental income | 410 | 293 |
| General insurance premium income | | 118 |
| Dealing profits | 111 | 68 |
| Profit on sale of investment securities | 31 | 29 |
| Other operating income | 24 | 25 |
| | 1,376 | 1,081 |

## BUSINESS AND FINANCIAL REVIEW – FINANCIAL REVIEW AND RISK MANAGEMENT (continued)

Operating expenses on an annualised basis grew by 6% reflecting higher staff numbers and technology costs to support higher business levels.

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 £m |
|---|---|---|
| Staff | 680 | 488 |
| Depreciation: | | |
| Tangible Fixed Assets | 89 | 78 |
| Operating Lease Assets | 274 | 188 |
| Goodwill Amortisation | 12 | 9 |
| Other | 737 | 648 |
| | 1,792 | 1,411 |

The underlying cost:income ratio excluding exceptional items and the amortisation of goodwill and after netting operating lease depreciation against operating lease income improved to 43.7% as shown in the table below:

| | Year ended 31 December 2002 £m | 10 months ended 31 December 2001 Restated £m |
|---|---|---|
| Operating expenses | 1,869 | 1,501 |
| Exceptional items | (77) | (90) |
| Goodwill amortisation | (12) | (9) |
| Operating lease depreciation | (274) | (188) |
| Underlying operating expenses | 1,506 | 1,214 |
| Net operating income | 3,751 | 2,742 |
| Amounts written off fixed asset investments | (33) | (12) |
| General insurance claims | | (15) |
| Operating lease depreciation | (274) | (188) |
| Underlying operating income | 3,444 | 2,527 |
| Cost:income ratio | 43.7% | 48.0% |

### Balance Sheet Growth

Advances to customers increased by 31% to £101 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 16 on page 43.

| | 31 December 2002 | | 31 December 2001 | |
|---|---|---|---|---|
| Gross advances | £bn | % | £bn | % |
| Commercial* | 64 | 62 | 50 | 63 |
| Residential Mortgages* | 29 | 28 | 20 | 25 |
| Other Personal | 10 | 10 | 9 | 12 |
| Total | 103 | 100 | 79 | 100 |

* After securitisation.

Customer deposits grew by 43% to £58 billion.

### Bad Debt Provisions

The growth in advances has been achieved without a reduction in overall asset quality. The combined specific and general provisions for bad and doubtful debts charged against Group profits totalled £618 million (period ended 31 December 2001 – £420 million). Within this the charge for specific provisions increased an annualised 27% to £593 million (period ended 31 December 2001 – £391 million) but this represented only 0.66% of average customer lending, no change from the annualised figure in 2001.

| | Specific £m | General £m | Total £m |
|---|---|---|---|
| At 1 January 2002 | 686 | 444 | 1,130 |
| Amounts written off during the year | (452) | | (452) |
| Charge for the year | 593 | 25 | 618 |
| Recoveries of amounts previously written off | 26 | | 26 |
| Exchange movements | 1 | 1 | 2 |
| At 31 December 2002 | 854 | 470 | 1,324 |

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

| | 31 December 2002 £m | 31 December 2002 As % of customer advances | 31 December 2001 £m | 31 December 2001 As % of customer advances |
|---|---|---|---|---|
| Specific Provisions | 854 | 0.85 | 686 | 0.89 |
| General Provisions | 470 | 0.46 | 444 | 0.57 |
| | 1,324 | 1.31 | 1,130 | 1.46 |

## Taxation

The tax charge for the year of £402 million (period ended 31 December 2001 – £275 million), represents 31% (period ended 31 December 2001 – 34%) of profit before tax compared with a UK corporation tax rate of 30% applicable to both periods. In 2001 this mainly reflects the disallowance for tax purposes of merger related costs.

## Capital Structure

| Regulatory Capital | 31 December 2002 £m | 31 December 2001 Restated £m |
|---|---|---|
| Risk Weighted Assets – on balance sheet | 97,500 | 74,505 |
| Risk Weighted Assets – off balance sheet | 12,244 | 6,408 |
| | 109,744 | 80,913 |
| Tier 1 | | |
| Share Capital | 767 | 728 |
| Perpetual securities | 297 | 297 |
| Eligible reserves | 5,186 | 3,555 |
| Minority interests (equity) | 439 | 351 |
| Minority and other interests (non-equity): | | |
| Preferred securities | 400 | 400 |
| Less: goodwill | (150) | (155) |
| Total tier 1 capital | 6,939 | 5,176 |
| Tier 2 | | |
| Perpetual subordinated debt | 1,412 | 1,135 |
| Term subordinated debt | 2,917 | 2,221 |
| General provisions | 485 | 456 |
| Total tier 2 capital | 4,814 | 3,812 |
| Supervisory deductions | | |
| Unconsolidated investments – life | | (113) |
| Unconsolidated investments – other | (6) | |
| Investments in other banks | (2) | (2) |
| Other deductions | (86) | (86) |
| Total supervisory deductions | (94) | (201) |
| Total capital | 11,659 | 8,787 |
| Tier 1 capital ratio (%) | 6.3 | 6.4 |
| Risk asset ratio (%) | 10.6 | 10.9 |

# BUSINESS AND FINANCIAL REVIEW – FINANCIAL REVIEW AND RISK MANAGEMENT (continued)

## Risk Management

The HBOS Group complies with all the provisions of the Combined Code ('the Code') as issued by the UK Listing Authority. An explanation of how the Group complies is included within the report of the Directors on Corporate Governance in the accounts of HBOS plc.

The management of risk for Bank of Scotland is undertaken within the framework operated for the HBOS Group. This section therefore refers to risk management across the whole of that Group, including Bank of Scotland, and references to Group and Board in this section are to the HBOS Group and Board.

The section reviews the Group's approach to risk management by describing:

- general principles for internal controls and operating practices;
- the governance structure for the Group's controls;
- the Group Risk functions which oversee risk management activities; and
- the major types of risks to which the Group is subject.

## Internal Control

The Board has overall responsibility for the Group's system of internal control and for reviewing its effectiveness. The system provides a documented and auditable trail of accountability. It applies across the Bank of Scotland Group's operations, covering strategic, market, financial and operational risks and provides successive assurances to ascending levels of management and ultimately the Board.

The systems of internal control have been regularly reviewed by the Board and accord with the Turnbull guidance on internal control. In addition the Board has reviewed the effectiveness of the current system of internal control specifically for the purposes of this statement.

The system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives, and can provide only reasonable – and not absolute – assurance against material misstatement or loss.

## Operating Principles and Practices

The Group seeks to maintain high standards of business conduct across all of its operations.

The risk appetite of the Group is set by the Board. The strategy for managing risk is formulated by the Executive and recommended to the Board for approval. The Group Management Board also reviews the effectiveness of the risk management systems through reports from management and from the Group risk committees. Management has the prime responsibility for identifying and evaluating significant risks to the business and for designing and operating suitable controls. Internal and external risks are regularly assessed, including control breakdowns, disruption of information systems, competition and regulatory requirements.

The assessment process is consistent across the divisions and 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 Group's controls, the Board reviews the reports of the Audit Committee and management. It also considers key performance indicators and reviews monthly financial and business performance showing variances against budgets.

## Group Level Controls

The Group committee structure considers risks and risk management from the Group's perspective and is supported by the Group Risk functions, namely Group Financial Risk (GFR) and Group Audit, Regulatory and Operational Risk (GAROR). Together 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.

## Audit Committee

Without diminishing its own accountability, the Board has delegated certain responsibilities to the Audit Committee including ensuring that there is regular review of the adequacy and efficiency of the internal control procedures and that there is a proper compliance structure throughout the Group. The Group's Audit Committee also acts as the audit committee for Bank of Scotland and Halifax plc and is supported by five divisional Risk Control Committees, namely Retail Risk Control Committee, Business Banking Risk Control Committee, Corporate Banking Risk Control Committee, Treasury Risk Control Committee and Insurance & Investment Risk Control Committee and the BankWest Audit Committee.

The Audit Committee, which meets at least quarterly, inter alia reviews management's procedures for:

- identifying business risks and controlling their financial impact;
- preventing or detecting fraud;
- ensuring compliance with regulatory and legal requirements; and
- monitoring the operational effectiveness of policies and systems.

The Audit Committee, which summarises its findings to the Board, obtains assurance about the internal control and risk management environment through regular reports from GFR and GAROR and consideration of external auditors' reports and review of the minutes and work of divisional Risk Control Committees.

The divisional Risk Control Committees (which are described under "Divisional Level Controls" below) and the BankWest Audit Committee operate under delegated authority from the Audit Committee and the planning and co-ordination of their activities is reviewed by the Audit Committee. The divisional risk control committees review, on behalf of the Audit Committee, the adequacy of the five business divisions' systems of internal control (including financial, regulatory and operational risk management).

### Group Credit Risk Committee

The Group Credit Risk Committee (GCRC) is responsible for assisting the Board to formulate the Group's risk appetite, policies and strategies for managing the credit risk facing the Group. It is also responsible for the implementation and maintenance of the Group's Credit Risk Management framework. It is supported by GFR, which monitors compliance with Group policies, standards and limits and aggregates credit risks to monitor the overall Group position independently from the business divisions.

### Group Asset and Liability Committee

The Group Asset and Liability Committee (GALCO) is responsible for the implementation and maintenance of the overall risk management framework relating to balance sheet structure, market risks, trading, funding and liquidity management across the Group's banking business. It recommends market risk appetite, policy and guidelines to the Board. It is supported by GFR, which monitors compliance with Group policies, standards and limits and aggregates market risks to monitor the overall Group position independently from the business divisions.

### Group Insurance and Investment Risk Committee

The Group Insurance and Investment Risk Committee (GIIRC) is responsible for the implementation and maintenance of the overall risk management framework relating to investment, credit, market and insurance risks, together with asset and liability management within the Insurance and Investment Division of the Group. It recommends policy, limits and guidelines to the Board. It is supported by GFR, which monitors compliance with the relevant Group policies, standards and limits and aggregates certain risks to monitor the overall Group position.

### Group Operational and Regulatory Risk Committee

The Group Operational and Regulatory Risk Committee (GORRC) is responsible for the overall operational and regulatory risk management framework across the Group. It recommends policy and guidelines to the Board. It is supported by Group Regulatory Risk and Group Operational Risk, which recommend and monitor compliance with Group policies and standards.

### Group Risk

Group Risk consists of two functions: GFR and GAROR, both of which report to the Group Finance Director. The Chief Financial Risk Officer, Head of GAROR, Head of Group Internal Audit, Head of Group Regulatory Risk, and Head of Operational Risk all have direct access to the Chairman of the Audit Committee and the Chief Executive.

The Group Risk areas provide functional leadership for specialist personnel throughout the Group's business areas and oversee risk management activities across the Group to ensure minimum standards are met and monitor aggregate risk data at Groupwide and cross-divisional regulated entity levels.

GFR has three main areas of focus:

- Group Asset and Liability Management monitors compliance with Group policies, standards and limits and aggregates market risks to monitor the overall Group position.
- Group Credit Risk monitors compliance with Group policies, standards and limits and aggregates all credit risks to monitor the overall Group position. In addition, specified Group Credit Risk colleagues have the authority to sanction specific transactions.
- Group Insurance and Investment Risk monitors compliance with the relevant Group policies, standards and limits and aggregates certain risks to monitor the overall Group position.

## BUSINESS AND FINANCIAL REVIEW – FINANCIAL REVIEW AND RISK MANAGEMENT (continued)

GAROR has three main areas of focus:

- Group Internal Audit supports the Audit Committee, divisional Risk Control Committees and senior management by reviewing independently and objectively the effectiveness of the control and risk environment.
- Group Regulatory Risk supports the GORRC to recommend policies and standards on regulatory risk and cultural issues for approval by the Board. It is also responsible for oversight of the Group's adherence to regulatory requirements and for oversight of communications with regulators on a Group-wide basis, with direct responsibility for relations with the Financial Services Authority (FSA), the Group's principal regulator.
- Group Operational Risk supports the GORRC to recommend policies and standards on operational risk for approval by the Board, providing operational risk oversight of the implementation of those policies and standards.

### Divisional Level Controls

Divisional Chief Executives have responsibility for managing strategic, market, credit, regulatory and operational issues affecting their own operations within the parameters of the Group policies set by the Board. All business divisions have Risk Control Committees which comprise at least two independent Non-executive Directors and an Executive Director, independent of that division, to provide objective assurance on the effectiveness of the division's internal control and risk management. These committees meet regularly to review the significant risks facing their division's business and the techniques used to identify, assess and manage them. Each business division also has its own risk management committee or committees, which relevant Group Risk personnel attend.

### Regulatory Controls

The Group's business areas are regulated by a range of authorities including the FSA, the Group's principal regulatory authority, and regulators in overseas jurisdictions in which the Group operates.

The Group's activities are monitored by the regulators through periodic reviews and inspections. External auditors report to the regulators, when requested, on certain aspects of internal controls and other matters. The findings of those reports are also considered by the appropriate divisional Risk Control Committees, Audit Committees and Boards.

### Mapping and Managing Risk

The Group is subject to risks, inherent in financial services activity. The Bank of Scotland's principal activities are the provision of retail, business and corporate banking services. It consequently makes loans to and takes deposits from customers and wholesale counterparties.

### Credit Risk

This is the risk of financial loss from a customer's failure to settle financial obligations as they fall due. GCRC, which was chaired until his retirement by the HBOS Executive Deputy Chairman, and thereafter by the Group Finance Director, and is comprised of senior executives, meets monthly (in general) and reviews the Group's lending portfolio to ensure a Group-wide understanding and control of credit risk.

Day to day management of credit risk is undertaken by specialist credit teams working within each business area in compliance with policies approved by the Board. A specialist support function within GFR provides centralised expertise in the area of credit risk measurement and management techniques. Performance of each portfolio is reported to the GCRC.

In Retail division, use is made, where it is practical to do so, of software technology in credit scoring new applications and current account overdraft extensions. In addition, behavioural scoring is used. Collections activity for credit card and current accounts, and for 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.

Within Business Banking division, small business customers may be rated using scorecards in a similar manner to retail customers. Larger SME (small to medium enterprises) customers are typically rated in the same way as corporate customers. Corporate Banking division conduct a full credit assessment of the financial strength of each potential transaction and/or customer, awarding an internal risk rating. Internal ratings are reviewed regularly.

In HBOS Treasury Services, policies are established and reviewed by the Group Wholesale Credit Committee, a sub-committee of GCRC.

The controls applied to lending assessment processes consider environmental risk and the potential impact this may have on the value of the underlying security.

### Insurance and Investment Risk

Insurance risk is the potential for loss arising from poor experience in relation to insurance contract pricing parameters (for both life and general insurance products). Investment risk is the potential for financial loss arising from the risks associated with the fund management activities of the Group. This includes both the assets where the Group retains the primary risk and those assets where it is retained by third parties, including policyholders.

Day-to-day management of such risks is undertaken both by line management and by specialist teams within the Insurance and Investment Division. Full use is made of the statutory Appointed Actuary and (Pension) Scheme Actuary roles, both to ensure regulatory compliance (in respect of the authorised insurance companies in the Group) and to meet HBOS control standards.

GIIRC receives regular reports on specified aggregate risks across the division.

### Regulatory Risk

This is the risk that the Group, or any part of it, fails to meet the requirements or expectations of regulatory authorities or supervisors responsible for enforcing legislation, codes, or regulations governing the way that the Group's business activities are conducted within the UK or elsewhere. Regulatory risk can also arise where the Group fails to anticipate and manage regulatory change adequately.

Day-to-day management of regulatory risk is undertaken both by line management and specialist teams of compliance experts working within business areas. Reports on regulatory risk management are made by business areas and divisions to their Risk Control Committee and to individual company Audit Committees. Group Regulatory Risk provides a high level assessment to the Audit Committee.

### Operational Risk

The Group has adopted the industry standard Basel Committee on Banking Supervision definition of operational risk:

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

The management of operational risk is an intrinsic part of every business manager's role. The Group's approach is to ensure business managers identify, assess, prioritise and manage all substantial risks in a cost effective and consistent manner.

To this end the Group uses a combination of risk self assessment, risk event and key risk indicator analysis, appropriate insurance cover and contingency arrangements, together with sound control procedures and systems. This approach is entirely consistent with the current requirements under the new Basel Capital Accord.

Each division and Group function is required half yearly to compile an operational risk profile which sets out the internal assessment of risk and controls against consistent categories as a form of self certification. These profiles are presented to the Risk Control Committees, the Audit Committee and the Board and are subject to independent review by the relevant risk teams. They are also validated by Group Internal Audit during the course of their work.

In addition a number of specialist support functions provide centralised expertise in operational risk areas such as information security, fraud, corporate insurance and business continuity planning.

### Liquidity Risk

Liquidity risk is the risk that the Group will be unable to meet financial commitments arising from the cashflows generated by its business activities. This risk can arise from mismatches in the timing of cashflows relating to assets, liabilities and off-balance sheet instruments.

The Group's UK liquidity is managed by HBOS Treasury Services. It operates within a framework and policies determined by GALCO which ensures that the Group's funding requirements can be met at all times and that a stock of high quality liquid assets is maintained in a form and at a level which reflects prudent banking practice.

A further objective is to raise funding as cost effectively as possible whilst ensuring that no significant unintended mismatches arise between loans and deposits. Close control is exercised over both volume and quality of short-term deposits, with the sources and maturities being managed to avoid a concentration of funding requirements at any one time from any one source. The framework ensures that the Group meets regulatory authority requirements.

### Market Risk

This is the risk of financial loss from changes in market prices of financial instruments – typically resulting from movements in interest rates (interest rate risk), equity or other indices, and foreign exchange rates (foreign exchange risk). Overall accountability for the management of market risk and responsibility for allocating limits for banking activities, within the parameters set by the Board, lies with GALCO.

### Interest Rate Risk

The primary market risk faced by the Group is interest rate risk. Interest rate risk exists where the Group's financial assets and liabilities have interest rates set under different bases or reset at different times. The Group assumes interest rate risk from dealings with customers, through fixed term lending, deposit taking or derivative contracts. This risk is monitored by Group and divisional Asset and Liability Management within a framework determined by GALCO. Trading activity is undertaken by HBOS Treasury Services.

The effect of interest rate movements is assessed using sensitivity analyses and other modelling techniques. Sensitivity to interest rate movements is shown in Note 42 to the Accounts on page 61 which provides the period end repricing profile for Bank of Scotland Group's financial assets and liabilities in the non-trading book, which includes lending, funding and liquidity activities.

## BUSINESS AND FINANCIAL REVIEW – FINANCIAL REVIEW AND RISK MANAGEMENT (continued)

### Foreign Exchange Risk

Structural foreign exchange exposures, which are set out in Note 44 of the Accounts on page 62, arise from Bank of Scotland Group's investments in overseas subsidiaries, branches and other investments.

Foreign exchange exposures in HBOS Treasury Services, which arise in the normal course of business, are transferred to the trading book where they are managed within GALCO approved limits.

### Trading

The Group's market risk trading activities are principally conducted by HBOS Treasury Services in the UK. The regulatory capital charge for market risk trading exposures represents less than 2.46% of the Group's capital base.

The Group employs several complementary techniques to measure and control trading activities including: Value at Risk ('VaR'), sensitivity analysis, stress testing and position limits. The VaR model used forecasts the Group's exposure to market risk within an estimated level of confidence over a defined time period.

The average VaR value in 2002 was £7.9 million. The calculation is based upon a confidence interval of 99% 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 or equity exposure.

The 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.

Bank of Scotland Group's trading market risk exposure for the year ended 31 December 2002 is analysed in Note 43 on page 62 of the Accounts.

### Derivatives

In the normal course of banking business, the Group uses a limited range of derivative instruments for both trading and non-trading purposes. The principal derivative instruments used are interest rate swaps, interest rate options, cross currency swaps, forward rate agreements, forward foreign exchange contracts and futures. The Group uses derivatives primarily as a risk management tool for hedging interest rate and foreign exchange rate risk. The table shown below provides an illustration of the traditional banking services and activities which can give rise to market risk exposures and the way in which this can be managed and mitigated by using derivatives.

| Activity | Risk | Type of Derivative |
|---|---|---|
| Management of the investment of reserves and other non-interest bearing liabilities | Sensitivity to falls in interest rates | Receive fixed interest rate swaps<br>Purchase of interest rate floors |
| Fixed and capped rate mortgage lending | Sensitivity to increases in interest rates | Pay fixed interest rate swaps<br>Purchase of interest rate caps |
| Fixed rate savings products | Sensitivity to falls in interest rates | Receive fixed interest rate swaps |
| Fixed rate funding | Sensitivity to falls in interest rates | Receive fixed interest rate swaps |
| Fixed rate asset investments | Sensitivity to increases in interest rates | Pay fixed interest rate swaps |
| Investment and funding in non-sterling currencies | Sensitivity to changes in foreign exchange rates and interest rates | Cross currency interest rate swaps<br>Foreign exchange contracts |
| Investment in assets ⁄ issuance with embedded options | Sensitivity to changes in underlying rates and rate volatility | Interest rate swaps, caps and floors<br>Matched swaps with embedded options |

The Group's activity in derivatives is controlled within risk management limits set by GALCO. 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 39 on page 57 of the Accounts.

# DIRECTORS' REPORT

The Directors have pleasure in presenting their Report & Accounts for the year ended 31 December 2002.

## Ultimate parent undertaking

HBOS plc is the ultimate parent undertaking of the Bank.

## 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 & Financial Review on pages 1 to 14. A list of the main subsidiary undertakings, and the nature of their business, is given in Note 52 to the Accounts on page 65.

## Results and dividends

The profit before tax and exceptional items for the year ended 31 December 2002 amounted to £1,373 million (period ended 31 December 2001 – £922 million).

The Directors recommend payment of a dividend of £371 million in respect of the year ended 31 December 2002.

Dividends on the 9¼% and 9¾% Non-Cumulative Irredeemable Preference Stocks for the half year ended 31 August 2002 were paid on 29 November 2002 and for the half year ended 28 February 2003 will be paid on 2 June 2003.

## Payment policy

The Group's policy for the payment of suppliers is as follows:

- payment terms are agreed at the start of the relationship with the supplier and is 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 2002 in Bank of Scotland was 23 days (period ended 31 December 2001 – 25 days).

## Employees

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 names of the current Directors are: George Mitchell (Governor, Treasurer and Chief Executive Corporate Banking), James Crosby (Director), Mike Ellis (Director), Phil Hodkinson (Chief Executive, Insurance & Investment), Andy Hornby (Chief Executive, Retail Banking), Colin Matthew (Chief Executive, Business Banking), Gordon McQueen (Chief Executive, Treasury), together with the following Non-Executive Directors: Charles Dunstone, Sir Ronald Garrick, Anthony Hobson, Brian Ivory, John Maclean, Coline McConville, Sir Bob Reid (Deputy Governor), Louis Sherwood, Lord Stevenson and Philip Yea.

Lord Simpson retired as a director on 15 May 2002. Sir Peter Burt retired on 6 January 2003.

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

## Charitable and other donations

Charitable donations by the Group in the UK during the year amounted to £2.3 million (period ended 31 December 2001 – £2.4million).

## Share capital

Full details of the movements in the authorised and issued share capital during the year are provided in Note 35 to the Accounts on page 55.

## DIRECTORS' REPORT (continued)

### Corporate governance and Directors' remuneration

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

### Auditors

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

On behalf of the Board
H F Baines
Company Secretary
24 February 2003

# APPENDIX TO DIRECTORS' REPORT

## 1.1 Directors' Share Interests

### 1.1.1 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 31.12.02 | Number of shares at 31.12.01 |
|---|---|---|
| Governor | | |
| George Mitchell – from 6 January 2003 | 48,092 | 32,833 |
| Sir Peter Burt (until his retirement 6 January 2003) | 529,414 | 508,615 |
| Executive Directors | | |
| James Crosby | 96,969 | 55,299 |
| Mike Ellis | 73,514 | 39,638 |
| Phil Hodkinson | 10,524 | 197 |
| Andy Hornby | 40,781 | 17,228 |
| Gordon McQueen | 54,709 | 54,445 |
| Colin Matthew | 54,084 | 41,348 |
| Non-Executive Directors | | |
| Charles Dunstone | 100,000 | 100,000 |
| Sir Ronald Garrick | 9,799 | 3,773 |
| Anthony Hobson | 2,000 | 1,000 |
| Brian Ivory | 11,000 | 11,000 |
| Coline McConville | 2,070 | 2,070 |
| John Maclean | 5,036 | 5,030 |
| Sir Bob Reid | 28,195 | 27,160 |
| Louis Sherwood | 2,000 | 10,000 |
| Lord Stevenson | 97,096 | 118,303 |
| Philip Yea | 9,529 | 6,185 |

Notes to Table 1

Note 1:

James Crosby, Brian Ivory, John Maclean, George Mitchell and Sir Bob Reid all have a non-beneficial interest as at 31 December 2002 over 7,830,342 ordinary shares (2001 – 7,723,565) as Trustees of the Bank of Scotland Profit Sharing Stock Ownership Scheme.

Brian Ivory has a non-beneficial interest over 4,500 ordinary shares (2001 – 4,500).

Lord Stevenson has a non-beneficial interest in nil ordinary shares of 15 pence each (2001 – 120,000) of St James's Place Capital, a fellow subsidiary undertaking of HBOS plc. Lord Stevenson ceased to have a beneficial interest in 21,614 ordinary shares of the Group and ceased to have a non-beneficial interest in 120,000 ordinary shares of St James's Place Capital during the year. These interests were previously included in Lord Stevenson's overall interests in relation to a connected person (within the meaning of the Companies Act) who, during the year, ceased to be classed as a connected person.

Note 2:

Certain Directors will receive further interests in the ordinary shares of the Group arising out of the short-term incentive plans and, potentially, the long-term incentive plans as set out in Tables 2,3 and 4.

Note 3:

Except as disclosed 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 end of the financial year. No options to subscribe for shares in other HBOS Group companies are granted to Directors of the Group.

### 1.1.2 Short-term Incentive Plan – HBOS Directors and former Halifax Directors

Certain Executive Directors have conditional entitlements to shares arising from the annual incentive 'sharekicker'. Where the annual incentive for 2000 and/or 2001 was taken in shares and these shares are retained in trust for three years, the following shares will also be transferred to the Directors:-

## APPENDIX TO DIRECTOR'S REPORT (continued)

### Table 2

| | Grant effective from | Shares as at 31.12.02 |
|---|---|---|
| Sir Peter Burt | March 2002 | 9,863 |
| James Crosby | March 2001 | 9,710 |
| | March 2002 | 19,335 |
| Mike Ellis | March 2001 | 7,308 |
| | March 2002 | 14,501 |
| Phil Hodkinson | March 2002 | 5,163 |
| Andy Hornby | March 2001 | 5,533 |
| | March 2002 | 11,762 |
| Colin Matthew | March 2002 | 5,692 |
| George Mitchell | March 2002 | 7,017 |

### Notes to Table 2

The shares, which relate to the 2000 and 2001 operations of the short-term incentive plan, were granted at £6.752 and £7.68, respectively.

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

### 1.1.3 Long-term Incentive Plan and Special Long-term Incentive Plan – HBOS Directors and former Halifax Directors

Details of the shares which have been conditionally awarded to Directors under the 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 31.12.01 | Granted (G) lapsed (L) or exercised (E) in year | At 31.12.02 |
|---|---|---|---|---|
| James Crosby | January 2000 | 62,684 | – | 62,684 |
| | January 2001 | 70,992 | – | 70,992 |
| | January 2002 | – | 75,000 (G) | 75,000 |
| | | 133,676 | 75,000 | 208,676 |
| Mike Ellis | January 2000 | 47,935 | – | 47,935 |
| | January 2001 | 53,435 | – | 53,435 |
| | January 2002 | – | 56,250 (G) | 56,250 |
| | | 101,370 | 56,250 | 157,620 |
| Andy Hornby | January 2000 | 80,752 | – | 80,752 |
| | January 2001 | 40,458 | – | 40,458 |
| | January 2002 | – | 45,625 (G) | 45,625 |
| | | 121,210 | 45,625 | 166,835 |
| Phil Hodkinson | January 2001 | 53,435 | – | 53,435 |
| | January 2002 | – | 87,500 (G) | 87,500 |
| | | 53,435 | 87,500 | 140,935 |
| Gordon McQueen | January 2002 | – | 45,625 (G) | 45,625 |
| | | – | 45,625 | 45,625 |
| Colin Matthew | January 2002 | – | 45,625 (G) | 45,625 |
| | | – | 45,625 | 45,625 |
| George Mitchell | January 2002 | – | 56,250 (G) | 56,250 |
| | | – | 56,250 | 56,250 |
| Lord Stevenson | July 1999 | 15,853 | – | 15,853 |
| | January 2000 | 36,873 | – | 36,873 |
| | January 2001 | 38,168 | – | 38,168 |
| | January 2002 | – | 56,250 (G) | 56,250 |
| | | 90,894 | 56,250 | 147,144 |

## APPENDIX TO DIRECTOR'S REPORT (continued)

### Notes to Table 3

Note 1:

Shares under these plans were granted using the average market price in the ten business days ending at the previous year or period end, as follows:-

| Plan | Share grant price £ |
|---|---|
| July 1999 – December 2002 | 7.885 |
| January 2000 – December 2002 | 6.78 |
| January 2001 – December 2003 | 6.55 |
| January 2002 – December 2004/06 | 8.00 |

Note 2:

The grant effective from January 2000 for Andy Hornby includes 44,248 shares which are related to his joining arrangements.

The grants effective from January 2001 and January 2002 for Phil Hodkinson include 53,435 shares and 43,750 shares, respectively, which are related to his joining arrangements.

Note 3:

Awards are not pensionable.

Note 4:

Subject to performance and subject also to a minimum release of 60% of the grant, as agreed by Halifax shareholders at the time of the merger, shares granted under the long-term plans effective from January 2000 and January 2001 will be released to most individuals shortly after the three-year anniversary (three and a half year anniversary in respect of the grant effective from July 1999) of the relevant effective grant date. However, shares receivable by Executive Directors and Lord Stevenson from those grants will be retained by them on their behalves for at least an additional two years.

For the 2002 grant, all participants can choose to take any shares released after three years or can continue to participate in the scheme for a further two years and take shares at that point based on the better of the three year and the five year performance outcome. 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.

Note 5:

In the case of Lord Stevenson the grants are awards of notional shares. For technical reasons he will become entitled to the cash value of the relevant shares on vesting. This value will, subject to any withholdings for tax or National Insurance, be applied in acquiring shares on his behalf.

Note 6:

The number of shares to be released to participants is dependent on the HBOS Group's TSR over a three year (three and a half year in respect of the grant effective from July 1999) period, compared to the annualised weighted average TSR of a basket of comparator companies over an equivalent period. This basket of companies comprises:-

- For the July 1999 and January 2000 grants: Abbey National, Alliance & Leicester, Bank of Scotland*, Barclays, Britannic Assurance, Legal & General, Lloyds TSB, NatWest*, Northern Rock, Norwich Union*, Prudential, Royal & Sun Alliance, Royal Bank of Scotland, Woolwich*;
- For the January 2001 grants: Abbey National, Alliance & Leicester, Bank of Scotland*, Barclays, Britannic Assurance, Legal & General, Lloyds TSB, Northern Rock, Prudential, Royal & Sun Alliance, Royal Bank of Scotland;
- For the January 2002 grants: Abbey National, Aviva, Barclays, Legal & General, Lloyds TSB, Prudential, Royal & Sun Alliance and Royal Bank of Scotland.

* For the periods for which they were independent entities.

Shares will be released as follows:

| HBOS Group's relative TSR performance | Amount released as a % of share grant |
|---|---|
| **1999-2001 grants** | |
| 0% p.a. (or below) | 0 |
| +4% p.a. | 100 |
| +8% p.a. (or above) | 200 |
| **2002 grant** | |
| 0% p.a. (or below) | 0 |
| +3% p.a. | 100 |
| +6% p.a. (or above) | 200 |

Intermediate positions are determined by interpolation.

## APPENDIX TO DIRECTOR'S REPORT (continued)

Note 7:

The performance period for the July 1999 grant ended on 31 December 2002. HBOS's (and previously Halifax's) TSR over the performance period exceeded the weighted average of the comparator group by 5.55% p.a. so 138.75% of the share grant will be released to the grant recipient, subject to Notes 4 and 5 above.

The performance period for the January 2000 grant ended on 31 December 2002. HBOS's (and previously Halifax's) TSR over the performance period exceeded the weighted average of the comparator group by 9.02% p.a. so 200% of share grants will be released to grant recipients, subject to Note 4 above.

Full details concerning these shares, which will be released to the HBOS Chairman and Executive Directors subject to Notes 4 and 5 above no earlier than 2003, will be contained in the HBOS 2003 Report & Accounts.

### 1.1.4 Long-term Incentive Plan – Former Bank of Scotland Directors

Share options granted between 1995 and 2000 under Bank of Scotland's plans were subject to a performance pre-condition on exercise that options were not capable of being exercised unless growth in diluted earnings per share ('EPS') exceeded the growth in the Retail Prices Index over a period of at least three consecutive financial years by not less than 2% per annum.

No performance target will apply in respect of unapproved share options following the third anniversary of grant, as agreed by Bank of Scotland stockholders at the time of the merger.

The performance target in respect of approved share options has now been satisfied for all grants and consequently all approved options become exercisable in accordance with the rules of the plans.

No further grants will be made under any of these plans.

# APPENDIX TO DIRECTOR'S REPORT (continued)

Details of the shares which have been conditionally awarded to Directors under the plans are set out below.

Table 4

| | Grant effective from | At 31.12.01 | Granted (G), exercised (E) or lapsed (L) in year | At 31.12.02 | Share Option Price £ | Exercisable |
|---|---|---|---|---|---|---|
| Sir Peter Burt | May 2000 | 75,000 | – | 75,000 | 5.5150 | 2003 |
| | October 2000 | 90,000 | – | 90,000 | 6.1000 | 2003 |
| | | 165,000 | – | 165,000 | | |
| Gordon McQueen | October 1995 | 48,000 | – | 48,000 | 2.5983 | 2003-2005 |
| | October 1996 | 45,000 | – | 45,000 | 2.7367 | 2003-2006 |
| | October 1997 | 32,000 | – | 32,000 | 5.3533 | 2003-2007 |
| | October 1998 | 5,223 | – | 5,223 | 5.7433 | 2003-2008 |
| | October 1998 | 29,777 | – | 29,777 | 5.8350 | 2003-2008 |
| | May 2000 | 35,000 | – | 35,000 | 5.5150 | 2003-2010 |
| | October 2000 | 40,000 | – | 40,000 | 6.1000 | 2003-2010 |
| | | 235,000 | – | 235,000 | | |
| Colin Matthew | October 1995 | 48,000 | – | 48,000 | 2.5983 | 2003-2005 |
| | October 1996 | 50,000 | – | 50,000 | 2.7367 | 2003-2006 |
| | October 1997 | 28,000 | – | 28,000 | 5.3533 | 2003-2007 |
| | October 1998 | 5,223 | – | 5,223 | 5.7433 | 2003-2008 |
| | October 1998 | 29,777 | – | 29,777 | 5.8350 | 2003-2008 |
| | May 2000 | 40,000 | – | 40,000 | 5.5150 | 2003-2010 |
| | October 2000 | 40,000 | – | 40,000 | 6.1000 | 2003-2010 |
| | | 241,000 | – | 241,000 | | |
| George Mitchell | October 1996 | 50,000 | – | 50,000 | 2.7367 | 2003-2006 |
| | October 1997 | 35,000 | – | 35,000 | 5.3533 | 2003-2007 |
| | October 1998 | 40,000 | – | 40,000 | 5.8350 | 2003-2008 |
| | May 2000 | 5,572 | – | 5,572 | 5.3833 | 2003-2010 |
| | May 2000 | 39,428 | – | 39,428 | 5.5150 | 2003-2010 |
| | October 2000 | 50,000 | – | 50,000 | 6.1000 | 2003-2010 |
| | | 220,000 | – | 220,000 | | |

Notes to Table 4

No Directors' share options lapsed in the period 1 January 2003 to 24 February 2003, the date of approval of this Annual Report and Accounts.

### 1.1.5 Sharesave Plan

The sharesave plan is available to nearly all 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 HBOS shares at a fixed price.

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 31.12.01 | Granted (G), lapsed (L) or exercised (E) in year | At 31.12.02 | Initial exercise date | Expiry date |
|---|---|---|---|---|---|---|
| James Crosby | Sep 1997 | 2,980 | 2,980 (E) | – | Sep 2002 | Mar 2003 |
| | Sep 2002 | – | 2,748 (G) | 2,748 | Jan 2008 | Jun 2008 |
| Mike Ellis | Sep 1997 | 2,980 | 2,980 (E) | – | Sep 2002 | Mar 2003 |
| Phil Hodkinson | Sep 2002 | – | 2,970 (G) | 2,970 | Jan 2010 | Jun 2010 |
| Andy Hornby | Oct 2000 | 2,362 | – | 2,362 | Oct 2003 | Apr 2004 |
| Gordon McQueen | Nov 2000 | 3,571 | – | 3,571 | Dec 2005 | Jun 2006 |
| George Mitchell | Oct 2001 | 1,723 | – | 1,723 | Jan 2005 | Jun 2005 |

Notes to Table 5

Note 1:

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

| Effective date of grant | Share option price £ |
|---|---|
| September 1997 | 5.7879 |
| October 2000 | 4.10 |
| November 2000 | 4.7253 |
| October 2001 | 5.62 |
| September 2002 | 5.975 |

Note 2:

Sharesave options for James Crosby and Mike Ellis were exercised in October 2002 and December 2002, respectively, and each has bought the number of shares under option. The market prices on the dates of exercise were £5.65 and £6.265 respectively. There were no such exercises in 2001.

### 1.1.6 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:-

- HBOS Group's Employee Share Ownership Trust. As such, they were each treated as at 31 December 2002 as being interested in the 8,606,603 ordinary shares (31 December 2001 – 2,100,617 ordinary shares) held by the trustee of this Trust. The shares held in the Trust will be used to satisfy share awards under the former Halifax Short-term and Long-term Incentive Plans. The relevant Executive Directors' specific individual interests are shown in Tables 2 and 3;

- HBOS Group's Qualifying Employee Share Ownership Trust (previously the Halifax plc Qualifying Employee Share Ownership Trust). As such, they were each treated as at 31 December 2001 as having been interested in the 14,626,075 ordinary shares held by the trustee of this Trust. The shares held in the Trust were available to satisfy the exercise of rights granted under the former Halifax Sharesave Scheme. On 12 June 2002 HBOS plc purchased those shares for a consideration of £1,000 and on the same day HBOS plc issued the same number of ordinary shares, at their nominal value of 25p per share, to the Group's Qualifying Employee Share Ownership Trust. The transaction, which was approved by shareholders at the 2002 Annual General Meeting, resolved an outstanding matter from the corporate restructuring of Halifax plc in 1999 and the subsequent merger of Halifax Group plc and Bank of Scotland in 2001. The relevant Executive Directors' specific individual interests are shown in Table 5;

- HBOS Group's Qualifying Employee Share Ownership Trust (previously the Bank of Scotland Qualifying Employee Share Ownership Trust). However, as the Trust was not pre-funded, they were each treated as at 31 December 2001 and 31 December 2002 as having no interest as a consequence of this Trust. The Trust was established to satisfy the exercise of rights granted under the former Bank of Scotland S.A.Y.E. Stock Option Schemes. The relevant Executive Directors' specific individual interests are shown in Table 5; and

- HBOS Group's Qualifying Employee Share Ownership Trust. However, as the Trust was originally not pre-funded, they were each treated as at 31 December 2001 as having no interest as a consequence of this Trust. As outlined above, shares were issued to this Trust on 12 June 2002 and, as a result, the interest as a consequence of this Trust is now in relation to 14,626,075 ordinary shares. The Trust was established to satisfy the exercise of rights granted under the HBOS Sharesave Scheme and will now also be used to satisfy entitlements of employees of Halifax plc arising on the exercise of options under the sharesave schemes operated by HBOS plc. The relevant Executive Directors' specific individual interests are shown in Table 5.

### 1.1.7 General

The market price of HBOS ordinary shares at 31 December 2002 was £6.55. The market price of HBOS ordinary shares at 31 December 2001 was £7.96. The range during the year was £5.565 to £8.83.

The register of Directors' interests, which is open to inspection, contains full particulars of the Directors' shareholdings and options to subscribe for shares in HBOS Group.

There has been no change in the Directors' interest in shares or options granted by HBOS plc and its subsidiaries between the end of the financial year and 24 February 2003, the date of approval of this Annual Report & Accounts.

## Directors' Accounting Responsibilities

The following statement, which should be read in conjunction with the Independent Auditors' Report on page 25, enables shareholders to distinguish the respective responsibilities of the Directors and the Auditors in relation to the accounts.

Company law requires the Directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the Bank and of the Group and of the profit or loss for that period. In preparing those accounts, 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 applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts;
- Prepare the accounts on the going concern basis unless it is inappropriate to presume that the Company and the Group will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the accounts 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.

# INDEPENDENT AUDITORS' REPORT TO THE PROPRIETORS OF BANK OF SCOTLAND

We have audited the accounts on pages 26 to 66.

This report is made solely to the Bank's proprietors, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Bank's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's proprietors 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 are responsible for preparing the Annual Report and Accounts. As described on page24, this includes responsibility for preparing the accounts in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of the Financial Services Authority, and by our profession's ethical guidance.

We report to you our opinion as to whether the accounts give a true and fair view and whether the accounts have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the accounts, if the Bank has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the group is not disclosed.

We read the other information contained in the Annual Report and Accounts, and consider whether it is consistent with the audited accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the accounts.

## Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the group'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 accounts 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 accounts.

## Opinion

In our opinion the accounts give a true and fair view of the state of affairs of the Bank and the Group as at 31 December 2002 and of the profit of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
Edinburgh
24 February 2003

# ACCOUNTING POLICIES

## Accounting Convention

The accounts have been prepared under the historical cost convention in compliance with the special provisions of Part VII of the Companies Act 1985 applicable to banking groups modified by the revaluation of items held for trading purposes. The accounts have been prepared in accordance with applicable accounting standards and pronouncements of the Urgent Issues Task Force and in accordance with the applicable Statements of Recommended Practice being those issued by the British Bankers' Association, and the Finance and Leasing Association.

Accounting policies are reviewed regularly to ensure they are the most appropriate to the circumstances of the Group for the purposes of giving a true and fair view.

## Changes in Accounting Policy

In the current year, the Group implemented FRS19 'Deferred Tax'. The cumulative impact on the taxation charge relating to previous periods has been recognised in the accounts as a prior period adjustment and the prior period results have been restated. The effect of implementing this new accounting standard was to decrease the taxation on profit on ordinary activities by £8m (10 months ended 31 December 2001 – £5m), increase the profit on ordinary activities after taxation by £8m (10 months ended 31 December 2001 – £5m) and increase the value of the Group's reserves at 1 January 2002 by £129m (1 March 2001 – £124m). This is mainly due to the recognition in full of a deferred tax asset on the general provision for bad and doubtful debts.

UITF 33 'Obligations in capital instruments' was also implemented in the current year. This required reclassification of certain capital instruments from minority and other interests (non-equity) to undated loan capital. The impact was to re-classify £297m (2001 – £297m) of perpetual securities within the consolidated balance sheet from capital and reserves to liabilities. Within the consolidated profit and loss account £22m (10 months ended 2001 – £18m) of interest on preferred securities was recognised as interest payable rather than minority interests (non-equity).

## Basis of Consolidation

### i) Consolidation

The Group's accounts include the audited results of the Bank and its subsidiary undertakings. The accounts of all principal subsidiary undertakings are made up to 31 December. The value of the long-term assurance business attributable to Proprietors and the assets and liabilities attributable to policyholders are presented separately on the consolidated balance sheet from those of other businesses in order to reflect the different nature of the Proprietors' and policyholders' interests therein.

### ii) Associated Undertakings and Joint Ventures

The Group's share in associated undertakings is stated in the consolidated balance sheet at the Group's share of their net tangible assets plus attributable goodwill. The attributable share of results of associated undertakings, generally based on audited accounts, is included in consolidated profit using the equity method of accounting. Joint ventures in which the Group has a long-term interest and shares control under a contractual agreement with other parties are accounted for using the gross equity method.

### iii) Goodwill

The excess of the fair value of purchase consideration over the fair value of net assets at the date of acquisition of subsidiary undertakings, associated undertakings, joint ventures and other businesses arising on acquisitions after 1 March 1998 is capitalised. This goodwill is amortised by equal instalments over its estimated useful life, normally 20 years.

Goodwill arising on acquisitions prior to 1 March 1998 was written off to reserves in the year in which it arose and has not been reinstated, as permitted by FRS 10 'Goodwill and Intangible Assets'. On the disposal of subsidiary undertakings and other businesses any related goodwill charged directly to reserves prior to 1 March 1998 is reinstated and included in the calculation of the profit or loss on disposal.

Goodwill carried in the consolidated balance sheet is subject to impairment review when events or changes in circumstances indicate that the carrying amount may not be recoverable and is written down by the amount of any impairment loss identified in the year. Impairment charges, if any, are included within goodwill amortisation.

## Long-term Assurance Business

The value of the long-term assurance business to Proprietors is a prudent estimate of the net present value of future cash flows attributable to the Proprietors based on the market value of the assets at 31 December using assumptions which reflect experience and a long-term outlook for the economy and the discounting at an appropriate risk discount rate.

## General Insurance Business

The Group both underwrites and acts as intermediary in the sale of general insurance products. For each general insurance policy underwritten, premiums net of refunds are credited to other operating income over the duration of the insurance policy. Premiums received relating to future accounting periods are deferred as accruals and deferred income and credited to other operating income when earned.

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. Claims equalisation provisions are calculated in accordance with relevant legislation and guidance.

## ACCOUNTING POLICIES (continued)

Where the Group acts as intermediary, commission income net of a provision for expected future policy cancellations is credited to other operating income at the commencement of each insurance policy.

### 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 of 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 profit and loss account, net of recoveries. If collection of interest is considered doubtful, it is suspended and excluded from interest income in the profit and loss account. Provisions and suspended interest are written off to the extent that there is no longer a realistic prospect of recovery.

### Securitisation

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 from the Group by special purpose securitisation companies which fund their purchase primarily through the issue of floating rate notes. In accordance with FRS 5, 'Reporting the Substance of Transactions', the proceeds of these note issues are shown deducted from the securitised assets on the face of the balance sheet.

### Finance Leases, Instalment Credit and Operating Leases

Assets leased to customers which transfer substantially all the risks and rewards of ownership to the customer are classified as finance leases and, together with instalment credit agreements, are recorded within loans and advances to customers or loans and advances to banks. The net investment in finance leases and instalment credit agreements represents total minimum payments less gross earnings allocated to future periods. Obligations under leases with third party finance lessors are included in customer accounts.

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.

Income from finance leases and instalment credit agreements is credited to interest receivable using an actuarial method to give a constant periodic return on the net cash investment. Operating lease rentals are recognised in the profit and loss account on a straight line basis with depreciation charged using an actuarial method to give a constant periodic return on the net cash investment.

Unguaranteed residual values in respect of both finance lease and operating lease assets are reviewed regularly and any impairments identified are charged to operating expenses.

### Debt Securities

(i) 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.

(ii) 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.

(iii) 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 as debt securities in the balance sheet 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 profit and loss account over the lives of the transactions, within interest payable or interest receivable as appropriate.

### Equity Shares

Equity shares 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.

### Tangible Fixed Assets and Depreciation

Freehold land is not depreciated. Freehold and leasehold property is stated at cost and depreciated over 50 years or the length of the lease term if shorter. Improvements to leasehold properties with unexpired lease terms of 50 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, including 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. Software development costs which lead to the creation of a definable software asset, subject to a de minimis limit, are capitalised and depreciated over their expected lives, generally four years.

Provision is made for the diminution in value of any tangible fixed asset where impairment is identified. The resulting net book value of the asset is written off over its remaining expected economic life. Impairment charges are included within administrative expenses.

## ACCOUNTING POLICIES (continued)

### Taxation
Deferred tax is recognised, without discounting, in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date, except as otherwise required by FRS19.

### 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 of gross yield basis been used.

### Fees and Commissions Receivable
Arrangement fees and commissions receivable for the continuing servicing 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.

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

### Retirement Benefits
The cost of providing retirement pensions and related benefits is charged against profits on a systematic basis over the employees' service lives in accordance with Statement of Standard Accounting Practice No.24 'Accounting for pension costs'.

### Foreign Currencies
Assets and liabilities and profit and loss accounts are translated at the rates of exchange ruling on the balance sheet date or at the forward exchange rate, as appropriate. Exchange differences arising on the translation of foreign equity investments are taken to reserves except to the extent that they are offset by corresponding differences arising on the translation of related borrowing. All other exchange differences are included in dealing profits.

### Collateral and Netting
The Group nets loans, deposits and derivative transactions where it enters into master agreements (occasionally collateralised) 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 lien over the counterparty's assets thereby enabling the Group to claim on these assets in respect of existing and future liabilities.

### 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.

(i) 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 dealing profits. 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.

(ii) 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 an accruals basis reflecting the treatment of the underlying items being hedged.

In order to qualify as a hedge, a derivative must effectively reduce the risk inherent in the hedged item from potential movements in interest rates, exchange rates and market values. Changes in the market value of the derivative must be highly correlated with changes in the market value of the underlying hedged item over the life of the hedge 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 remaining life of the underlying asset or liability being hedged. 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.

# CONSOLIDATED PROFIT AND LOSS ACCOUNT

For the year ended 31 December 2002

| | Notes | | Year ended 31 December 2002 £ million | | Period ended 31 December 2001 Restated £ million |
|---|---|---|---|---|---|
| Interest receivable | | | | | |
| Interest receivable and similar income arising from debt securities | | | 567 | | 331 |
| Other interest receivable | | | 9,518 | | 5,830 |
| | | | 10,085 | | 6,161 |
| Interest payable | | | (7,710) | | (4,500) |
| Net interest income | | | 2,375 | | 1,661 |
| Fees and commissions receivable | | | 1,054 | | 787 |
| Fees and commissions payable | | | (254) | | (239) |
| Dealing profits | 1 | | 111 | | 68 |
| Other operating income | | | 465 | | 465 |
| Net operating income (all from continuing operations) | 1 | | 3,751 | | 2,742 |
| Administrative expenses | 2 | (1,494) | | (1,226) | |
| Depreciation and amortisation | | | | | |
| Tangible fixed assets | | (89) | | (78) | |
| Operating lease assets | | (274) | | (188) | |
| Goodwill amortisation | 23 | (12) | | (9) | |
| | | (375) | | (275) | |
| Operating expenses | | | (1,869) | | (1,501) |
| General insurance claims | | | | | (15) |
| Provisions for bad and doubtful debts | 18 | | (618) | | (420) |
| Amounts written off fixed asset investments | 19, 20 | | (33) | | (12) |
| Operating profit (all from continuing operations) | | | 1,231 | | 794 |
| Before exceptional items | | 1,308 | | 884 | |
| Exceptional items | 3 | (77) | | (90) | |
| Share of operating profits of joint ventures | | | 13 | | 23 |
| Share of operating profits of associated undertakings | | | 27 | | 15 |
| Profit on disposal of business | 4 | | 25 | | |
| Merger costs – exceptional | 3 | | | | (25) |
| Profit on ordinary activities before taxation | | | 1,296 | | 807 |
| Before exceptional items | | 1,373 | | 922 | |
| Exceptional items | 3 | (77) | | (115) | |
| Tax on profit on ordinary activities | 10 | | (402) | | (275) |
| Profit on ordinary activities after taxation | | | 894 | | 532 |
| Before exceptional items | | 949 | | 621 | |
| Exceptional items | 3 | (55) | | (89) | |
| Minority interests (equity) | | | (36) | | (30) |
| (non-equity) | | | (32) | | (27) |
| Profit attributable to Proprietors | | | 826 | | 475 |
| Dividends | 11 | | | | |
| Ordinary | | 371 | | 368 | |
| Preference | | 37 | | 31 | |
| | | | 408 | | 399 |
| Retained profit of the year | 12 | | 418 | | 76 |
| Underlying earnings per Ordinary Stock unit (2001 – annualised) | 13 | | 60.9p | | 49.3p |
| Basic earnings per Ordinary Stock unit (2001 – annualised) | 13 | | 56.1p | | 40.4p |

It is estimated that Group profit on ordinary activities before taxation and retained profit of the period calculated solely on a historical cost basis would not differ materially from those stated in the Consolidated Profit and Loss Account above.

The statement of accounting policies on pages 26 to 28 and the notes on pages 35 to 66 form part of these accounts.

# CONSOLIDATED BALANCE SHEET

As at 31 December 2002

| | Notes | | 31 December 2002 £ million | | 31 December 2001 Restated £ million |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances at central banks | | | 1,049 | | 917 |
| Items in course of collection | | | 596 | | 462 |
| Treasury bills and other eligible bills | 14 | | 5,836 | | 505 |
| Loans and advances to banks | 15 | | 45,211 | | 5,756 |
| Loans and advances to customers | | 104,323 | | 80,553 | |
| Less: non-returnable finance | | (3,090) | | (3,141) | |
| | 16 | | 101,233 | | 77,412 |
| Debt securities | 19 | | 42,836 | | 9,993 |
| Equity shares | 20 | | 223 | | 224 |
| Interest in joint ventures | | | | | |
| Share of gross assets | | 2,763 | | 1,426 | |
| Share of gross liabilities | | (2,602) | | (1,345) | |
| | 21(i) | | 161 | | 81 |
| Interest in associated undertakings | 21(ii) | | 172 | | 134 |
| Intangible fixed assets | 23 | | 147 | | 152 |
| Tangible fixed assets | 24 | | 550 | | 565 |
| Operating lease assets | 25 | | 1,540 | | 1,354 |
| Other assets | 26 | | 6,246 | | 1,796 |
| Prepayments and accrued income | | | 1,291 | | 922 |
| Long-term assurance business attributable to Proprietors | 28 | | | | 47 |
| | | | 207,091 | | 100,320 |
| Long-term assurance assets attributable to policyholders | 28 | | | | 177 |
| Total assets | | | 207,091 | | 100,497 |
| **Liabilities** | | | | | |
| Deposits by banks | 29 | | 50,105 | | 11,103 |
| Customer accounts | 30 | | 57,712 | | 40,462 |
| Debt securities in issue | 31 | | 76,908 | | 35,183 |
| Notes in circulation | | | 821 | | 737 |
| Corporate taxation | | | 238 | | 104 |
| Dividends payable | 11 | | 383 | | 258 |
| Other liabilities | 32 | | 7,201 | | 2,083 |
| Accruals and deferred income | | | 1,934 | | 1,316 |
| Provisions for liabilities and charges | | | | | |
| Deferred taxation | 33(i) | 348 | | 338 | |
| Other provisions | 33(ii) | 131 | | 123 | |
| | | | 479 | | 461 |
| Subordinated liabilities | 34 | | | | |
| Dated loan capital | | 3,046 | | 2,322 | |
| Undated loan capital | | 1,709 | | 1,431 | |
| | | | 4,755 | | 3,753 |
| | | | 200,536 | | 95,460 |
| **Capital & reserves** | | | | | |
| Called up share capital | 35 | | | | |
| Ordinary stock | | 367 | | 328 | |
| Preference stock (non-equity) | | 400 | | 400 | |
| | | 767 | | 728 | |
| Share premium account | 36 | 1,794 | | 583 | |
| Other reserves | 36 | (19) | | (22) | |
| Profit and loss account | 36 | 3,411 | | 2,993 | |
| Proprietors' funds (including non-equity interests) | 37 | | 5,953 | | 4,282 |
| Minority interests (equity) | | | 202 | | 178 |
| Minority and other interests (non-equity) | 34 | | 400 | | 400 |
| | | | 6,555 | | 4,860 |
| | | | 207,091 | | 100,320 |
| Long-term assurance liabilities attributable to policyholders | 28 | | | | 177 |
| Total liabilities | | | 207,091 | | 100,497 |

# CONSOLIDATED BALANCE SHEET (continued)

As at 31 December 2002

| | Notes | 31 December 2002 £ million | 31 December 2001 Restated £ million |
|---|---|---|---|
| **Memorandum Items** | 38 | | |
| Contingent liabilities | | | |
| Acceptances and endorsements | | 156 | 121 |
| Guarantees and assets pledged as collateral security | | 2,770 | 2,079 |
| | | 2,926 | 2,200 |
| Commitments | | | |
| Other commitments | | 31,887 | 23,283 |

Approved by the Board on 24 February 2003 and signed on its behalf by:

| | | | |
|---|---|---|---|
| G E Mitchell | A J Hobson | J R Crosby | M H Ellis |
| Governor | Chairman of Audit Committee | Director | Director |

The statement of accounting policies on pages 26 to 28 and the notes on pages 35 to 66 form part of these accounts.

# BALANCE SHEET

As at 31 December 2002

| | Notes | | 31 December 2002 £ million | | 31 December 2001 Restated £ million |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances at central banks | | | 895 | | 832 |
| Items in course of collection | | | 596 | | 462 |
| Loans and advances to banks | 15 | | 14,719 | | 11,207 |
| Loans and advances to customers | | 74,262 | | 55,941 | |
| Less: non-returnable finance | | (2,940) | | (2,937) | |
| | 16 | | 71,322 | | 53,004 |
| Debt securities | 19 | | 934 | | 895 |
| Equity shares | 20 | | 58 | | 50 |
| Interest in associated undertakings | 21(ii) | | 76 | | 76 |
| Shares in group undertakings | 22 | | 1,894 | | 1,239 |
| Tangible fixed assets | 24 | | 373 | | 375 |
| Deferred tax asset | 33(i) | | 127 | | 119 |
| Other assets | | | 242 | | 196 |
| Prepayments and accrued income | | | 546 | | 479 |
| Total assets | | | 91,782 | | 68,934 |
| **Liabilities** | | | | | |
| Deposits by banks | 29 | | 41,946 | | 28,065 |
| Customer accounts | 30 | | 34,554 | | 28,940 |
| Debt securities in issue | 31 | | 2,540 | | 2,453 |
| Notes in circulation | | | 821 | | 737 |
| Corporate taxation | | | 164 | | 66 |
| Dividends payable | 11 | | 383 | | 258 |
| Other liabilities | | | 683 | | 418 |
| Accruals and deferred income | | | 557 | | 522 |
| Provisions for liabilities and charges | | | | | |
| Other provisions | 33(ii) | | 113 | | 100 |
| Subordinated liabilities | 34 | | | | |
| Dated loan capital | | 2,947 | | 2,184 | |
| Undated loan capital | | 2,062 | | 1,784 | |
| | | | 5,009 | | 3,968 |
| | | | 86,770 | | 65,527 |
| **Capital & reserves** | | | | | |
| Called up share capital | 35 | | | | |
| Ordinary stock | | 367 | | 328 | |
| Preference stock (non-equity) | | 400 | | 400 | |
| | | 767 | | 728 | |
| Share premium account | 36 | 1,794 | | 583 | |
| Other reserves | 36 | 68 | | 15 | |
| Profit and loss account | 36 | 2,383 | | 2,081 | |
| Proprietors' funds (including non-equity interests) | 37 | | 5,012 | | 3,407 |
| Total liabilities | | | 91,782 | | 68,934 |

## BALANCE SHEET (continued)

As at 31 December 2002

| | Notes | 31 December 2002 £ million | 31 December 2001 Restated £ million |
|---|---|---|---|
| **Memorandum Items** | 38 | | |
| Contingent liabilities | | | |
| Acceptances and endorsements | | 148 | 113 |
| Guarantees and assets pledged as collateral security | | 4,065 | 2,336 |
| | | 4,213 | 2,449 |
| Commitments | | | |
| Other commitments | | 24,784 | 18,438 |

Approved by the Board on 24 February 2003 and signed on its behalf by:

| | | | |
|---|---|---|---|
| G E Mitchell | A J Hobson | J R Crosby | M H Ellis |
| Governor | Chairman of Audit Committee | Director | Director |

The statement of accounting policies on pages 26 to 28 and the notes on pages 35 to 66 form part of these accounts.

## CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

For the year ended 31 December 2002

| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million |
|---|---|---|
| Profit attributable to Proprietors | 826 | 475 |
| Exchange translation | 3 | (4) |
| Total recognised gains and losses in the year | 829 | 471 |
| Prior period adjustment in the implementation of FRS 19 | 129 | |
| Total recognised gains and losses since last report and accounts | 958 | |

## CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2002

| | Notes | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million |
|---|---|---|---|
| Net cash inflow from operating activities | 46 | 41,544 | 1,919 |
| Dividends received from joint ventures | | 39 | 7 |
| Dividends received from associates | | 2 | |
| Returns on investments and servicing of finance | 47(i) | (341) | (249) |
| Taxation | | (244) | (337) |
| Capital expenditure and financial investment | 47(ii) | (15,472) | (1,259) |
| | | 25,528 | 81 |
| Acquisitions and disposals | 47(iii) | (106) | (33) |
| Equity dividends paid | | (246) | (229) |
| Net cash outflow before financing | | 25,176 | (181) |
| Financing | 47(iv) | 2,299 | 591 |
| Increase in cash | 48 | 27,475 | 410 |

The statement of accounting policies on pages 26 to 28 and the notes on pages 35 to 66 form part of these accounts.

# NOTES ON THE ACCOUNTS

## 1. NET OPERATING INCOME

| | Notes | | Year ended 31 December 2002 £ million | | Period ended 31 December 2001 £ million |
|---|---|---|---|---|---|
| Net operating income includes: | | | | | |
| Dividend income from equity shares | | | 6 | | 6 |
| General insurance premium income | | | – | | 118 |
| Finance lease rental income | | | 702 | | 538 |
| Operating lease rental income | | | 410 | | 293 |
| Profit on sale of investment securities | | | 31 | | 29 |
| Mortgage incentives | | | (76) | | (21) |
| Increase in value of long-term assurance business | 28 | | – | | 7 |
| Interest payable on subordinated liabilities | | | (259) | | (191) |
| Dealing profits | | | | | |
| Foreign exchange | | 58 | | 34 | |
| Interest related | | 53 | 111 | 34 | 68 |

Dealing profits arise from the Group's trading book. The types of instrument in which the Group trades are as set out in Note 39.

## 2. ADMINISTRATIVE EXPENSES

| | Notes | Year ended 31 December 2002 £ million | Period ended 31 December 2001 £ million |
|---|---|---|---|
| Administrative expenses includes: | | | |
| Staff costs | 5 | 680 | 488 |
| Property rentals | | 36 | 36 |

## 3. EXCEPTIONAL ITEMS

Exceptional items have been incurred as follows:

| | Notes | Year ended 31 December 2002 £ million | Period ended 31 December 2001 £ million |
|---|---|---|---|
| Merger costs | (a) | | (25) |
| HBOS merger integration costs | (b) | (77) | (90) |
| | | (77) | (115) |
| Tax effect | | 22 | 26 |

(a) Merger costs comprise the deal costs incurred in connection with the merger of Bank of Scotland Group and Halifax Group plc.

(b) The HBOS plc merger integration costs cover the costs of integrating and reorganising Bank of Scotland Group following the merger with Halifax Group plc.

## 4. PROFIT OF DISPOSAL OF BUSINESS

On 27 November 2002, Bank of Scotland disposed of its merchant services business for £25 million, generating a gain of £25 million.

## NOTES ON THE ACCOUNTS (continued)

### 5. STAFF

| | Year ended 31 December 2002 Number | Period ended 31 December 2001 Number |
|---|---|---|
| The average number of persons employed by the Group during the year was: | | |
| Full time | 17,811 | 16,806 |
| Part time | 4,347 | 4,104 |
| | 22,158 | 20,910 |

| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 £ million |
|---|---|---|
| The aggregate remuneration payable to those employees comprises: | | |
| Wages and salaries | 571 | 426 |
| Social security costs | 49 | 34 |
| Other pension costs (Note 9) | 60 | 31 |
| | 680 | 491 |
| Less: Long-term assurance business staff costs | | (3) |
| Staff cost charged to administrative expenses | 680 | 488 |

Staff costs in respect of long-term assurance business are not charged to administrative expenses but are taken account of in determining the increase in value of long-term assurance business (Note 1).

### 6. DIRECTORS' REMUNERATION

The directors of Bank of Scotland during the year also served as directors of the parent undertaking HBOS plc. All remuneration paid to them was in respect of services to HBOS plc and is disclosed in the 2002 HBOS plc Annual Report and Accounts within the 'Report of the Board in relation to remuneration policy and practice'.

In respect of the comparative period, directors remuneration was as follows:

| | Period ended 31 December 2001 £000 |
|---|---|
| Total emoluments | 3,234 |
| Total potential pre-tax gains on stock options exercised | 1,195 |
| Highest paid Director – emoluments | 872 |
| – potential pre-tax gains on stock options exercised | 1,195 |
| – accrued pension entitlement per annum | 296 |

# NOTES ON THE ACCOUNTS (continued)

## 7. AUDITORS' REMUNERATION

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

| | Year ended 31 December 2002 | | | Period ended 31 December 2001 | | |
|---|---|---|---|---|---|---|
| | Within UK £ million | Outwith UK £ million | Total £ million | Within UK £ million | Outwith UK £ million | Total £ million |
| Group | | | | | | |
| Statutory audits | 1.4 | 0.4 | 1.8 | 1.0 | 0.3 | 1.3 |
| As auditors or reporting accountants | 0.8 | 0.2 | 1.0 | 2.2 | 0.1 | 2.3 |
| | 2.2 | 0.6 | 2.8 | 3.2 | 0.4 | 3.6 |
| Accounting, advisory and consultancy | 1.0 | 0.1 | 1.1 | 4.8 | 0.6 | 5.4 |
| Tax advisory | 0.3 | 0.2 | 0.5 | 0.1 | 0.2 | 0.3 |
| Merger and acquisitions | | | | 2.7 | | 2.7 |
| | 3.5 | 0.9 | 4.4 | 10.8 | 1.2 | 12.0 |
| Bank | | | | | | |
| Statutory audit | 0.2 | | 0.2 | 0.2 | | 0.2 |
| Other | 1.6 | | 1.6 | 5.5 | | 5.5 |
| Merger and acquisitions | | | | 2.7 | | 2.7 |

Both the Board and the external auditors have safeguards in place to prevent the auditors' independence and objectivity from being compromised. Each year the Audit Committee establishes a limit on the fees that can be paid to the external auditors in respect of advisory and consultancy work, and seek to ensure that these fees do not in any way compromise their independence as auditors. The external auditors also report regularly to the Committee on the actions that they have taken to comply with professional and regulatory requirements and current best practice in order to maintain their independence. This includes the rotation of key audit team members.

## 8. OPERATING LEASES

| | Group | | | | Bank | | | |
|---|---|---|---|---|---|---|---|---|
| | 31 December 2002 | | 31 December 2001 | | 31 December 2002 | | 31 December 2001 | |
| | Property £ million | Equipment £ million | Property £ million | Equipment £ million | Property £ million | Equipment £ million | Property £ million | Equipment £ million |
| There are commitments to make payments in the following year in respect of non-cancellable operating leases which expire: | | | | | | | | |
| within 1 year | 1 | 2 | 2 | 3 | 1 | | 1 | |
| between 1 and 5 years | 7 | 35 | 5 | 11 | 2 | 33 | 2 | 6 |
| after 5 years | 30 | | 27 | | 18 | | 16 | |
| | 38 | 37 | 34 | 14 | 21 | 33 | 19 | 6 |

# NOTES ON THE ACCOUNTS (continued)

## 9. PENSION COSTS

The Group operates several pension schemes.

The principal scheme, the Bank of Scotland 1976 Pension Scheme (the 'Scheme') is a funded scheme covering 84 per cent of the Group's pensionable employees, and provides defined benefits based on final pensionable salary. 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 profit and loss account, the Group has been advised by Watson Wyatt LLP, Actuaries and Consultants. The most recently published formal valuation of the Scheme took place as at 31 December 2001. The financial assumptions are derived based upon the economic conditions prevailing at the date of valuation. The main financial assumptions adopted in making this valuation were as follows:

| | Rates per annum |
|---|---|
| Future price inflation | 2.5 per cent |
| Return on new investments | 6.6 per cent |
| Return on existing investments | 6.0 per cent |
| Increases in earnings* | 3.5 per cent |
| Increases in pensions** | 2.5 per cent |

* 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.

** The pension increase is on the excess over the Guaranteed Minimum Pension. Pensions which are guaranteed to increase at a rate of 3.0 per cent per annum have been assumed to increase at 3.0 per cent.

The pension costs for accounting purposes have been calculated using the same assumptions as those adopted for the formal valuation. The following disclosures are based on these assumptions using the projected unit method of valuation:

| | |
|---|---|
| Effective date of valuation | 31/12/2001 |
| Market value of assets | £1,409m |
| Asset cover level | 98 per cent |
| Regular pension charge (as a percentage of pensionable salaries) | 15.9 per cent |

The asset cover level disclosed in the above table represent the ratio of the Scheme's assets to the value of the benefits that had accrued to members and pensioners at the valuation date after allowing for expected future increases in earnings and pensions.

The charge has been increased by spreading the shortfall in assets in the Scheme over the average future working lifetime of the membership (16 years) by fixed capital instalments plus interest on the reducing balance. These elements, together with interest on the opening balance sheet position result in a charge of £54 million (10 month period to 31 December 2001 – £27 million). Included in the charge is an exceptional charge of £1 million.

Contributions to the Schemes of £50 million were paid over the year. As contributions differ from the amount charged in the Profit and Loss Account a provision of £82 million (2001 – £78 million) for future contributions is included in the Balance Sheet. The Group contributes at a rate of 16.6% of pensionable salaries.

The pension costs charged in the Profit and Loss Account include £6 million (10 month period to 31 December 2001 – £4 million) relating to schemes other than the Scheme.

# NOTES ON THE ACCOUNTS (continued)

## 9. PENSION COSTS (continued)

The results of the actuarial valuation of the Bank of Scotland 1976 Pension Scheme as at 31 December 2001, updated by Watson Wyatt LLP to take account of the requirements of FRS 17 and to assess the assets and liabilities of the Scheme as at 31 December 2002, have been used in assessing the FRS 17 disclosures. Scheme assets are stated at their market value at 31 December 2002. The liabilities of the Scheme under FRS 17 were calculated using the projected unit method and the following financial assumptions:

| | Rates per annum at 31 December 2002 | Rates per annum at 31 December 2001 |
|---|---|---|
| Future price inflation | 2.40 per cent | 2.50 per cent |
| Discount rate | 5.80 per cent | 6.00 per cent |
| Increases in earnings* | 3.40 per cent | 3.50 per cent |
| Increases in pensions** | 2.40 per cent | 2.50 per cent |

* 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.

** The pension increase is on the excess over the Guaranteed Minimum Pension. Pensions which are guaranteed to increase at a rate of 3.0 per cent per annum have been assumed to increase at 3.0 per cent.

The Scheme is closed to new entrants. Under the Projected Unit method, the current service cost will increase as members of the Scheme approach retirement.

The assets of the Scheme and the expected rates of return were:

| | Long-term expected rate of return per annum at 31 December 2002 | Value at 31 December 2002 £ million | Long-term expected rate of return per annum at 31 December 2001 | Value at 31 December 2001 £ million |
|---|---|---|---|---|
| Equities | 8.50 per cent | 864 | 7.75 per cent | 1,050 |
| Bonds | 5.00 per cent | 254 | 5.25 per cent | 286 |
| Cash | 3.80 per cent | 55 | 4.50 per cent | 73 |
| Total market value of assets | | 1,173 | | 1,409 |
| Present value of liabilities of the Scheme | | 1,567 | | 1,423 |
| Deficit in the Scheme | | 394 | | 14 |
| Potential deferred tax asset | | (118) | | (4) |
| Net pension liability | | 276 | | 10 |

The movement in the deficit in the Scheme during the year can be analysed as follows:

| | Year ended 31 December 2002 £ million |
|---|---|
| Deficit in the Scheme at beginning of year | (14) |
| Contributions paid | 50 |
| Current service cost | (55) |
| Past service cost | (12) |
| Other finance income | 15 |
| Actuarial loss | (378) |
| Deficit in the Scheme at end of year | (394) |

# NOTES ON THE ACCOUNTS (continued)

## 9. PENSION COSTS (continued)

### Components of defined benefit cost for the year 2002

| Analysis of amounts that would be charged to operating profit | Year ended 31 December 2002 £ million |
|---|---|
| Current service cost | 55 |
| Past service cost | 12 |
| Total that would be charged to operating profit | 67 |

Analysis of amounts that would be charged to other finance income

| | Year ended 31 December 2002 £ million |
|---|---|
| Interest on pension scheme liabilities | 83 |
| Expected return on assets in pension scheme | (98) |
| Net amount that would be credited to other finance income | (15) |
| Total potential profit and loss charge before deduction for tax | 52 |

Analysis of amounts that would be recognised in Statement of Total Recognised Gains and Losses

| | Year ended 31 December 2002 £ million |
|---|---|
| Loss on assets | 329 |
| Experience loss on liabilities | 19 |
| Loss on change of assumptions (financial and demographic) | 30 |
| Total potential loss recognised in Statement of Total Recognised Gains and Losses before adjustment for tax | 378 |

History of experience gains and losses

| | Year ended 31 December 2002 |
|---|---|
| Loss on Scheme assets | |
| Amount (£ million) | 334 |
| % of Scheme assets at end of year | 28% |
| Experience loss on Scheme liabilities | |
| Amount (£ million) | 19 |
| % of Scheme liabilities at end of year | 1% |
| Total actuarial loss recognised in Statement of Total Recognised Gains and Losses | |
| Amount (£ million) | 383 |
| % of Scheme liabilities at end of year | 24% |

## 10. TAXATION

| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million |
|---|---|---|
| UK Corporation Tax at 30 per cent (period ended 31 December 2001 – 30 per cent) | 308 | 222 |
| Relief for overseas taxation | (17) | (11) |
| | 291 | 211 |
| Overseas taxation | 87 | 44 |
| Tax relating to change in value of long-term assurance business (Note 28) | | 2 |
| Share of joint ventures' taxation | 9 | 9 |
| Share of associated undertakings' taxation | 5 | 4 |
| Total current corporation tax | 392 | 270 |
| Deferred taxation (Note 33i) | 10 | 5 |
| Tax on profit on ordinary activities | 402 | 275 |

## NOTES ON THE ACCOUNTS (continued)

### 10. TAXATION (continued)

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

| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million |
|---|---|---|
| Profit on ordinary activities before taxation | 1,296 | 807 |
| Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 30 per cent (2001 – 30 per cent) | 389 | 242 |
| Effects of: | | |
| Expenses not deductible for tax purposes | 12 | 14 |
| Capital allowances in excess of depreciation | (31) | (36) |
| Net effect of differing tax rates overseas | (2) | 6 |
| Book gains covered by capital losses/indexation | (5) | (7) |
| Deductible interest on innovative tier 1 capital | (10) | (8) |
| Expenditure qualifying for capital allowances | 6 | 16 |
| Amounts written off fixed asset investments | 10 | 3 |
| Tax deductible contributions to Qualifying Employee Share Trust | | (1) |
| Other timing differences | 3 | 11 |
| Adjustments in respect of previous periods | 20 | 24 |
| Others | | 6 |
| Current corporation tax charge for year | 392 | 270 |

### 11. DIVIDENDS

| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 £ million |
|---|---|---|
| Preference dividends paid | 25 | 19 |
| payable | 12 | 12 |
| | 37 | 31 |
| Ordinary dividend | | |
| Interim dividend | | 122 |
| Proposed final dividend | 371 | 246 |
| | 371 | 368 |
| | 408 | 399 |

### 12. RETAINED PROFIT

| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million |
|---|---|---|
| The profit of the Group has been retained by | | |
| Bank of Scotland | 302 | (145) |
| Subsidiary undertakings | 111 | 204 |
| | 413 | 59 |
| Associated undertakings and joint ventures | 5 | 17 |
| | 418 | 76 |

By virtue of the exemption contained within Section 230 of the Companies Act 1985, the Profit and Loss Account of the Company is not presented.

# NOTES ON THE ACCOUNTS (continued)

## 13. EARNINGS PER ORDINARY STOCK UNIT

Basic earnings per ordinary stock unit are based upon Group profit attributable to Proprietors of £789 million (10 months ended 31 December 2001 restated – £444 million). The underlying earnings per ordinary stock unit are based upon Group profit attributable to Proprietors (before exceptional items and goodwill amortisation but after tax) of £856 million (10 months ended 31 December 2001 restated – £542 million). For the basic and underlying earnings per ordinary stock unit the weighted average number of 25p ordinary stock units of 1,406 million (2001 – 1,310 million) is used. Group profit attributable to Proprietors equals profit attributable to Proprietors of £826 million (10 months ended 31 December 2001 restated – £475 million) less preference dividends of £37 million (10 months ended 31 December 2001 – £31 million).

The calculation of the underlying earnings per 25p ordinary stock units, noted below, has been included to enable the Proprietors to assess the underlying trading performance.

| | Year ended 31 December 2002 pence | Period ended 31 December 2001 pence Restated (annualised) |
|---|---|---|
| Basic earnings per ordinary stock unit | 56.1 | 40.4 |
| Exceptional items: | | |
| Exceptional merger costs and administrative expenses | 3.9 | 8.1 |
| Goodwill amortisation | 0.9 | 0.8 |
| Underlying earnings per ordinary stock unit | 60.9 | 49.3 |

## 14. TREASURY BILLS AND OTHER ELIGIBLE BILLS

| | 31 December 2002 | | 31 December 2001 | |
|---|---|---|---|---|
| | Book Value £ million | Market Value £ million | Book Value £ million | Market Value £ million |
| Investment securities | | | | |
| Treasury bills and similar securities | 3,576 | 3,577 | | |
| Other eligible bills | 302 | 303 | 448 | 451 |
| | 3,878 | 3,880 | 448 | 451 |
| Other securities | | | | |
| Treasury bills and similar securities | 1,118 | 1,118 | 57 | 57 |
| Other eligible bills | 840 | 840 | | |
| | 1,958 | 1,958 | 57 | 57 |
| | 5,836 | 5,838 | 505 | 508 |

| | Group £ million |
|---|---|
| The movement on treasury bills and other eligible bills held for investment purposes was as follows: | |
| At 1 January 2002 | 448 |
| Exchange translation | 2 |
| Additions and transfers | 11,166 |
| Disposals | (7,779) |
| Amortisation | 41 |
| At 31 December 2002 | 3,878 |
| Aggregate unamortised discounts net of premiums at 31 December 2002 | 19 |

# NOTES ON THE ACCOUNTS (continued)

## 15. LOANS AND ADVANCES TO BANKS

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Repayable on demand or at short notice | 28,009 | 666 | 5,287 | 2,274 |
| Other loans and advances repayable | | | | |
| in 3 months or less excluding on demand or at short notice | 14,012 | 3,862 | 2,892 | 2,761 |
| 1 year or less but over 3 months | 2,007 | 1,111 | 735 | 1,117 |
| 5 years or less but over 1 year | 406 | 94 | 694 | 280 |
| over 5 years | 777 | 23 | 5,111 | 4,775 |
| | 45,211 | 5,756 | 14,719 | 11,207 |
| Included above are loans to subsidiary undertakings | | | | |
| Subordinated | | | 1,300 | 710 |
| Unsubordinated | | | 12,476 | 10,085 |
| Fellow subsidiary undertakings – Unsubordinated | 34,695 | 740 | 49 | |
| | 34,695 | 740 | 13,825 | 10,795 |

## 16. LOANS AND ADVANCES TO CUSTOMERS

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Repayable on demand or at short notice | 15,627 | 14,282 | 14,660 | 11,769 |
| Other loans and advances repayable | | | | |
| in 3 months or less excluding on demand or at short notice | 22,730 | 15,917 | 18,680 | 14,024 |
| 1 year or less but over 3 months | 8,181 | 6,870 | 4,498 | 3,869 |
| 5 years or less but over 1 year | 19,086 | 12,474 | 10,080 | 5,781 |
| over 5 years | 37,074 | 29,121 | 24,386 | 18,324 |
| Gross loans and advances to customers (excludes securitisation) | 102,698 | 78,664 | 72,304 | 53,767 |
| Provisions for bad and doubtful debts (Note 18) | (1,324) | (1,130) | (900) | (692) |
| Interest in suspense | (141) | (122) | (82) | (71) |
| Loans and advances to customers | 101,233 | 77,412 | 71,322 | 53,004 |
| Included above are loans to: | | | | |
| Subsidiary undertakings | | | 2,052 | 1,677 |
| Fellow subsidiary undertakings | 153 | | 35 | |
| Ultimate parent undertaking | 3 | 1 | 3 | 1 |
| Joint Ventures and associated undertakings | 4,133 | 2,682 | 2,600 | 1,670 |
| | 4,289 | 2,683 | 4,690 | 3,348 |

Group loans and advances to customers include finance lease receivables of £3,064 million ( 2001 – £3,065 million). Assets acquired in the year for letting under finance leases amounted to £827 million ( 2001 – £681 million).

The Group's gross lending exposure is analysed below.

| | 31 December 2002 £ million | 31 December 2001 £ million |
|---|---|---|
| Agriculture, forestry and fishing | 1,095 | 1,037 |
| Energy | 1,491 | 1,501 |
| Manufacturing industry | 5,630 | 5,633 |
| Construction and property | 16,435 | 11,137 |
| Hotels, restaurants and wholesale and retail trade | 8,128 | 5,837 |
| Transport, storage and communication | 2,863 | 2,607 |
| Financial | 6,532 | 5,551 |
| Other services | 11,712 | 8,678 |
| Individuals | | |
| Home mortgages | 28,517 | 19,921 |
| Other personal lending | 10,200 | 9,096 |
| Overseas residents | 10,095 | 7,666 |
| Gross loans and advances to customers | 102,698 | 78,664 |

## NOTES ON THE ACCOUNTS (continued)

### 16. LOANS AND ADVANCES TO CUSTOMERS (continued)

Loans and advances to customers which have been securitised are shown below. These meet the criteria set out in FRS 5 'Reporting the Substance of Transactions', for a linked presentation format.

| | | At 31 December 2002 | | | | At 31 December 2001 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Gross assets securitised | | Non-returnable finance | | Gross assets securitised | | Non-returnable finance | |
| | Assets Securitised | Group £ million | Bank £ million | Group £ million | Bank £ million | Group £ million | Bank £ million | Group £ million | Bank £ million |
| SWAN Trust | Mortgages | 150 | | 150 | | 204 | | 204 | |
| Mound Financing (No 1) PLC | Mortgages | 750 | 750 | 748 | 748 | 750 | 750 | 748 | 748 |
| Mound Financing (No 2) PLC | Mortgages | 750 | 750 | 748 | 748 | 750 | 750 | 748 | 748 |
| Melrose Financing No 1 plc | Corporate Loans | 1,500 | 1,500 | 1,444 | 1,444 | 1,500 | 1,500 | 1,441 | 1,441 |
| | | 3,150 | 3,000 | 3,090 | 2,940 | 3,204 | 3,000 | 3,141 | 2,937 |

These special purpose companies, all of which are ultimately beneficially owned by charitable trusts, have been funded primarily through the issue of floating rate notes. Neither the Bank nor its subsidiary undertakings will support any losses that may be suffered by the noteholders in accordance with the terms of the notes. When all liabilities to the noteholders have been discharged any proceeds from assets in addition to the non-returnable amounts already received in the securitisation companies accrue to the Bank or its subsidiary undertakings.

Neither the Bank nor its subsidiary undertakings have the right or obligation to repurchase any securitised advance unless it has been in breach of warranty.

The Bank of Scotland Group undertakings and third parties have entered into a number of interest rate swaps with the securitisation undertakings, the intention of which is to swap all or part of the interest flows from customers into variable rate interest flows to match the variable rate interest payable to the noteholders.

In aggregate the securitisation companies had net interest income of £6.1 million (10 months to 31 December 2001 – £2.7 million); operating expenses of £3.6 million (10 months to 31 December 2001 – £1.2 million); provisions for bad and doubtful debts of £2.5 million (10 months to 31 December 2001 – £nil); resulting in a profit for the year of £nil (10 months to 31 December 2001 – £1.5 million).

### 17. NON-PERFORMING ASSETS

The aggregate amount of gross non-performing loans and advances is £2,615 million (2001 – £2,468 million) including £1,145 million (2001 – £1,087 million) of advances on which interest is being held in suspense. Net of provisions and interest in suspense, non-performing loans amount to £1,150 million (2001 – £1,216 million).

### 18. PROVISIONS FOR BAD AND DOUBTFUL DEBTS

| | Group | | | Bank | | |
|---|---|---|---|---|---|---|
| | Specific £ million | General £ million | Total £ million | Specific £ million | General £ million | Total £ million |
| At 1 January 2002 | 686 | 444 | 1,130 | 402 | 290 | 692 |
| Exchange movements | 1 | 1 | 2 | | | |
| New provisions less releases | 619 | 25 | 644 | 467 | 19 | 486 |
| Amounts written off | (452) | | (452) | (278) | | (278) |
| Cumulative provisions as at 31 December 2002 | 854 | 470 | 1,324 | 591 | 309 | 900 |
| New provisions less releases | 619 | 25 | 644 | 467 | 19 | 486 |
| Recoveries of amounts previously written off | (26) | | (26) | (11) | | (11) |
| Net charge to profit and loss account | 593 | 25 | 618 | 456 | 19 | 475 |

## NOTES ON THE ACCOUNTS (continued)

### 19. DEBT SECURITIES

| | 31 December 2002 | | | | 31 December 2001 | | | |
|---|---|---|---|---|---|---|---|---|
| | Issued by public bodies £ million | Issued by others £ million | Total £ million | Market Value £ million | Issued by public bodies £ million | Issued by others £ million | Total £ million | Market Value £ million |
| Group | | | | | | | | |
| Investment securities | | | | | | | | |
| Listed | | | | | | | | |
| British Government Securities | 232 | | 232 | 233 | | | | |
| Others | 1,318 | 13,840 | 15,158 | 15,151 | 314 | 3,866 | 4,180 | 4,190 |
| Unlisted | | | | | | | | |
| Certificates of deposit issued by banks and building societies | | 1,962 | 1,962 | 1,963 | | 4,278 | 4,278 | 4,291 |
| Others | 14 | 6,314 | 6,328 | 6,271 | 8 | 848 | 856 | 855 |
| Total investment securities | 1,564 | 22,116 | 23,680 | 23,618 | 322 | 8,992 | 9,314 | 9,336 |
| Other securities | | | | | | | | |
| Listed | 486 | 1,826 | 2,312 | 2,312 | 201 | | 201 | 201 |
| Unlisted | | 16,844 | 16,844 | 16,844 | 229 | 249 | 478 | 478 |
| | 2,050 | 40,786 | 42,836 | 42,774 | 752 | 9,241 | 9,993 | 10,015 |
| of which: | | | | | | | | |
| maturing within 1 year | | | 21,217 | | | | 5,885 | |
| in more than 1 year | | | 21,619 | | | | 4,108 | |
| | | | 42,836 | | | | 9,993 | |
| Bank | | | | | | | | |
| Investment securities | | | | | | | | |
| Listed | | | | | | | | |
| Others | 2 | 382 | 384 | 384 | 2 | 420 | 422 | 421 |
| Unlisted | | | | | | | | |
| Certificates of deposit issued by banks and building societies | | 282 | 282 | 282 | | 183 | 183 | 183 |
| Others | | 268 | 268 | 269 | | 290 | 290 | 292 |
| Total investment securities | 2 | 932 | 934 | 935 | 2 | 893 | 895 | 896 |
| of which: | | | | | | | | |
| maturing within 1 year | | | 282 | | | | 185 | |
| 1 year and over | | | 652 | | | | 710 | |
| | | | 934 | | | | 895 | |

The movement on debt securities held as investment securities is as follows:

| | Group | | | Bank | | |
|---|---|---|---|---|---|---|
| | Amortised Cost £ million | Aggregate amount written off £ million | Value £ million | Amortised Cost £ million | Aggregate amount written off £ million | Book Value £ million |
| At 1 January 2002 | 9,329 | (15) | 9,314 | 907 | (12) | 895 |
| Exchange translation | (543) | | (543) | (76) | | (76) |
| Additions | 30,743 | | 30,743 | 515 | | 515 |
| Amortisation | (28) | | (28) | (1) | | (1) |
| Disposals | (15,804) | | (15,804) | (400) | | (400) |
| Amounts written off | | (2) | (2) | | 1 | 1 |
| At 31 December 2002 | 23,697 | (17) | 23,680 | 945 | (11) | 934 |
| Aggregate unamortised premium at 31 December 2002 | (1) | | | | | |

Debt securities include securities pledged as collateral of £12,416 million (2001 – nil).

Debt securities include securities with a market value of £662 million (2001 – £114 million) for the Group, sold subject to repurchase.

Debt securities include asset backed securities of £9,320 million (2001 – nil) which have been sold 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

# NOTES ON THE ACCOUNTS (continued)

## 19. DEBT SECURITIES (continued)

have been retained by HBOS Treasury Services plc. The securitisation does not qualify for linked presentation under FRS 5 and the asset backed securities have therefore been retained on the Group Balance Sheet with commercial paper being included within debt securities in issue (Note 31).

## 20. EQUITY SHARES

| | Listed | | | Unlisted | | | |
|---|---|---|---|---|---|---|---|
| Investment Securities | Cost £ million | Aggregate amount written off £ million | Book Value £ million | Cost £ million | Aggregate amount written off £ million | Book Value £ million | Total Book Value £ million |
| Group | | | | | | | |
| At 1 January 2002 | 64 | | 64 | 171 | (11) | 160 | 224 |
| Exchange translation | 1 | | 1 | (1) | | (1) | |
| Additions | 11 | | 11 | 58 | | 58 | 69 |
| Disposals | (7) | | (7) | (32) | | (32) | (39) |
| Amounts written off | | (12) | (12) | | (19) | (19) | (31) |
| At 31 December 2002 | 69 | (12) | 57 | 196 | (30) | 166 | 223 |

| | Listed | | | Unlisted | | | |
|---|---|---|---|---|---|---|---|
| | Cost £ million | Aggregate amount written off £ million | Book Value £ million | Cost £ million | Aggregate amount written off £ million | Book Value £ million | Total Book Value £ million |
| Bank | | | | | | | |
| At 1 January 2002 | 9 | | 9 | 48 | (7) | 41 | 50 |
| Additions | 3 | | 3 | 22 | | 22 | 25 |
| Disposals | | | | (2) | | (2) | (2) |
| Amounts written off | | | | | (15) | (15) | (15) |
| At 31 December 2002 | 12 | | 12 | 68 | (22) | 46 | 58 |

The total value of equity shares as at 31 December 2002 for the Group was £274 million (2001 – £285 million) and for the Bank £117 million (2001 – £131 million) including for the Group £96 million (2001 – £114 million) and for the Bank £66 million (2001 – £80 million) in respect of listed equity shares.

## 21. INTERESTS IN JOINT VENTURES AND ASSOCIATED UNDERTAKINGS

(i) Joint Ventures

| | Group | | | | |
|---|---|---|---|---|---|
| | Acquired Book Value £ million | Equity Adjustments £ million | Share of Net Tangible Assets £ million | Goodwill £ million | Book Value £ million |
| At 1 January 2002 | 66 | 13 | 79 | 2 | 81 |
| Acquisitions and subscriptions of capital | 113 | | 113 | | 113 |
| Disposals | | 1 | 1 | | 1 |
| Equity accounting adjustments | | (34) | (34) | | (34) |
| At 31 December 2002 | 179 | (20) | 159 | 2 | 161 |

(ii) Associated Undertakings

| | Group | | | | | Bank |
|---|---|---|---|---|---|---|
| | Acquired Book Value £ million | Equity Adjustments £ million | Share of Net Tangible Assets £ million | Goodwill £ million | Book Value £ million | Cost £ million |
| At 1 January 2002 | 128 | 6 | 134 | | 134 | 76 |
| Acquisitions and subscriptions of capital | 22 | | 22 | | 22 | |
| Disposals | (3) | | (3) | | (3) | |
| Equity accounting adjustments | | 19 | 19 | | 19 | |
| At 31 December 2002 | 147 | 25 | 172 | | 172 | 76 |

The main joint ventures and associated undertakings are listed in Note 51 on page 64.

All the interests in joint ventures and associated undertakings are unlisted.

# NOTES ON THE ACCOUNTS (continued)

## 22. SHARES IN GROUP UNDERTAKINGS

| | Banks £ million | Others £ million | Total £ million |
|---|---|---|---|
| At cost at 1 January 2002 | 541 | 698 | 1,239 |
| Acquisitions and subscriptions of capital | 600 | 241 | 841 |
| Disposals | (231) | | (231) |
| Exchange translation | 12 | 33 | 45 |
| At cost at 31 December 2002 | 922 | 972 | 1,894 |

The main subsidiary undertakings of the Bank are listed in Note 52 on page 65.

## 23. INTANGIBLE FIXED ASSETS

| | Goodwill £ million |
|---|---|
| Cost | |
| At 1 January 2002 | 169 |
| Additions | 7 |
| At 31 December 2002 | 176 |
| Amortisation | |
| At 1 January 2002 | 17 |
| Amortisation charged in year | 12 |
| At 31 December 2002 | 29 |
| Net Book Value | |
| At 31 December 2002 | 147 |
| At 31 December 2001 | 152 |

Goodwill on acquisitions is capitalised and amortised by equal instalments over its estimated useful life which, for all material acquisitions, is 20 years.

During the year, a further £7 million of goodwill arose primarily from the acquisition of minority interests.

# NOTES ON THE ACCOUNTS (continued)

## 24. TANGIBLE FIXED ASSETS

| | Group | | | Bank | | |
|---|---|---|---|---|---|---|
| | Cost £ million | Depreciation £ million | Book Value £ million | Cost £ million | Depreciation £ million | Book Value £ million |
| **Property** | | | | | | |
| At 1 January 2002 | 312 | (35) | 277 | 175 | (20) | 155 |
| Exchange translation | (1) | | (1) | (1) | | (1) |
| Additions | 15 | | 15 | 8 | | 8 |
| Disposals | (22) | 1 | (21) | (4) | | (4) |
| Depreciation for year | | (12) | (12) | | (9) | (9) |
| At 31 December 2002 | 304 | (46) | 258 | 178 | (29) | 149 |
| of which: | | | | | | |
| Freehold | | | 240 | | | 138 |
| Long leasehold | | | 4 | | | 4 |
| Short leasehold | | | 14 | | | 7 |
| | | | 258 | | | 149 |
| Occupied for own activities | | | 245 | | | 136 |
| **Equipment** | | | | | | |
| At 1 January 2002 | 672 | (384) | 288 | 447 | (227) | 220 |
| Exchange translation | (1) | 1 | | | | |
| Additions | 87 | | 87 | 59 | | 59 |
| Disposals | (45) | 39 | (6) | (23) | 21 | (2) |
| Depreciation for year | | (77) | (77) | | (53) | (53) |
| At 31 December 2002 | 713 | (421) | 292 | 483 | (259) | 224 |
| Total tangible fixed assets at 31 December 2002 | 1,017 | (467) | 550 | 661 | (288) | 373 |
| Total tangible fixed assets at 31 December 2001 | 984 | (419) | 565 | 622 | (247) | 375 |
| Assets in the course of construction | 7 | | | | | |
| Equipment includes amounts acquired under finance leases | 32 | (31) | 1 | 32 | (31) | 1 |

## 25. OPERATING LEASE ASSETS

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

| | £ million |
|---|---|
| Cost | |
| At 1 January 2002 | 1,790 |
| Additions | 871 |
| Disposals | (573) |
| At 31 December 2002 | 2,088 |
| Aggregate depreciation | |
| At 1 January 2002 | 436 |
| Charge for the year | 274 |
| Disposals | (162) |
| At 31 December 2002 | 548 |
| Net Book Value at 31 December 2002 | 1,540 |
| Net Book Value at 31 December 2001 | 1,354 |

# NOTES ON THE ACCOUNTS (continued)

## 25. OPERATING LEASE ASSETS (continued)

The Group's unguaranteed residual value exposure in respect of operating lease assets, assuming disposal at the end of the lease term is as follows:

| | Group | |
|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million |
| On operating leased assets where the residual value is expected to be recovered in: | | |
| 1 year or less | 14 | 17 |
| 2 years or less but over 1 year | 8 | 7 |
| 5 years or less but over 2 years | 4 | 3 |
| Total | 26 | 27 |

## 26. OTHER ASSETS

| | Group | |
|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million |
| Positive market values of trading derivative contracts | 5,885 | 1,332 |
| Other assets | 361 | 464 |
| | 6,246 | 1,796 |

## 27. CAPITAL AND OTHER COMMITMENTS

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Commitments in respect of capital expenditure on fixed assets, authorised but not provided for in the accounts for which contracts have been entered into | 2 | | 1 | |
| Included in other liabilities are net obligations under finance leases payable as follows: | | | | |
| 1 year or less | 7 | 8 | | |
| 5 years or less but over 1 year | 7 | 14 | | |

Commitments for which contracts have been placed in relation to operating leased assets were £6 million as at 31 December 2002 (2001 – £13 million).

# NOTES ON THE ACCOUNTS (continued)

## 28. LONG-TERM ASSURANCE BUSINESS

With effect from 1 January 2002, HBOS Insurance & Investment Group Ltd, a fellow subsidiary undertaking of the HBOS Group, acquired CHH (Holdings) plc and its subsidiary undertakings from the Group at net asset value. The business of CHH (Holdings) plc includes the long-term assurance business.

The value of long-term assurance business is actuarially assessed and comprises the surplus attributable to the Group, including minority interests, together with the net present value of in-force business. This method of calculating the net worth of the business to the Group is known as the embedded value approach. The principal economic assumptions behind the embedded value calculation are reviewed regularly and are as follows:

| | As at 31 December 2001 % |
|---|---|
| Risk discount rate (net of tax) for traditional with profits business | 8.5 |
| Risk discount rate (net of tax) for other business | 9.5 |
| Return on equities (gross of tax) | 7.5 |
| Return on gilts (gross of tax) | 5.0 |
| Expense inflation | 3.0 |

In-force business is defined as all live policies where the first premium has been paid. The entire surplus is attributable to the Group.

The income from long-term assurance business which is included within other operating income in the consolidated profit and loss account is calculated as follows:

| | Period ended 31 December 2001 £ million |
|---|---|
| Closing value of Group's interest in long-term assurance business including minority interests | 47 |
| Opening value of Group's interest in long-term assurance business including minority interests | (42) |
| Increase in value of long-term assurance business | 5 |
| Income after tax from long-term assurance business | 5 |
| Taxation relating to long-term assurance business (Note 10) | 2 |
| Income before tax from long-term assurance business (Note 1) | 7 |

The assets and liabilities attributable to policyholders are presented separately from those arising from other Group activities to reflect the different nature of the policyholders' interest.

The long-term assurance assets attributable to policyholders comprise:

| | 31 December 2001 £ million |
|---|---|
| Investments | 226 |
| Value of in-force policies | 9 |
| Net current liabilities | (11) |
| | 224 |
| Long-term assurance business attributable to Proprietors | (47) |
| Long-term assurance assets attributable to policyholders | 177 |
| Long-term assurance liabilities attributable to policyholders | 177 |

Derivatives (options and futures) are used for efficient portfolio management of the long-term assurance business and to match obligations to policyholders. These derivatives are included in investments at market value.

# NOTES ON THE ACCOUNTS (continued)

## 29. DEPOSITS BY BANKS

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Repayable on demand | 14,630 | 2,717 | 9,477 | 5,222 |
| Repayable: | | | | |
| 3 months or less but not repayable on demand | 26,323 | 5,441 | 22,414 | 15,702 |
| 1 year or less but over 3 months | 8,509 | 2,835 | 5,545 | 2,876 |
| 5 years or less but over 1 year | 141 | 44 | 2,788 | 3,223 |
| over 5 years | 502 | 66 | 1,722 | 1,042 |
| | 50,105 | 11,103 | 41,946 | 28,065 |
| Amounts above include: | | | | |
| Subsidiary undertakings | | | 39,604 | 27,183 |
| Fellow subsidiary undertakings | 4,789 | 393 | | 38 |
| Associated undertakings | 352 | 444 | 4 | |

## 30. CUSTOMER ACCOUNTS

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Repayable on demand | 37,903 | 28,424 | 31,487 | 25,657 |
| Repayable: | | | | |
| 3 months or less but not repayable on demand | 16,209 | 9,833 | 2,494 | 2,728 |
| 1 year or less but over 3 months | 2,724 | 1,464 | 313 | 394 |
| 5 years or less but over 1 year | 708 | 307 | 260 | 161 |
| over 5 years | 168 | 434 | | |
| | 57,712 | 40,462 | 34,554 | 28,940 |
| Amounts above include: | | | | |
| Subsidiary undertakings | | | 897 | 611 |
| Fellow subsidiary undertakings | 779 | | 540 | |
| Ultimate parent undertaking | 956 | 487 | 182 | 50 |
| Associated undertakings | 31 | 9 | 31 | 9 |
| Joint ventures | 71 | 26 | 71 | 6 |

## 31. DEBT SECURITIES IN ISSUE

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Bonds and Medium Term Notes | | | | |
| Repayable: | | | | |
| 1 year or less or on demand | 2,867 | 7,865 | 250 | 250 |
| 2 years or less but over 1 year | 7,720 | 2,363 | | 250 |
| 5 years or less but over 2 years | 5,993 | 3,115 | | |
| over 5 years | 1,170 | 493 | 268 | |
| | 17,750 | 13,836 | 518 | 500 |
| Other Debt Securities | | | | |
| Repayable: | | | | |
| 3 months or less | 47,339 | 12,389 | 1,019 | 639 |
| 1 year or less but over 3 months | 11,761 | 8,688 | 987 | 1,314 |
| 2 years or less but over 1 year | 54 | 205 | 16 | |
| 5 years or less but over 2 years | | 61 | | |
| over 5 years | 4 | 4 | | |
| | 59,158 | 21,347 | 2,022 | 1,953 |
| Total debt securities in issue | 76,908 | 35,183 | 2,540 | 2,453 |

Bonds and Medium Term Notes includes £303 million for the Group (2001 – £320 million) secured on advances to customers and certain other assets of the Group.

Other Debt Securities issued by the Bank includes nil (2001 – £84 million) held by subsidiary undertakings.

During 2002, the Group securitised a portfolio of mortgage advances. Under FRS 5 "Reporting the Substance of Transactions" linked presentation is not available and therefore the funding from this securitisation of £300 million is included in Bonds and Medium Term Notes. The portfolio of mortgage advances continues to be reported in Loans and Advances to Customers (Note 16).

## NOTES ON THE ACCOUNTS (continued)

### 31. DEBT SECURITIES IN ISSUE (continued)

Other Debt Securities includes £9,286 million (31 December 2001 – nil) in respect of commercial paper issued to fund the purchase of asset backed securities by special purpose vehicles (Note 19).

### 32. OTHER LIABILITIES

| | Group | |
|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million |
| Negative market values of trading derivative contracts | 6,134 | 1,254 |
| Other liabilities | 1,067 | 829 |
| | 7,201 | 2,083 |

### 33. PROVISIONS FOR LIABILITIES AND CHARGES

| (i) Deferred Taxation | Group £ million | Bank £ million |
|---|---|---|
| At 1 January 2002 | 471 | (32) |
| Prior year adjustment | (133) | (87) |
| At 1 January 2002 – Restated | 338 | (119) |
| Charge/(credit) in year (Note 10) | 10 | (15) |
| Other movements | | 7 |
| At 31 December 2002 | 348 | (127) |

| | 31 December 2002 | | 31 December 2001 Restated | |
|---|---|---|---|---|
| Deferred taxation comprises: | Provided for in Accounts £ million | Full Potential Liability £ million | Provided for in Accounts £ million | Full Potential Liability £ million |
| **Group** | | | | |
| Capital allowances: | | | | |
| on assets leased to customers | 450 | 450 | 425 | 425 |
| on other assets | 28 | 28 | 19 | 19 |
| General provisions | (141) | (141) | (133) | (133) |
| Other timing differences | 11 | 11 | 27 | 27 |
| | 348 | 348 | 338 | 338 |
| **Bank** | | | | |
| Capital allowances on fixed assets | 1 | 1 | (2) | (2) |
| General provisions | (93) | (93) | (87) | (87) |
| Other timing differences | (35) | (35) | (30) | (30) |
| | (127) | (127) | (119) | (119) |

(ii) Other Provisions

| Group | Pensions and other similar obligations £ million | Merger integration provision £ million | Other provisions £ million | Total provisions £ million |
|---|---|---|---|---|
| At 1 January 2002 | 78 | 31 | 14 | 123 |
| Charge for year | 54 | 77 | | 131 |
| Utilised in year | (51) | (71) | (1) | (123) |
| At 31 December 2002 | 81 | 37 | 13 | 131 |

| Bank | Pensions and other similar obligations £ million | Merger integration provision £ million | Other provisions £ million | Total provisions £ million |
|---|---|---|---|---|
| At 1 January 2002 | 75 | 24 | 1 | 100 |
| Charge for year | 38 | 60 | | 98 |
| Utilised in year | (35) | (49) | (1) | (85) |
| At 31 December 2002 | 78 | 35 | | 113 |

# NOTES ON THE ACCOUNTS (continued)

## 34. SUBORDINATED LIABILITIES

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Dated Loan Capital | | | | |
| €51.1 million 8.30% Notes 2002 | | 31 | | |
| US$300 million 8.80% Notes 2004 | 186 | 207 | 186 | 207 |
| US$150 million 8.85% Notes 2006 | 93 | 103 | 93 | 103 |
| £60 million 9.00% Instruments 2006 | 60 | 60 | | |
| A$100 million Callable Notes 2007 | | 35 | | |
| €500 million 5.50% Instruments 2009 | 325 | 305 | 325 | 305 |
| US$500 million Notes 2010 | 309 | 343 | 309 | 343 |
| £75 million Floating Rate Instruments 2010 | 75 | 75 | 75 | 75 |
| US$150 million Notes 2011 | 92 | 103 | 92 | 103 |
| €7 million Floating Rate Notes 2011 | 5 | 4 | | |
| €12.8 million 6.25% Instruments 2012 | 8 | 8 | | |
| €325 million 6.125% Notes 2013 | 209 | 196 | 209 | 196 |
| €1,000 million subordinated Callable Fixed/Floating rate instruments 2013 | 649 | 608 | 649 | 608 |
| £250 million 6.375% Instruments 2019 | 245 | 244 | 245 | 244 |
| €750 million 5.5% Notes 2012 | 487 | | 487 | |
| US$450 million Subordinated Floating Rate Notes 2012 | 277 | | 277 | |
| A$75 million Callable Notes 2012 | 26 | | | |
| | 3,046 | 2,322 | 2,947 | 2,184 |
| Repayable: | | | | |
| in 1 year or less | | 31 | | |
| in more than 1 year but not more than 5 years | 339 | 370 | 279 | 310 |
| after 5 years | 2,707 | 1,921 | 2,668 | 1,874 |
| | 3,046 | 2,322 | 2,947 | 2,184 |

No repayment, for whatever reason, of dated loan capital prior to its stated maturity and no purchase by the relevant company 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 that 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.

On 29 October 2002 the Bank issued €600 million Subordinated Fixed Rate Notes 2012 at an issue price of 99.812% of the principal amount. The Notes bear interest at a fixed rate 5.5% per annum. On 25 November 2002 Bank of Scotland issued a further €150 million at an issue price of 101.611% of the principal amount plus €610,274 representing 27 days accrued interest for the period from and including 29 October 2002.

On 22 November 2002 the Bank issued US$450 million Subordinated Floating Rate Notes 2012 at an issue price of 99.665% of the principal amount. The Notes bear interest at 3 months US$-LIBOR-BBA plus 0.50% per annum until 22 November 2007 at which time the interest rate becomes 3 month US$-LIBOR-BBA plus 1.00% per annum.

On 10 December 2002 a subsidiary of the Bank issued A$75 million Callable Notes 2012. The Notes bear interest at the three month Australian bank bill rate plus 0.75% per annum. The issuer has the option to redeem the Notes at par after 10 December 2007.

# NOTES ON THE ACCOUNTS (continued)

## 34. SUBORDINATED LIABILITIES (CONTINUED)

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 Restated £ million | 31 December 2002 £ million | 31 December 2001 Restated £ million |
| Undated Loan Capital | | | | |
| US$300 million Reset Notes | 186 | 207 | 186 | 207 |
| £200 million Perpetual Notes | 200 | 200 | 200 | 200 |
| £300 million Perpetual Regulatory tier One Securities | 297 | 297 | 297 | 297 |
| €500 million Instruments | 325 | | 325 | |
| US$250 million Floating Rate Primary Capital Notes | 155 | 172 | 155 | 172 |
| £150 million Instruments | 150 | 150 | 150 | 150 |
| £150 million Instruments | 150 | 149 | 150 | 149 |
| JPY 17 billion Instruments | 99 | 110 | 99 | 110 |
| £100 million Instruments | 100 | 99 | 100 | 99 |
| JPY 9 billion Instruments | 47 | 47 | | |
| £250 million Perpetual Preferred Notes | | | 250 | 250 |
| £150 million Perpetual Preferred Notes | | | 150 | 150 |
| | 1,709 | 1,431 | 2,062 | 1,784 |

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.

The undated loan capital has no final date of maturity. All or some of the Capital Notes may be redeemed at the option of the Bank at par on any interest payment date. The £200 million Perpetual Notes may, at the option of the Bank on 4 November 2013, be redeemed at par or exchanged for new notes. The new notes (and any further new notes issued) may be similarly redeemed or exchanged for further new notes at the option of the Bank on the fifth anniversary of their respective date(s) of issue.

The Instruments may, at the option of the Bank or relevant subsidiary undertaking on giving 30 days notice, be redeemed at par or exchanged for new instruments on 10 August 2015 (£100 million); 9 February 2016 (JPY 17 billion); 30 May 2016 (JPY 9 billion); 30 October 2006 (£150 million) and 10 February 2023 (£150 million). The new Instruments (and any further new Instruments issued) may be similarly redeemed or exchanged for further new notes at the option of the Bank on the fifth anniversary of their respective date(s) of issue. The JPY 17 billion Instruments have been converted into an obligation of US$160 million, bearing interest at US$ LIBOR plus 1.01% by means of swap arrangements. The Reset Notes may be redeemed at the option of the Bank at par on 20 November 2007, at which time the interest rate becomes US$ LIBOR plus 1.625%, or any interest payment date thereafter.

The £250 million and £150 million Perpetual Preferred Notes were issued to Bank of Scotland Capital Funding LP by the Bank as subordinated notes. Bank of Scotland Capital Funding LP has issued preferred securities of equivalent amount. These are included in minority non-equity interests in the consolidated Balance Sheet.

On 28 February 2001, £300 million Perpetual Regulatory tier One Securities were issued by the Bank (£297 million net of expenses). These qualify as Tier 1 regulatory capital. A £150 million Series A Issue has a fixed coupon of 7.286% to 2016 and a Series B Issue of £150 million has a fixed coupon of 7.281% to 2026. Thereafter, if not redeemed on their respective dates, for each Issue the coupon will be reset and will be further reset at five yearly intervals. There is an option to settle the coupon payment through the issue of ordinary stocks. Coupon payments may be deferred but the Bank may not declare or pay dividends on any of its ordinary stocks whilst any coupon payments are deferred. UITF 33 was implemented during 2002 which required these securities to be reclassified from minority and other interests (non-equity) to undated loan capital. Comparative amounts have been restated.

On 10 June 2002, €500 million Instruments were issued by the Bank, at par, to its parent undertaking HBOS plc. The instruments bear interest at the three month EURIBOR rate plus 1.28% per annum.

## NOTES ON THE ACCOUNTS (continued)

### 35. SHARE CAPITAL

| | Ordinary Stock 25p each £ million | 9¼% Non-Cumulative Irredeemable Preference Stock £1 each £ million | 9¾% Non-Cumulative Irredeemable Preference Stock £1 each £ million | 8.117% Non-Cumulative Preference Stock Class A £ million | 7.754% Non-Cumulative Preference Stock Class B £ million |
|---|---|---|---|---|---|
| **Authorised** | | | | | |
| At 1 January 2002 | 396 | 375 | 125 | 2.5 | 1.5 |
| Created in year | 50 | | | | |
| At 31 December 2002 | 446 | 375 | 125 | 2.5 | 1.5 |
| **Allotted, called up and fully paid** | | | | | |
| At 1 January 2002 | 328 | 300 | 100 | | |
| Issued | 39 | | | | |
| At 31 December 2002 | 367 | 300 | 100 | | |

On 28 May 2002 the Bank issued 156,250,000 ordinary stock units of 25p each for a consideration of £1,250 million. The proceeds raised were invested on 1 June 2002 in shares and subordinated loan stock in its subsidiary undertaking HBOS Treasury Services plc, in connection with the transfer from Halifax plc, a fellow subsidiary undertaking of the Group, of the majority of the net assets and undertaking of its treasury operations.

### 36. RESERVES

| | Share Premium £ million | Perpetual Securities £ million | Other Reserves £ million | Profit and Loss Account £ million |
|---|---|---|---|---|
| **Group** | | | | |
| At 1 January 2002 | 583 | 297 | (22) | 2,864 |
| Prior period adjustments | | (297) | | 129 |
| Restated at 1 January 2002 | 583 | | (22) | 2,993 |
| Premium arising on the issue of new stock | 1,211 | | | |
| Exchange translation | | | 3 | |
| Retained profit | | | | 418 |
| At 31 December 2002 | 1,794 | | (19) | 3,411 |
| **Bank** | | | | |
| At 1 January 2002 | 583 | 297 | 15 | 1,994 |
| Prior period adjustments | | (297) | | 87 |
| Restated at 1 January 2002 | 583 | | 15 | 2,081 |
| Premium arising on the issue of new stock | 1,211 | | | |
| Exchange translation | | | 53 | |
| Retained profit | | | | 302 |
| At 31 December 2002 | 1,794 | | 68 | 2,383* |

* Of which £2,188 million is distributable.

The cumulative amount of positive goodwill on acquisitions of subsidiary undertakings written off in the Group reserves is £228 million (2001 – £228 million).

# NOTES ON THE ACCOUNTS (continued)

## 37. RECONCILIATION OF PROPRIETORS' FUNDS

| | Group | | Bank | |
|---|---|---|---|---|
| | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million | Year ended 31 December 2002 £ million | Period ended 31 December 2001 Restated £ million |
| Profit attributable to Proprietors | 826 | 475 | 710 | 254 |
| Dividends | (408) | (399) | (408) | (399) |
| Other recognised gains and losses | 3 | (4) | 53 | (20) |
| Dividends retained on account of stock dividends | | 24 | | 24 |
| Contribution to Employee Share Trust | | (3) | | (3) |
| Ordinary capital subscribed | 1,250 | 17 | 1,250 | 17 |
| | 1,671 | 110 | 1,605 | (127) |
| Proprietors' Funds at 1 January 2002 as previously stated | 4,450 | 4,345 | 3,617 | 3,749 |
| Prior period adjustments | (168) | (173) | (210) | (215) |
| Proprietors' Funds at 1 January 2002 – Restated | 4,282 | 4,172 | 3,407 | 3,534 |
| Proprietors' Funds at 31 December 2002 | 5,953 | 4,282 | 5,012 | 3,407 |
| of which: | | | | |
| Attributable to non-equity interests | 400 | 400 | 400 | 400 |
| Attributable to equity interests | 5,553 | 3,882 | 4,612 | 3,007 |
| | 5,953 | 4,282 | 5,012 | 3,407 |

## 38. MEMORANDUM ITEMS

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.

| | 31 December 2002 Contract Amount £ million | 31 December 2001 Contract Amount £ million |
|---|---|---|
| **Group** | | |
| **Contingent Liabilities** | | |
| Acceptances and endorsements | 156 | 121 |
| Guarantees and assets pledged as collateral security | | |
| Guarantees and irrevocable letters of credit | 2,770 | 2,079 |
| | 2,926 | 2,200 |
| **Commitments** | | |
| Other commitments | | |
| Short-term trade related transactions | 129 | 202 |
| Undrawn formal standby facilities, credit lines and commitments to lend | | |
| up to and including 1 year | 21,417 | 15,393 |
| over 1 year | 10,341 | 7,688 |
| | 31,887 | 23,283 |
| **Bank** | | |
| **Contingent Liabilities** | | |
| Acceptances and endorsements | 148 | 113 |
| Guarantees and assets pledged as collateral security | | |
| Guarantees and irrevocable letters of credit | 4,065 | 2,336 |
| | 4,213 | 2,449 |
| Amounts included above in respect of guarantees to subsidiary undertakings | 1,663 | 513 |
| **Commitments** | | |
| Other commitments | | |
| Short-term trade related transactions | 120 | 153 |
| Undrawn formal standby facilities, credit lines and commitments to lend | | |
| up to and including 1 year | 15,672 | 11,353 |
| over 1 year | 8,992 | 6,932 |
| | 24,784 | 18,438 |
| Amounts included above in respect of commitments to subsidiary undertakings | 128 | 290 |

## NOTES ON THE ACCOUNTS (continued)

### 39. DERIVATIVES

The Bank and Group use 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. Trading transactions are either customer driven and are generally matched or carried out for proprietary trading purposes within limits approved by the Board.

The Bank and Group have entered into derivative contracts as noted below. The notional principal amounts and fair values of these derivatives (excluding internal trades) are analysed between non trading and trading activity. 'Fair value' is the amount at which instruments could be exchanged in an arms length transaction.

| | 31 December 2002 | | | 31 December 2001 | | |
|---|---|---|---|---|---|---|
| | Notional Principal Amount £ million | Year End Fair Value Asset £ million | Year End Fair Value Liability £ million | Notional Principal Amount £ million | Period End Fair Value Asset £ million | Period End Fair Value Liability £ million |
| **Group** | | | | | | |
| **Non Trading** | | | | | | |
| **Exchange Rate Related Contracts** | | | | | | |
| Forward foreign exchange | 411 | 8 | 11 | 134 | 1 | 7 |
| Cross currency swaps | 33,085 | 555 | 1,044 | 9,291 | 261 | 266 |
| | 33,496 | 563 | 1,055 | 9,425 | 262 | 273 |
| **Interest Rate Related Contracts** | | | | | | |
| Interest rate swaps | 51,902 | 1,223 | 1,476 | 21,122 | 326 | 429 |
| Forward rate agreements | | | | 596 | | |
| Options | 984 | 6 | 5 | | | |
| Futures | 2,678 | 1 | 1 | | | |
| | 55,564 | 1,230 | 1,482 | 21,718 | 326 | 429 |
| Equity and Commodity Related Contracts | | | | | | |
| Options and swaps | 935 | 32 | 40 | 3 | | |
| **Total Non Trading Derivatives** | 89,995 | 1,825 | 2,577 | 31,146 | 588 | 702 |
| **Trading** | | | | | | |
| **Exchange Rate Related Contracts** | | | | | | |
| Forward foreign exchange | 49,471 | 682 | 1,674 | 23,019 | 160 | 224 |
| Cross currency swaps | 142 | 5 | 7 | 78 | 1 | 1 |
| Options | 12,728 | 9 | 9 | 223 | 2 | 2 |
| | 62,341 | 696 | 1,690 | 23,320 | 163 | 227 |
| **Interest Rate Related Contracts** | | | | | | |
| Interest rate swaps | 251,359 | 3,800 | 3,654 | 52,287 | 556 | 491 |
| Forward rate agreements | 9,856 | 2 | 2 | 2,103 | 1 | 1 |
| Options | 58,120 | 128 | 190 | 21,129 | 53 | 50 |
| Futures | 190,017 | 49 | 74 | 6,103 | 3 | 2 |
| | 509,352 | 3,979 | 3,920 | 81,622 | 613 | 544 |
| **Equity and Commodity Related Contracts** | | | | | | |
| Options and swaps | 563 | 37 | 28 | 323 | 11 | 5 |
| **Total Trading Derivatives** | 572,256 | 4,712 | 5,638 | 105,265 | 787 | 776 |
| **Total Group Derivatives** | 662,251 | 6,537 | 8,215 | 136,411 | 1,375 | 1,478 |

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

| | 31 December 2002 | | 31 December 2001 | |
|---|---|---|---|---|
| | Notional Principal Amount £ million | Replacement Cost £ million | Notional Principal Amount £ million | Replacement Cost £ million |
| **Group** | | | | |
| **Contracts maturing:** | | | | |
| In 1 year or less | 228,345 | 1,371 | 62,409 | 527 |
| In more than 1 year but not more than 5 years | 159,317 | 2,156 | 49,296 | 467 |
| In more than 5 years | 81,894 | 2,960 | 18,603 | 378 |
| | 469,556 | 6,487 | 130,308 | 1,372 |

# NOTES ON THE ACCOUNTS (continued)

## 39. DERIVATIVES (continued)

| | 31 December 2002 | | | 31 December 2001 | | |
|---|---|---|---|---|---|---|
| | Notional Principal Amount £ million | Year End Fair Value Asset £ million | Year End Fair Value Liability £ million | Notional Principal Amount £ million | Period End Fair Value Asset £ million | Period End Fair Value Liability £ million |
| **Bank** | | | | | | |
| **Non Trading** | | | | | | |
| **Exchange Rate Related Contracts** | | | | | | |
| Cross currency swaps | 89 | 13 | | 89 | | 5 |
| | 89 | 13 | | 89 | | 5 |
| **Interest Rate Related Contracts** | | | | | | |
| Interest rate swaps | 19,578 | 786 | 127 | 15,489 | 352 | 26 |
| Forward rate agreements | | | | 1,125 | | 1 |
| | 19,578 | 786 | 127 | 16,614 | 352 | 27 |
| **Equity and Commodity Related Contracts** | | | | | | |
| Options and swaps | 184 | 4 | 5 | 8 | 1 | 1 |
| **Total Non Trading Derivatives** | 19,851 | 803 | 132 | 16,711 | 353 | 33 |
| **Trading** | | | | | | |
| **Exchange Rate Related Contracts** | | | | | | |
| Forward foreign exchange | 904 | 22 | 22 | 873 | 8 | 8 |
| **Total Trading Derivatives** | 904 | 22 | 22 | 873 | 8 | 8 |
| **Total Bank Derivatives** | 20,755 | 825 | 154 | 17,584 | 361 | 41 |

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

| | 31 December 2002 | | 31 December 2001 | |
|---|---|---|---|---|
| | Notional Principal Amount £ million | Replacement Cost £ million | Notional Principal Amount £ million | Replacement Cost £ million |
| **Bank** | | | | |
| **Contracts maturing:** | | | | |
| In 1 year or less | 3,649 | 52 | 5,227 | 62 |
| In more than 1 year but not more than 5 years | 9,090 | 263 | 6,664 | 123 |
| In more than 5 years | 8,016 | 510 | 5,693 | 176 |
| | 20,755 | 825 | 17,584 | 361 |

# NOTES ON THE ACCOUNTS (continued)

## 39. DERIVATIVES (continued)

### Credit Risk Analyses

Counterparties of the Bank and Group's derivative 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:

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| **Institutional** | | | | |
| Financial Institutions | 5,542 | 1,112 | 810 | 352 |
| Non-financial Institutions | 945 | 260 | 15 | 9 |
| | 6,487 | 1,372 | 825 | 361 |
| **Geographical** | | | | |
| UK | 6,308 | 1,136 | 825 | 361 |
| Rest of World | 179 | 236 | | |
| | 6,487 | 1,372 | 825 | 361 |

The Group's objectives and policies in managing the risks that arise in connection with the use of financial instruments are set out on pages 12 to 14 of the Financial Review and Risk Management section of the Business and Financial Review.

## 40. FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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.

Derivatives held for trading purposes as disclosed in Note 39 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:

| | 31 December 2002 | | | | 31 December 2001 Restated | | | |
|---|---|---|---|---|---|---|---|---|
| | Assets | | Liabilities | | Assets | | Liabilities | |
| | Carrying Amount £ million | Fair Value £ million | Carrying Amount £ million | Fair Value £ million | Carrying Amount £ million | Fair Value £ million | Carrying Amount £ million | Fair Value £ million |
| **Group** | | | | | | | | |
| **Non Trading** | | | | | | | | |
| Treasury bills and other eligible bills | 3,878 | 3,880 | | | 448 | 451 | | |
| Debt securities | 23,680 | 23,618 | | | 9,314 | 9,336 | | |
| Equity shares | 223 | 274 | | | 224 | 285 | | |
| Debt securities in issue | | | 76,661 | 77,004 | | | 34,817 | 32,516 |
| Dated loan capital | | | 3,046 | 3,273 | | | 2,322 | 2,406 |
| Undated loan capital | | | 1,709 | 1,923 | | | 1,431 | 1,550 |
| Minority and other interests (non-equity) | | | 400 | 470 | | | 400 | 554 |
| Derivatives | 298 | 1,825 | 453 | 2,577 | 296 | 588 | 214 | 702 |
| **Total Non Trading** | 28,079 | 29,597 | 82,269 | 85,247 | 10,282 | 10,660 | 39,184 | 37,728 |
| **Trading** | | | | | | | | |
| Treasury bills and other eligible bills | 1,958 | 1,958 | | | 57 | 57 | | |
| Loans and advances to banks | 1,348 | 1,348 | | | 130 | 130 | | |
| Loans and advances to customers | 709 | 709 | | | 123 | 123 | | |
| Debt securities | 19,156 | 19,156 | | | 679 | 679 | | |
| Other assets | 63 | 63 | | | 56 | 56 | | |
| Debt securities in issue | | | 247 | 247 | | | 366 | 366 |
| Deposits by banks | | | 11,650 | 11,650 | | | 374 | 374 |
| Customer accounts | | | 2,309 | 2,309 | | | 67 | 67 |
| Other liabilities | | | 66 | 66 | | | 48 | 48 |
| Derivatives | 4,712 | 4,712 | 5,638 | 5,638 | 787 | 787 | 776 | 776 |
| **Total Trading** | 27,946 | 27,946 | 19,910 | 19,910 | 1,832 | 1,832 | 1,631 | 1,631 |

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

Fair value information is not provided for items that do not meet the definition of a financial instrument or for certain other financial instruments, including short-term debtors and creditors. The fair value information presented does not therefore represent the fair value of the Group as a going concern at 31 December 2002.

## NOTES ON THE ACCOUNTS (continued)

### 41. HEDGES

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:

| | 31 December 2002 | | |
|---|---|---|---|
| | Gains £ million | Losses £ million | Total Net Gains/(Losses) £ million |
| Unrecognised gains and losses on hedges at 1 January 2002 | 300 | 496 | (196) |
| Gains and losses arising in previous years that were recognised in the year ended 31 December 2002 | 146 | 387 | (241) |
| Gains and losses arising before 1 January 2002 that were not recognised in the year ended 31 December 2002 | 154 | 109 | 45 |
| Gains and losses arising in the year ended 31 December 2002 that were not recognised in that year | 1,396 | 2,038 | (642) |
| Unrecognised gains and losses on hedges at 31 December 2002 | 1,550 | 2,147 | (597) |
| of which: | | | |
| Gains and losses expected to be recognised in the year ended 31 December 2003 | 456 | 778 | (322) |
| Gains and losses expected to be recognised after 31 December 2003 | 1,094 | 1,369 | (275) |

| | 31 December 2001 | | |
|---|---|---|---|
| | Gains £ million | Losses £ million | Total Net Gains/(Losses) £ million |
| Unrecognised gains and losses on hedges at 1 March 2001 | 581 | 451 | 130 |
| Gains and losses arising in previous years that were recognised in the period ended 31 December 2001 | 331 | 235 | 96 |
| Gains and losses arising before 1 March 2001 that were not recognised in the period ended 31 December 2001 | 250 | 216 | 34 |
| Gains and losses arising in the period ended 31 December 2001 that were not recognised in that period | 50 | 280 | (230) |
| Unrecognised gains and losses on hedges at 31 December 2001 | 300 | 496 | (196) |
| of which: | | | |
| Gains and losses expected to be recognised in the year ended 31 December 2002 | 101 | 284 | (183) |
| Gains and losses expected to be recognised after 31 December 2002 | 199 | 212 | (13) |

# NOTES ON THE ACCOUNTS (continued)

## 42. INTEREST RATE SENSITIVITY GAP

The tables below summarise the repricing profiles of the Group's assets and liabilities.

| | As at 31 December 2002 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Not more than 3 months £ million | Over 3 months but not over 6 months £ million | Over 6 months but not over 1 year £ million | Over 1 year but not over 5 years £ million | Over 5 years £ million | Non-interest bearing £ million | Trading £ million | Total £ million |
| **Assets** | | | | | | | | |
| Treasury bills and other eligible bills | 3,802 | 76 | | | | | 1,958 | 5,836 |
| Loans and advances to banks | 42,907 | 648 | 200 | 30 | 77 | 1 | 1,348 | 45,211 |
| Loans and advances to customers | 80,113 | 4,654 | 3,830 | 9,415 | 1,659 | 853 | 709 | 101,233 |
| Debt securities and equity shares | 20,007 | 1,351 | 510 | 667 | 849 | 519 | 19,156 | 43,059 |
| Other assets | 455 | 122 | 203 | 404 | 44 | 10,461 | 63 | 11,752 |
| | 147,284 | 6,851 | 4,743 | 10,516 | 2,629 | 11,834 | 23,234 | 207,091 |
| **Liabilities** | | | | | | | | |
| Deposits by banks | 36,578 | (46) | 1,890 | 23 | 10 | | 11,650 | 50,105 |
| Customer accounts | 51,345 | 1,005 | 935 | 425 | 153 | 1,540 | 2,309 | 57,712 |
| Debt securities in issue | 59,915 | 13,502 | 3,100 | 54 | 90 | | 247 | 76,908 |
| Other liabilities | | | 1 | 13 | | 10,976 | 66 | 11,056 |
| Subordinated liabilities | 815 | 155 | | 465 | 3,320 | | | 4,755 |
| Minority interests and Proprietors' funds | | | | | 400 | 6,155 | | 6,555 |
| Internal funding of trading business | (4,467) | (2,822) | (1,865) | (150) | 342 | | 8,962 | |
| | 144,186 | 11,794 | 4,061 | 830 | 4,315 | 18,671 | 23,234 | 207,091 |
| On-balance sheet gap | 3,098 | (4,943) | 682 | 9,686 | (1,686) | (6,837) | | |
| Non trading derivatives | 3,037 | 7,609 | (3,393) | (11,293) | 4,040 | | | |
| Net interest rate repricing gap at 31 December 2002 | 6,135 | 2,666 | (2,711) | (1,607) | 2,354 | (6,837) | | |
| Cumulative gap at 31 December 2002 | 6,135 | 8,801 | 6,090 | 4,483 | 6,837 | | | |

| | As at 31 December 2001 Restated | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Not more than 3 months £ million | Over 3 months but not over 6 months £ million | Over 6 months but not over 1 year £ million | Over 1 year but not over 5 years £ million | Over 5 years £ million | Non-interest bearing £ million | Trading £ million | Total £ million |
| **Assets** | | | | | | | | |
| Treasury bills and other eligible bills | 339 | 109 | | | | | 57 | 505 |
| Loans and advances to banks | 4,453 | 823 | 246 | 78 | 26 | | 130 | 5,756 |
| Loans and advances to customers | 55,271 | 3,307 | 2,936 | 7,546 | 7,855 | 374 | 123 | 77,412 |
| Debt securities and equity shares | 5,893 | 2,410 | 357 | 67 | 359 | 452 | 679 | 10,217 |
| Other assets | 224 | 221 | 215 | 497 | 88 | 3,853 | 1,332 | 6,430 |
| | 66,180 | 6,870 | 3,754 | 8,188 | 8,328 | 4,679 | 2,321 | 100,320 |
| **Liabilities** | | | | | | | | |
| Deposits by banks | 8,072 | 1,628 | 983 | 27 | 19 | | 374 | 11,103 |
| Customer accounts | 36,234 | 772 | 935 | 557 | 10 | 1,887 | 67 | 40,462 |
| Debt securities in issue | 24,903 | 6,213 | 3,617 | 22 | 55 | 7 | 366 | 35,183 |
| Other liabilities | | | 1 | 20 | | 3,684 | 1,254 | 4,959 |
| Subordinated liabilities | 221 | 203 | | 310 | 3,019 | | | 3,753 |
| Minority interests and Proprietors' funds | | | | | | 4,860 | | 4,860 |
| Internal funding of trading business | (260) | | | | | | 260 | |
| | 69,170 | 8,816 | 5,536 | 936 | 3,103 | 10,438 | 2,321 | 100,320 |
| On-balance sheet gap | (2,990) | (1,946) | (1,782) | 7,252 | 5,225 | (5,759) | | |
| Non trading derivatives | 1,072 | (2,046) | 428 | (1,889) | 2,435 | | | |
| Net interest rate repricing gap at 31 December 2001 | (1,918) | (3,992) | (1,354) | 5,363 | 7,660 | (5,759) | | |
| Cumulative gap at 31 December 2001 | (1,918) | (5,910) | (7,264) | (1,901) | 5,759 | | | |

All derivative instruments which alter the interest bases of the non trading portfolio of assets and liabilities are reflected in the above tables.

# NOTES ON THE ACCOUNTS (continued)

## 43. 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 14 of the Financial Review and Risk Management Review Section. The Group's trading market risk exposure for the year ended 31 December 2002 is analysed below.

| | Exposure | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Average | | Highest | | Lowest | |
| | As at 31 December 2002 £ million | As at 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Total Value at Risk | 7.9 | 1.9 | 6.9 | 1.5 | 13.9 | 4.3 | 0.9 | 0.3 |

For all significant exposures VaR has been calculated on a daily basis.

## 44. 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.

| | 31 December 2002 | | | 31 December 2001 | | |
|---|---|---|---|---|---|---|
| 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 | 222 | 185 | 37 | 114 | 85 | 29 |
| Euro | 282 | 190 | 92 | 212 | 56 | 156 |
| Australian Dollar | 371 | 315 | 56 | 307 | 281 | 26 |
| Other | 2 | 2 | | 2 | 2 | |
| Total | 877 | 692 | 185 | 635 | 424 | 211 |

As at 31 December 2002 and 31 December 2001 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 for the reason set out on page 14 of the Financial Review and Risk Management Review Section.

## 45. ASSETS AND LIABILITIES IN FOREIGN CURRENCIES

| | Group | | Bank | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| The aggregate amounts of assets and liabilities denominated in currencies other than sterling were: | | | | |
| Assets | 60,982 | 31,799 | 13,310 | 10,087 |
| Liabilities | 103,085 | 42,975 | 9,468 | 6,635 |

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 ON THE ACCOUNTS (continued)

## 46. RECONCILIATION OF OPERATING PROFIT TO NET CASH INFLOW FROM OPERATING ACTIVITIES

| | 31 December 2002 £ million | 31 December 2001 Restated £ million |
|---|---|---|
| Group operating profit | 1,231 | 769 |
| Decrease/(increase) in accrued income and prepayments | (369) | 17 |
| Increase in accruals and deferred income | 613 | 37 |
| Provision for bad and doubtful debts | 618 | 420 |
| Depreciation and goodwill amortisation | 375 | 275 |
| Amortisation of debt securities | 28 | 1 |
| Decrease/(increase) in the value of long-term assurance business | 47 | (5) |
| Interest on subordinated liabilities | 259 | 191 |
| Profits on sale of investment securities | (31) | (29) |
| Provisions for liabilities and charges | 8 | 50 |
| Amounts written off fixed asset investments | 33 | 12 |
| Exchange differences | 500 | 62 |
| (Profit)/loss on sale of fixed assets | (1) | 1 |
| Net cash inflow from trading activities | 3,311 | 1,801 |
| Net increase in notes in circulation | 84 | 135 |
| Net (increase)/decrease in items in course of collection | (134) | 70 |
| Net increase in treasury and other eligible bills | (5,331) | (140) |
| Net increase in loans and advances to banks and customers | (36,554) | (12,622) |
| Net increase in deposits by banks and customer accounts | 56,252 | 7,659 |
| Net increase in debt securities in issue | 41,725 | 5,222 |
| Net increase in other assets | (4,450) | (566) |
| Net increase in other liabilities | 5,118 | 557 |
| Net increase in debt securities | (18,477) | (197) |
| Net cash inflow from operating activities | 41,544 | 1,919 |

## 47. GROSS CASH FLOWS

| | Notes | 31 December 2002 £ million | 31 December 2001 Restated £ million |
|---|---|---|---|
| (i) Returns on investments and servicing of finance | | | |
| Interest paid on subordinated liabilities | | (254) | (169) |
| Preference dividends paid | | (37) | (37) |
| Dividends paid to minority shareholders in subsidiary undertakings | | (50) | (43) |
| | | (341) | (249) |
| (ii) Capital expenditure and financial investment | | | |
| Purchase of investment securities | | (30,812) | (7,540) |
| Sale and maturity of investment securities | | 15,874 | 6,641 |
| Purchase of property and equipment | | (102) | (141) |
| Sale of property and equipment | | 28 | 61 |
| Purchase of operating lease assets | | (871) | (783) |
| Sale of operating lease assets | | 411 | 503 |
| | | (15,472) | (1,259) |
| (iii) Acquisitions and disposals | | | |
| Investment in associated undertakings and joint ventures | | (135) | (64) |
| Disposal of associated undertakings, joint ventures and business interests | | 27 | 31 |
| Minority interest acquired | | 2 | |
| | | (106) | (33) |
| (iv) Financing | | | |
| Issue of ordinary stock | 49 | 1,250 | 17 |
| Issue of subordinated liabilities | 49 | 1,115 | 608 |
| Repayments of subordinated liabilities | 49 | (66) | (31) |
| Contribution to Employee Share Trust | | | (3) |
| | | 2,299 | 591 |

## NOTES ON THE ACCOUNTS (continued)

### 48. ANALYSIS OF THE BALANCES OF CASH AS SHOWN IN THE BALANCE SHEET

| | As at 1 January 2002 £ million | Cashflow £ million | As at 31 December 2002 £ million | As at 1 March 2001 £ million | Cashflow £ million | As at 31 December 2001 £ million |
|---|---|---|---|---|---|---|
| Cash and balances at central banks | 917 | 132 | 1,049 | 745 | 172 | 917 |
| Loans and advances to other banks repayable on demand | 666 | 27,343 | 28,009 | 428 | 238 | 666 |
| | 1,583 | 27,475 | 29,058 | 1,173 | 410 | 1,583 |

The Group maintains balances with the Bank of England which, at 31 December 2002, amounted to £681 million (2001 – £568 million).

### 49. ANALYSIS OF THE CHANGES IN FINANCING DURING THE YEAR

| | 31 December 2002 | | 31 December 2001 Restated | |
|---|---|---|---|---|
| | Share Capital (including Premium) £ million | Loan Capital £ million | Share Capital (including Premium) £ million | Loan Capital £ million |
| At 1 January | 1,311 | 3,753 | 1,294 | 3,218 |
| Effect of foreign exchange differences | | (47) | | (42) |
| Proceeds of capital issues (including premium) – ordinary stock | 1,250 | | 17 | |
| Repayments of subordinated liabilities | | (66) | | (31) |
| Proceeds of loan capital issues | | 1,115 | | 608 |
| At 31 December | 2,561 | 4,755 | 1,311 | 3,753 |

### 50. RELATED PARTY TRANSACTIONS

In the year ended 31 December 2002, 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 £28 million (period ended 31 December 2001 – £17 million), of which £4 million was outstanding at the year end (2001 – £6 million).

During the year, IBM United Kingdom (Systems Operations) Limited, a non consolidated subsidiary undertaking, provided to Bank of Scotland Group systems operations services. The amounts in respect of these services payable from Bank of Scotland Group during the year were £147 million (period ended 31 December 2001 – £105 million), of which £5 million was outstanding at the year end (2001 – £11 million). On 19 August 2002 the Group served notice of contract severance to IBM United Kingdom (Systems Operations) Limited. There is a one year notice period contained in the contract.

On 1 June 2002, the majority of the Treasury assets and liabilities of Halifax plc, a fellow subsidiary undertaking, were transferred to HBOS Treasury Services plc at book value in accordance with the business banking transfer provisions of Part VII of the Financial Services and Markets Act 2000. The principal items transferred comprised treasury bills and other eligible bills, loans and advances to banks, debt securities, deposits from banks, certain debt securities in issue and derivative instruments.

With effect from 1 January 2002, the Group sold its subsidiary undertaking, CHH Holdings plc and its subsidiaries including St Andrews Group, to HBOS Insurance & Investment Group Ltd., a fellow subsidiary undertaking of HBOS plc. The consideration for the transfer amounted to £112 million which was the net asset value of the company at that date. The transaction did not generate a profit or loss for the Group.

### 51. MAIN JOINT VENTURES AND ASSOCIATED UNDERTAKINGS

| | Nature of Business | Issued Share and Loan Capital | | Group's Interest | Statutory Accounts Made up to | Principal Area of Operations |
|---|---|---|---|---|---|---|
| Incorporated in the UK | | | | | | |
| Joint Ventures: | | | | | | |
| Centrica Personal Finance Limited | Finance | ordinary | £3,000,002 | 50.0%* | December 2002 | UK |
| | | loan | £4,500,000 | 50.0%* | | |
| NFU Mutual Finance Limited | Finance | ordinary | £500,002 | 50.0%* | December 2002 | UK |
| RFS Limited | Finance | ordinary | £6,000,006 | 50.0%* | December 2002 | UK |
| Associated Undertaking: | | | | | | |
| Sainsbury's Bank plc | Banking | ordinary | £130,000,000 | 45.0% | February 2002^ | UK |
| | | loan | £25,000,000 | 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 2002.

# NOTES ON THE ACCOUNTS (continued)

## 52. MAIN SUBSIDIARY UNDERTAKINGS

| | Company's Interest in Ordinary Share Capital and Voting Rights | Principal Business | Incorporated |
|---|---|---|---|
| HBOS Treasury Services PLC | 100% | Banking | UK |
| Bank of Western Australia Ltd | 56.8%# | Retail and commercial banking | Australia |
| CAPITAL BANK plc | 100%* | Banking and personal finance | UK |

* Bank of Scotland also holds 100% of the issued preference share capital.
# Held by a subsidiary undertaking.

## 53. TRANSACTIONS WITH DIRECTORS, OFFICERS AND CONNECTED PERSONS

The aggregate amounts outstanding at 31 December 2002 in respect of loans and credit cards which were made available by the Group for persons who are, or were during the period, Directors and officers of Bank of Scotland and their connected persons were:

| | Number | Aggregate amount Outstanding £000 |
|---|---|---|
| Loans | 6 | 1,056 |
| Credit card accounts | 6 | 29 |

## 54. SEGMENTAL ANALYSIS

### Business Sector

The Group reports through five divisions: Retail, Business, Corporate, Treasury, Insurance & Investment plus BankWest and Group Items.

| | Year ended 31 December 2002 | | | Period ended 31 December 2001 Restated | | |
|---|---|---|---|---|---|---|
| | Profit before tax and exceptional items £ million | Exceptional items £ million | Profit before tax £ million | Profit before tax and exceptional items £ million | Exceptional items £ million | Profit before tax £ million |
| Retail | 319 | (4) | 315 | 155 | (6) | 149 |
| Business | 261 | (16) | 245 | 218 | (9) | 209 |
| Corporate | 556 | | 556 | 367 | (1) | 366 |
| Treasury | 163 | (6) | 157 | 93 | (1) | 92 |
| Insurance & Investment | 87 | | 87 | 121 | (6) | 115 |
| BankWest | 75 | | 75 | 67 | | 67 |
| Group Items | (88) | (51) | (139) | (99) | (92) | (191) |
| Profit on ordinary activities before tax | 1,373 | (77) | 1,296 | 922 | (115) | 807 |

| | Net Assets Restated | | Total Assets | |
|---|---|---|---|---|
| | 31 December 2002 £ million | 31 December 2001 £ million | 31 December 2002 £ million | 31 December 2001 £ million |
| Retail | 1,182 | 913 | 34,372 | 25,070 |
| Business | 1,301 | 1,006 | 25,869 | 21,206 |
| Corporate | 2,457 | 1,857 | 41,800 | 32,490 |
| Treasury | 771 | 194 | 96,484 | 13,725 |
| Insurance & Investment | | 101 | 30 | 224 |
| BankWest | 242 | 211 | 8,536 | 7,782 |
| | 5,953 | 4,282 | 207,091 | 100,497 |

# NOTES ON THE ACCOUNTS (continued)

## 55. SEGMENTAL ANALYSIS (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.

| | 31 December 2002 | | | 31 December 2001 Restated | | |
|---|---|---|---|---|---|---|
| | UK £ million | Rest of World £ million | Group Total £ million | UK £ million | Rest of World £ million | Group Total £ million |
| Interest receivable | 8,861 | 1,224 | 10,085 | 5,199 | 962 | 6,161 |
| Fees and commissions receivable | 886 | 168 | 1,054 | 673 | 114 | 787 |
| Dealing profits | 103 | 8 | 111 | 64 | 4 | 68 |
| Other operating income | 441 | 24 | 465 | 440 | 25 | 465 |
| Gross income | 10,291 | 1,424 | 11,715 | 6,376 | 1,105 | 7,481 |
| Operating profit before exceptional items | 1,032 | 276 | 1,308 | 704 | 180 | 884 |
| Share of operating profits of joint ventures | 24 | (11) | 13 | 28 | (5) | 23 |
| Share of operating profits of associated undertakings | 19 | 8 | 27 | 11 | 4 | 15 |
| Profit on disposal of business | 25 | | 25 | | | |
| Exceptional items | (77) | | (77) | (115) | | (115) |
| Group profit before taxation | 1,023 | 273 | 1,296 | 628 | 179 | 807 |
| Total assets | 182,359 | 24,399 | 206,758 | 80,728 | 19,554 | 100,282 |
| Joint ventures | | | 161 | | | 81 |
| Associated undertakings | | | 172 | | | 134 |
| Group total assets | | | 207,091 | | | 100,497 |
| Net assets (excluding minority interests) | 4,779 | 1,174 | 5,953 | 3,494 | 788 | 4,282 |

## 56. ULTIMATE PARENT UNDERTAKING

HBOS plc is the ultimate parent undertaking of Bank of Scotland Group. The accounts of HBOS plc may be obtained from its head office at The Mound, Edinburgh, EH1 1YZ.

## 57. APPROVAL OF ACCOUNTS

The accounts, which have been prepared under the Bank Accounts Directive (Miscellaneous Banks) Regulations 1991 and comply with Part VII of the Companies Act 1985 were approved by the Directors on 24 February 2003.

## SUMMARY OF CONSOLIDATED BALANCE SHEET

As at 31 December 2002

Accounts in US Dollars

At $1.61195 to the £ (31 December 2001 – $1.4517 to the £)

| | 31 December 2002 US$ million | 31 December 2001 Restated US$ million |
|---|---|---|
| Assets | | |
| Cash and balances at central banks | 1,691 | 1,331 |
| Items in course of collection | 961 | 671 |
| Bills, debt securities and equity shares | 78,816 | 15,565 |
| Loans, advances and other accounts | 250,692 | 126,646 |
| Shares in associated undertakings and joint ventures | 537 | 312 |
| Intangible and tangible fixed assets | 1,124 | 1,041 |
| Long-term assurance business attributable to Proprietors | | 68 |
| Long-term assurance assets attributable to policyholders | | 257 |
| | 333,821 | 145,891 |
| Financed by | | |
| Liabilities | | |
| Deposits by banks, customers and debt securities in issue | 297,767 | 125,932 |
| Notes in circulation | 1,323 | 1,070 |
| Proposed dividends | 617 | 374 |
| Deferred taxation | 561 | 491 |
| Other liabilities and provisions | 15,321 | 5,264 |
| Subordinated liabilities – Dated loan capital | 4,910 | 3,371 |
| – Undated loan capital | 2,755 | 2,077 |
| Long-term assurance liabilities attributable to policyholders | | 257 |
| | 323,254 | 138,836 |
| Capital Resources | | |
| Called up share capital | | |
| Ordinary stock | 592 | 476 |
| Preference stocks | 645 | 581 |
| Reserves | 8,360 | 5,159 |
| Minority interests | 970 | 839 |
| | 10,567 | 7,055 |
| | 333,821 | 145,891 |

## SUMMARY OF CONSOLIDATED PROFIT AND LOSS ACCOUNT

For the year ended 31 December 2002

| | Year ended 31 December 2002 US$ million | Period ended 31 December 2001 Restated US$ million |
|---|---|---|
| Operating profit before provisions | 2,980 | 1,762 |
| Provisions for bad and doubtful debts | (996) | (610) |
| Operating profit | 1,984 | 1,152 |
| Profit on ordinary activities before taxation | 2,089 | 1,172 |
| Profit attributable to Proprietors | 1,331 | 690 |
| Dividends: | | |
| Ordinary | 598 | 534 |
| Preference | 60 | 45 |
| Retained profit | 673 | 111 |
| Underlying earnings per Ordinary Stock unit | 98.2c | 71.6c |

## SUMMARY OF CONSOLIDATED BALANCE SHEET

As at 31 December 2002

### Accounts in Euros

### At €1.536653 to the £ (31 December 2001 – €1.6380 to the £)

| | 31 December 2002 € million | 31 December 2001 Restated € million |
|---|---|---|
| Assets | | |
| Cash and balances at central banks | 1,612 | 1,502 |
| Items in course of collection | 916 | 757 |
| Bills, debt securities and equity shares | 75,135 | 17,562 |
| Loans, advances and other accounts | 238,982 | 142,899 |
| Shares in associated undertakings and joint ventures | 512 | 353 |
| Intangible and tangible fixed assets | 1,071 | 1,174 |
| Long-term assurance business attributable to Proprietors | | 77 |
| Long-term assurance assets attributable to policyholders | | 290 |
| | 318,228 | 164,614 |
| Financed by | | |
| Liabilities | | |
| Deposits by banks, customers and debt securities in issue | 283,858 | 142,093 |
| Notes in circulation | 1,262 | 1,207 |
| Proposed dividends | 589 | 422 |
| Deferred taxation | 535 | 555 |
| Other liabilities and provisions | 14,604 | 5,941 |
| Subordinated liabilities – Dated loan capital | 4,681 | 3,803 |
| – Undated loan capital | 2,626 | 2,344 |
| Long-term assurance liabilities attributable to policyholders | | 290 |
| | 308,155 | 156,655 |
| Capital Resources | | |
| Called up share capital | | |
| Ordinary stock | 564 | 538 |
| Preference stock | 615 | 655 |
| Reserves | 7,969 | 5,819 |
| Minority interests | 925 | 947 |
| | 10,073 | 7,959 |
| | 318,228 | 164,614 |

## SUMMARY OF CONSOLIDATED PROFIT AND LOSS ACCOUNT

For the year ended 31 December 2002

| | Year ended 31 December 2002 € million | Period ended 31 December 2001 Restated € million |
|---|---|---|
| Operating profit before provisions | 2,841 | 1,989 |
| Provisions for bad and doubtful debts | (950) | (688) |
| Operating profit | 1,891 | 1,301 |
| Profit on ordinary activities before taxation | 1,992 | 1,322 |
| Profit attributable to Proprietors | 1,269 | 778 |
| Dividends: | | |
| Ordinary | 570 | 603 |
| Preference | 57 | 51 |
| Retained profit | 642 | 124 |
| Underlying earnings per Ordinary Stock unit | 93.6c | 80.8c |

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