BANK OF SCOTLAND REPORT AND ACCOUNTS

FOR THE YEAR ENDED 31 DECEMBER 2003

Contents

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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 are aligned with those of the HBOS Group and comprise:

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

Business and Financial Review – Retail Banking and Insurance & Investment

Retail Banking

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Net interest income	972	796
Non-interest income	145	187
Operating income	1,117	983
Operating expenses*	(475)	(547)
Operating profit before provisions	642	436
Provisions for bad & doubtful debts	(187)	(149)
Share of profits in joint ventures	40	32
Pre-tax profit*	495	319
Advances to Customers**	£43.5bn	£34.7bn
Customer deposits	£8.6bn	£11.2bn
Net interest margin***	2.39%	2.68%
Cost:income ratio*	42.5%	55.6%

* Excluding exceptional items.

** Before deduction of securitised assets of £3.4bn (2002 £1.5bn).

***Certain loans and advances to customers have been securitised. A "linked presentation" format is used for the statutory balance sheet presentation of these assets and the associated non-returnable finance. The margin is calculated before deduction of average loans and advances subject to non-returnable finance.

Retail Banking's performance in 2003 was strong, delivering further growth in profit before tax and exceptional items at £495m, 55% higher than 2002.

Strong advances growth, up 25%, has more than offset the decline in margin resulting in an increase of 22% in net interest income at £972m. During 2003 Retail Banking securitised a further £2.3bn of residential mortgages. Both non-interest income and operating expenses were lower, reflecting the reclassification in the year of certain fees payable whilst expenses also benefited from lower technology and other centrally allocated costs. The cost:income ratio was 42.5%.

Asset quality remains robust. Whilst the provisions charge increased by 26% year on year, this mainly reflects the significant growth in unsecured lending balances in recent years. The bad debt charge represented 0.48% (2002 0.50%) of average loans and advances. We have experienced some increase in provisions and non-performing assets as the portfolio matures. This is a natural consequence of our relative growth in balances over the past few years where the normal seasoning of loan performance is more pronounced. Closing provisions as a percentage of year end advances decreased from 1.4% at the end of 2002 to 1.1% at the end of 2003.

On 21 July 2003 £3,052m of customer deposits were transferred to Halifax plc using the banking business transfer provisions of part VII of the Financial Services and Markets Act 2000.

Insurance & Investment

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Net interest income	(1)	1
Non-interest income	63	94
Operating income	62	95
Operating expenses	(6)	(8)
Pre-tax profit	56	87

The Group's insurance business relates to repayment insurance on the Group's lending products. As the table above shows, both commission income and pre-tax profit have declined in the year as the insurance interests are progressively re-aligned within the wider HBOS Group.

Business and Financial Review – Business Banking

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Net interest income	**699**	603
Non-interest income	**655**	559
Operating income	**1,354**	1,162
Operating expenses*	**(873)**	(776)
Operating profit before provisions*	**481**	386
Provisions for bad & doubtful debts	**(139)**	(157)
Share of profits in joint ventures	**13**	7
Profit on disposal of business		25
Pre-tax profit*	**355**	261
Advances to Customers	**£30.2bn**	£22.5bn
Customer deposits	**£16.2bn**	£11.5bn
Net interest margin	**2.56%**	3.04%
Cost:income ratio**	**53.8%**	56.5%

* Excluding exceptional items.

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

During 2003 Business Banking generated significant growth and recorded meaningful market share gains to build on the investment of the previous year. 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. A significant increase in customer numbers has delivered strong growth in both lending (customer advances up 34%) and deposit balances (up 41%) following a period of focussed investment in both infrastructure and people and our expansion into England and Wales.

In the UK, our Field New Business Hunters, who identify and generate new business opportunities, have delivered growth on both sides of the balance sheet. The Direct Business Bank, which is dedicated to serving small business customers, has continued to grow with almost 35,000 new customers in the year, whilst other key business areas across the division also delivered impressive results.

The overseas operations have delivered a record profit with strong growth in activity levels. Capital Finance Australia Ltd produced record year end receivables of A$5.1bn in 2003, an increase of 21% over 2002 performance with the three business divisions, Property, Motor and Business Equipment all contributing. Bank of Scotland (Ireland) now has over 19% share of the SME market in Ireland.

Operating income has grown 17% to £1,354m (2002 £1,162m). Net interest income has increased by 16% to £699m with strong growth in both interest-earning advances and deposits. Non-interest income increased by 17% to £655m.

Operating expenses excluding operating lease depreciation increased by 12% to £561m, as 2003 saw the fulfilment of our recruitment drive. This, combined with the growth in income, saw the cost:income ratio improve to 53.8% from 56.5% in 2002.

The net interest margin contracted from 3.04% to 2.56% over the last year, mainly due to a change in the business mix and reduced capital earnings.

Provisions for bad and doubtful debts fell £18m to £139m representing 0.5% of average customer lending (2002 - 0.8%).

Pre-tax profit before exceptional items rose 36% overall to £355m.

From 1 January 2004, following a restructuring within HBOS Group, Business Banking's UK activities will be merged within the Corporate and Retail Banking Divisions strengthening our ability to grow the customer base in England and Wales and providing a wider portfolio of integrated products and services across the UK. The overseas operations will become part of the International Operations Division.

Business and Financial Review – Corporate Banking

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Net interest income	782	678
Non-interest income	431	340
Operating income	1,213	1,018
Operating expenses	(211)	(168)
Operating profit before provisions	1,002	850
Provisions for bad & doubtful debts	(338)	(295)
Share of profits in joint ventures	9	1
Pre-tax profit	673	556
Advances to customers*	£42.3bn	£38.6bn
Customer deposits	£20.4bn	£14.0bn
Net interest margin**	1.84%	1.96%
Cost:income ratio***	17.3%	16.5%

* Before deduction of securitised assets of £1.4bn (2002 £1.4bn)

** Certain loans and advances to customers have been securitised. A "linked presentation" format is used for the statutory balance sheet presentation of these assets and the associated non-returnable finance. The margin is calculated before deduction of average loans and advances subject to non-returnable finance.

***Cost:income ratio has been calculated after netting operating lease depreciation against operating lease income.

Operating from 22 offices in the UK and 13 overseas, Corporate Banking provides a comprehensive and growing range of products and services, predominantly to mid-market corporates, principally in the United Kingdom, but increasingly in appropriate overseas markets. Our franchise now includes profitable activities in Europe, North America and Australia. In North America, a recent initiative has been selective partnering with regional US banks on their larger customer transactions. This is a non-threatening, mutually beneficial approach to a real problem faced by these institutions as they attempt to compete with the larger indigenous banks.

Corporate Banking has once again delivered a set of strong results with profit before tax up by 21% to £673m notwithstanding a challenging economic backdrop for much of the year.

A 15% increase in net interest income and an even stronger 27% increase in non-interest income saw total operating income rising by 19% to £1,213m.

Operating Expenses rose by 26% leading to an increase in the cost:income ratio from 16.5% to 17.3%. Cost efficiency is, and will remain a cornerstone of our operating philosophy and we will continue to invest in our people and infrastructure as we build for the future.

The total charge for bad and doubtful debts in 2003 was £338m, equivalent to 0.84% of average advances (2002- 0.85%)

As planned, our lending growth continued to slow. Total loans and advances to customers increased by 10% to £42.3bn. The vast majority of this growth came in asset backed sectors that are very well known to us and in which we have a wealth of experience. We also continued to syndicate participations in larger transactions.

Business and Financial Review – Treasury

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Net interest income	**179**	149
Non-interest income	**144**	85
Operating income	**323**	234
Operating expenses*	**(91)**	(67)
Operating profit before provisions	**232**	167
Provisions for bad and doubtful debts		(4)
Pre-tax profit*	**232**	163
Net interest margin excluding trading assets	**0.13%**	0.16%
Cost:income ratio*	**28.2%**	28.6%

* Excluding exceptional items.

Treasury provides and manages prudential and regulatory liquidity and wholesale multi-currency funding for the HBOS Group. It is also responsible for arranging the Group's debt capital issuance and asset securitisation programmes. In addition, a range of treasury services is provided to SMEs and large corporate customers of the Business and Corporate Banking Divisions.

In June 2002 substantially all of the Halifax treasury business was successfully combined in Bank of Scotland Treasury Services PLC. The transfer was completed using the banking business transfer provisions of part VII of the Financial Services and Markets Act 2002. The company was re-branded HBOS Treasury Services plc. Hence, 2003 is the first full year of operation for the new combined entity.

As a result of this transfer, net interest income increased to £179m (2002 £149m), non-interest income to £144m (2002 £85m), and costs to £91m (2002 £67m).

Business and Financial Review – Bankwest

	Year ended 31 December 2003 A$m	Year ended 31 December 2002 A$m
Net interest income	**479**	416
Non-interest income	**273**	239
Operating income	**752**	655
Operating expenses	**(443)**	(404)
Operating profit before provisions	**309**	251
Provisions for bad & doubtful debts	**(42)**	(38)
Profit before tax	**267**	213
Total lending to customers***	**A$24.2bn**	A$21.7bn
Net interest margin****	**2.13%**	2.07%
Cost:income ratio**	**58.2%**	60.7%

* The table has been prepared under Australian GAAP.

** Including income representing the fully tax equivalent gross up of A$9m (2002 - A$11m).

*** Before deduction of securitised assets of A$0.9bn (2002 A$1.3bn).

**** Certain loans and advances to customers have been securitised. A "linked presentation" format is used for the statutory balance sheet presentation of these assets and the associated non-returnable finance. The margin is calculated before deduction of average loans and advances subject to non-returnable finance.

During the year BankWest made good progress with its strategies aimed at extracting more value from its strong position in the West Australian market, while expanding nationally in niche markets.

Profit before tax increased by 25% to A$267m (2002 A$213m).

Total operating income increased by 15% to A$752m. Strong volume growth and an increase in net interest margins from 2.07% to 2.13% as a result of a flat to negative yield curve growth resulted in a 15% increase in net interest income. Non-interest income, which increased by 14%, was positively impacted by a first half fee review on many consumer and business products.

Operating expenses increased by 10% compared with the previous year. This included increases in personnel expenses reflecting inflationary increases and A$11m of redundancy costs. These costs resulted from the reduction of about 160 full-time equivalent staff in management and sales support areas following the implementation of a number of efficiency and cost control initiatives. In addition, other expenses increased with A$10m of costs incurred in relation to the HBOS acquisition of the minority interests in BankWest. The cost:income ratio was 58.2% (2002 - 60.7%).

The combined charge for specific and general provisions was A$42m. Net non-performing assets as a percentage of total lending to customers were 0.4% (2002 0.8%).

In August 2003 BankWest became a wholly owned subsidiary of Bank of Scotland, following a proposal to the minority shareholders to acquire all of the outstanding shares that it did not already control.

Business and Financial Review – Financial Review and Risk Management

Overview of Results

Group profit before tax and exceptional items amounts to £1,826 million (2002 – £1,373 million) and is derived as follows:

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Group profit before tax	1,769	1,296
Add back:		
Exceptional items	57	77
Group profit before tax and exceptional items	1,826	1,373

On a divisional basis, Group profit before tax and exceptional items is made up as follows:	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Retail Banking	495	319
Insurance & Investment	56	87
Business Banking	355	261
Corporate Banking	673	556
Treasury	232	163
BankWest	113	75
Group items*	(98)	(88)
	1,826	1,373

* 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 £2,836 million is up £461 million, reflecting strong asset led growth.

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Interest receivable	11,621	10,085
Interest payable	(8,785)	(7,710)
Net interest income	2,836	2,375
Average balances*		
Interest earning assets:		
– Loans and advances	123,425	97,674
– Securities and other liquid assets	29,987	14,615
	153,412	112,289
Securitised assets	4,255	3,115
	157,667	115,404
Net interest margin	1.80%	2.06%

* Certain loans and advances to customers have been securitised. A "linked presentation" format is used for the statutory balance sheet presentation of these assets and the associated non-returnable finance. In the calculation of net interest margin above, average balances are stated before deduction of non-returnable finance. Trading assets within treasury operations are excluded from the net interest margin calculation.

Non-interest income amounted to £1,571 million for the year compared with £1,376 million for the year to 31 December 2002.

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Net fees and commissions receivable	840	800
Operating lease rental income	452	410
Dealing profits	176	111
Profit on sale of investment securities	34	31
Other operating income	69	24
	1,571	1,376

Business and Financial Review – Financial Review and Risk Management (continued)

Operating expenses, excluding exceptional items, grew by 8% reflecting higher staff numbers to support higher business levels.

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Staff	791	680
Depreciation:		
Tangible fixed assets	94	89
Operating lease assets	313	274
Goodwill amortisation	18	12
Other	718	737
	1,934	1,792

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 39.4% as shown in the table below:

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Operating expenses	1,991	1,869
Exceptional items	(57)	(77)
Goodwill amortisation	(18)	(12)
Operating lease depreciation	(313)	(274)
Underlying operating expenses	1,603	1,506
Net operating income	4,407	3,751
Amounts written off fixed asset investments	(29)	(33)
Operating lease depreciation	(313)	(274)
Underlying operating income	4,065	3,444
Cost:income ratio	39.4%	43.7%

Balance Sheet Growth

Advances to customers increased by 26% to £131 billion before deduction of securitised assets. 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 15 on page 46.

	31 December 2003		31 December 2002	
Gross advances	£bn	%	£bn	%
Commercial*	80	63	64	62
Residential Mortgages*	39	30	29	28
Other Personal	9	7	10	10
Total	128	100	103	100

* After securitisation and before provisions.

Customer deposits grew by 20% to £69 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 £682 million (2002 – £618 million). Within this the charge for specific provisions increased 7% to £636 million (2002 – £593 million) but this represented only 0.54% (2002 - 0.64%) of average customer lending.

	Specific £m	General £m	Total £m
At 1 January 2003	854	470	1,324
Amounts written off during the year	(616)		(616)
Disposal of subsidiary undertakings and transfers	(27)	(4)	(31)
Charge for the year	636	46	682
Recoveries of amounts previously written off	33		33
Exchange movements	4	12	16
At 31 December 2003	884	524	1,408

Closing provisions as a % of customer advances (before deduction of securitised assets) are analysed in the following table:

	31 December 2003		31 December 2002	
	£m	As % of customer advances	£m	As % of customer advances
Specific provisions	884	0.67	854	0.82
General provisions	524	0.40	470	0.45
	1,408	1.07	1,324	1.27

Taxation

The tax charge for the year of £550 million (2002 – £402 million), represents 31% (2002 – 31%) of profit before tax compared with a UK corporation tax rate of 30% applicable to both periods.

Capital Structure

Regulatory Capital	31 December 2003 £m	31 December 2002 £m
Risk weighted assets – on balance sheet	116,600	97,500
Risk weighted assets – off balance sheet	14,683	12,244
	131,283	109,744
Tier 1		
Share capital	810	767
Perpetual securities	297	297
Eligible reserves	6,956	5,186
Minority interests (equity)	287	439
Minority and other interests (non-equity):		
Preferred securities	400	400
Less: goodwill	(474)	(150)
Total tier 1 capital	8,276	6,939
Tier 2		
Perpetual subordinated debt	1,697	1,412
Term subordinated debt	3,499	2,917
Other minority interest (non-equity)	431	
General provisions	548	485
Total tier 2 capital	6,175	4,814
Supervisory deductions		
Unconsolidated investments – other	(3)	(6)
Investments in other banks	(83)	(2)
Other deductions	(678)	(86)
Total supervisory deductions	(764)	(94)
Total capital	13,687	11,659
Tier 1 capital ratio (%)	6.3	6.3
Total capital ratio (%)	10.4	10.6

European Economic and Monetary Union (EMU)

In June 2003, the government announced that its economic tests for entry to the single currency had not been fully met and the position would be reviewed at the time of the budget in 2004.

The Group continues to monitor government developments and remains actively involved in discussions within the Banking industry and other sectors of the economy to help assess the implications for the Group and its customers.

Business and Financial Review – Financial Review and Risk Management (continued)

The Group's Operating Controls

The HBOS Group has complied throughout the year with all the provisions of the Combined Code on Corporate Governance ('the Code') as issued by the UK Listing Authority. The Code contains both general principles of good governance and detailed requirements. An explanation of how the Group complies is included within the Corporate Governance Statement in the accounts of HBOS plc.

The management of risk for Bank of Scotland group 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, unless otherwise stated, are to the HBOS Group and Board.

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

- general principles for internal control 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. This system has been in place throughout the period to the date of approval of the Report and Accounts, with refinements where needed during the period, to meet changing business needs. It is regularly reviewed by the Board and accords with the Turnbull guidance on internal control.

In addition the Board has reviewed the effectiveness of the system of internal control specifically for the purposes of this statement.

The system of internal control 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.

The system provides for a documented and auditable trail of accountability and applies across the Group's operations. It covers strategic, financial, regulatory and operational risks and provides for assurances to successive levels of management and, ultimately, to the Board.

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 senior management 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 Control

The Group committee structure considers risks and risk management from the Group's perspective and is supported by the Group Risk functions which are described under "Group Risk Functions" below, namely Group Financial Risk (GFR), Group Operational Risk (GOR) and Group Regulatory Risk (GRR). 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

The full responsibilities of the Audit Committee are described in the Corporate Governance Statement in the accounts of HBOS plc. This section describes the Committee's role in the monitoring of risk.

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 acts as the audit committee for Bank of Scotland and is supported by divisional Risk Control Committees 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, GOR and GRR 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 business divisions' systems of internal control (including financial, operational and regulatory risk management).

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. The Head of Group Internal Audit has direct access to the Chairman of the Audit Committee and the Chief Executive.

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 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 GOR and GRR, which recommend and monitor compliance with Group policies and standards.

Group Risk Functions

The Group Chief Financial and Operational Risk Officer and the Head of Group Regulatory Risk report directly to the Group Finance Director and have direct access to the Chairman of the Audit Committee and the Chief Executive. Prior to 1 January 2004 the same senior executive had responsibility for GOR and GRR.

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

GFR has two main areas of focus for Bank of Scotland:

- 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.

GOR monitors compliance with Group policies and standards on operational risk, providing operational risk oversight of the implementation of those policies and standards. 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.

GRR focuses on supporting the GORRC to recommend policies and standards on regulatory risk and cultural issues for approval by the Board. It monitors compliance with those policies and standards and oversees the Group's adherence to regulatory requirements and communications with regulators on a Group-wide basis, with direct responsibility for relations with the Financial Services Authority (FSA), the Group's principal regulator.

Business and Financial Review – Financial Review and Risk Management (continued)

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. Divisional Risk Control Committees, which comprise at least two independent Non-executive Directors and an Executive Director independent of that division, provide objective assurance on the effectiveness of each division's internal control and risk management. These committees meet regularly to review the risks facing the relevant division's business and the techniques used to identify, assess and manage them. Each business division also has its own specialist risk functions and 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. Skilled persons report to the regulators if requested. The findings of such reports would also be 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 Group's principal activities are the provision of retail, business, corporate banking and treasury 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 is chaired 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. It also assists the Board in formulating the Group's credit risk appetite.

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. Typical functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts. A specialist support function within GFR provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance of each divisional portfolio to GCRC, GFR provides a challenge in terms of adherence to laid down standards, policies and limits.

In Retail Banking Division use is made, where it is practical to do so, of software technology in credit scoring new applications. In addition, where practical, behavioural scoring is used to provide an assessment of the conduct of a customer's accounts in granting extensions to, and setting limits for, existing facilities. 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.

Corporate Banking division typically 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. The same approach is also used for larger SME (small to medium enterprise) customers. Small business customers may be rated using scorecards in a similar manner to retail customers.

For HBOS Treasury Services plc (HBOSTS), a subsidiary of Bank of Scotland, policies are established and reviewed by the Group Wholesale Credit Committee, a sub-committee of GCRC.

An additional measure within the risk framework is the establishment of industrial sector and country limits. All such limits are set and monitored by 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.

Target and benchmark standards have been established across the Group for the management of credit risk, tailored to meet the demands of Basel II and the Integrated Prudential Sourcebook (PSB). All divisions are committed to continuously improving all facets of credit risk management and there have been significant levels of investment in the development of risk rating tools, including scorecards, better able to discriminate risk across the portfolio.

Operational Risk

The HBOS 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 divisional 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.

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 experts working within business areas. Reports on regulatory risk management are made by business areas and divisions to their Risk Control Committee and individual company Audit Committee. GRR provides a high level assessment to the Audit Committee.

Liquidity Risk

Liquidity risk is the risk that the Group will be unable to meet financial commitments arising from 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.

Liquidity policy, including specific limits and guidelines, is set by the HBOS Board. The responsibility to direct the management of liquidity and to report against policy is delegated to GALCO. Liquidity is managed on a Group basis. Overseas units may be subject to specific regulatory requirements, but the activities in such units are also reflected within Group policy.

Policy is reviewed at least annually to ensure its continued relevance to the Group's current and planned operations. Operational liquidity management is delegated to HBOSTS; GALCO oversees the controls exercised by HBOSTS.

The Group uses the FSA's Sterling Stock Liquidity approach. The key element of the FSA's Sterling Stock Liquidity policy is that a bank should hold a stock of high quality Sterling liquid assets that can be sold quickly and discreetly in order to replace funding that has been withdrawn due to an actual or perceived problem with the bank. The objective is that this stock should enable the bank to continue business whilst providing an opportunity to arrange more permanent funding solutions. The FSA have a prescriptive regime for retail banks that specifies the formula for determining both the quantum and type of assets qualifying for Sterling stock liquidity. Sterling stock liquidity is regarded as a 'cost' of doing business. It is not regarded as an operational liquidity pool as it will always be required in case of emergency. From an operational perspective, the Group will place greater reliance on market access to funding sources and the retention of a pool of diversified assets that can be sold in an efficient and discreet manner. The Board requires that prudential liquidity limits should be set by GALCO at both aggregate levels and for individual currencies in which the Group has significant wholesale funding. These limits are established by way of cashflow mismatch and are quantified over two time horizons – for sight to eight days and for sight to one month. For the purpose of calculation, marketable assets are subject to both instrument concentration limits and prudential discount factors. An assessment is also made for the possible outflow from customer deposits and committed facilities, determined by prudential behavioural modelling.

The funding capacity of the Group is dependent upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position. GALCO assesses the Group funding mix to ensure that adequate diversity is maintained. It is Group policy to manage its balance sheet profile to ensure customer deposits sourced outside of HBOSTS represents a significant component of its overall funding. Within HBOSTS, the Group avoids undue concentration by maintaining both a widespread mix of counterparties and inward credit lines and a core set of bank and non-bank depositor relationships providing a stable source of funding. GALCO approves the appropriate balance of short to medium term funding.

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

Business and Financial Review – Financial Review and Risk Management (continued)

Market Risk

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

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

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

- market risk is taken only in accordance with the Board's appetite for such risk;
- such risk is within the Group's financial capability, management understanding and staff competence;
- the Group complies with all regulatory requirements relating to the taking of market risk;
- the quality of the Group's profits is appropriately managed and its reputation safeguarded; and
- appropriate information on market risk is known to those making decisions, such that the taking of market risk is designed to enhance shareholder value.

Risk appetite is set by the Board who allocate responsibility for oversight and management of market risk to GALCO. Market risk is controlled across the Group by setting limits using a mixture of measurement methodologies. Detailed market risk framework documents and limit structures have been developed for each division. These are tailored to the specific market risk characteristics and business objectives of each operating division. Each Divisional policy document requires appropriate Divisional sanction, and is then forwarded to GALCO for approval on at least an annual basis. Group items (net free reserves, subordinated debt and structural foreign exchange) are governed by separate policies and limits/mandates as set by 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 Board limit for structural interest rate risk is expressed in terms of potential volatility of net interest income in adverse market conditions using an Earnings at Risk (EaR) methodology. The EaR methodology combines an analysis of the Group's current on and off- balance sheet risk position overlaid with behavioural assessment and repricing assumptions of planned future activity. In addition to this primary control, a number of other risk methodologies are applied to manage risk, including:

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

The Board has delegated authority to GALCO to allocate limits to business areas as appropriate within the overall risk appetite. In turn, GALCO has granted limits which represent the risk tolerance for each division. Core risk is required to be transferred to HBOSTS from the banking divisions. The residual risk in the banking divisions is primarily that related either to behavioural characteristics or to basis risk arising from imperfect correlations in the adjustment of rates earned and paid on different instruments with otherwise similar characteristics. Risk in the business divisions is measured by EaR. With respect to HBOSTS the primary risk measure is the impact attributable to a 1 basis point move in the yield curve. This is a more appropriate control given the nature of exposures that HBOSTS's banking book carries. These two measures have been calibrated and expressed as an EaR equivalent. GALCO undertakes to ensure that the aggregate exposure does not exceed the total Group risk appetite.

Sensitivity to interest rate movements is shown in Note 41 to the Accounts on page 63 which provides the year end repricing profile for the Group's financial assets and liabilities in the non-trading book, which includes lending, funding and liquidity activities.

Foreign Exchange Risk

The Board has delegated authority to GALCO to set structural foreign exchange limits. GALCO has established limits for foreign exchange transaction and translation risk: Transaction exposures arise primarily from profits generated in the overseas operations, which will be remitted back to the UK in sterling. Translation exposures arise due to earnings that are retained within the overseas operations and reinvested within their own balance sheet.

Structural foreign exchange exposures are set out in Note 43 to the Accounts on Page 64.

Trading

The Group's market risk trading activities are principally conducted by HBOSTS. This Group activity is subject to a Trading Policy Statement which is approved by the Board and limits set by GALCO.

Treasury Trading primarily centres around two activities: proprietary trading and trading on the back of customer flows. Both activities incur market risk, the majority being interest rate and foreign exchange rate exposure. The framework for managing the market risk in these activities requires detailed and tailored modelling techniques and is the responsibility of the Treasury Market Risk team.

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 2003 was £11.9million. 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 in the Treasury Trading business.

The current methodology for providing an aggregated VaR for the business uses very conservative assumptions. In order to assess the effectiveness of VaR the Group uses a technique known as backtesting which compares the daily profit and loss from trading activities to the VaR estimate for that day. Daily standard deviation of Trading P&L was £1.6 million.

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.

The Group's trading market risk exposure for the year ended 31 December 2003 is analysed in Note 42 on page 64 of the Accounts.

The regulatory capital charge for market risk trading exposures represents less than 2.43% of the Group's capital base.

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 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
Fixed and capped rate mortgage lending	Sensitivity to increases in interest rates	Pay fixed interest rate swaps 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 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 Matched swaps with embedded options

The Group's activity in derivatives is controlled within risk management limits set by the Board and overseen 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 38 of the Accounts on page 59.

Business and Financial Review – Financial Review and Risk Management (continued)

The Basel Capital Accord

Due to the growing complexity of the financial markets since 1988 the banking industry has responded by developing a suite of sophisticated risk management techniques. The new Basel Capital Accord (BIS II) was conceived against this background and is intended to encourage improvements in banks' ability to measure risk and to align capital requirements closely with risk management practices.

Since the publication of the first Consultative Document on BIS II, the Group has worked to ensure that its strategic programme to prepare for BIS II has complemented our own internal drive to invest in the development of market leading risk management and reporting systems.

The Group remains committed to the construction of an environment that improves the risk management practices of the industry. Whilst a delay to the publication of the final rules to mid-2004 has been announced, the Group remains committed to working towards the expected date of 1 January 2007 for the BIS II implementation.

Director's Report

The Directors have pleasure in presenting their Report & Accounts for the year ended 31 December 2003.

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 16. A list of the main subsidiary undertakings, and the nature of their business, is given in Note 52 to the Accounts on page 68.

Results and dividends

The profit before tax and exceptional items for the year ended 31 December 2003 amounted to £1,826 million (year ended 31 December 2002 – £1,373 million).

An interim dividend of £198 million was paid on 17 October 2003. The Directors recommend payment of a dividend of £317 million in respect of the year ended 31 December 2003.

Dividends on the 9 1/4% and 9 3/4% Non-Cumulative Irredeemable Preference Stocks for the half year ended 31 August 2003 were paid on 1 December 2003 and for the half year ended 28 February 2004 will be paid on 1 June 2004.

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 2003 in Bank of Scotland was 22 days (year ended 31 December 2002 – 23 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, Strategy and International Operations), 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. Sir Peter Burt retired as a director on 6 January 2003 and Gordon McQueen retired as a Director on 31 December 2003. Sir Bob Reid and Louis Sherwood will retire on 27 April 2004. Sir Ron Garrick, John Maclean, Mike Ellis and Anthony Hobson will retire by rotation at the Annual General Meeting and resolutions for their re-election will be proposed at the meeting. Katherine (Kate) Nealon and David Shearer have been appointed Directors of the Company with effect from 23 March 2004 and both will retire at the forthcoming Annual General Meeting and offer themselves for re-election.

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 £nil million (year ended 31 December 2002 – £2.3 million).

Share capital

Full details of the movements in the authorised and issued share capital during the year are provided in Note 33 to the Accounts on page 57.

Director's 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 2004

Appendix to Director's 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 31.12.03	Number of shares at 31.12.02
Governor		
George Mitchell	72,622	48,092
Executive Directors		
James Crosby	184,280	96,969
Mike Ellis	168,833	73,514
Phil Hodkinson	28,806	10,524
Andy Hornby	174,759	40,781
Gordon McQueen	73,115	54,709
Colin Matthew	72,366	54,084
Non-Executive Directors		
Charles Dunstone	100,000	100,000
Sir Ronald Garrick	17,306	9,799
Anthony Hobson	5,500	2,000
Brian Ivory	11,000	11,000
Coline McConville	2,070	2,070
John Maclean	5,038	5,036
Sir Bob Reid	29,496	28,195
Louis Sherwood	2,000	2,000
Lord Stevenson	166,541	97,096
Philip Yea	10,044	9,529

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 2003 over 4,514,752 ordinary shares (2002 – 7,830,342) as Trustees of the Bank of Scotland Profit Sharing Stock Ownership Scheme.

Brian Ivory has a non-beneficial interest over 4,500 ordinary shares (2002 – 4,500).

Note 2:

Certain Directors will receive further interests in the ordinary shares of HBOS arising out of the short-term incentive plans and, potentially, the long-term incentive plans as set out in Tables 2, 3, 4 and 5.

Note 3:

No Director had any interest in the preference shares of HBOS or in the loan or share capital of any HBOS Group undertaking at the beginning or 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 Plans – 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 and/or 2002 was taken in shares and these shares are retained in trust for three years, additional shares will also be transferred to the Directors. The basic shares shown below which have already vested are also included in Table 1. The additional shares shown below arise as a result of "sharekicker".

Appendix to Director's Report (continued)

Table 2

	Grant effective from	At 31.12.02 Basic shares	At 31.12.02 Additional shares	Granted in year Basic shares	Granted in year Additional shares	Released in year	At 31.12.03 Basic shares	At 31.12.03 Additional shares
James Crosby	Mar 2001	19,420	9,710				**19,420**	**9,710**
	Mar 2002	38,671	19,335				**38,671**	**19,335**
	Mar 2003			32,177	16,088		**32,177**	**16,088**
		58,091	29,045				**90,268**	**45,133**
Mike Ellis	Mar 2001	14,617	7,308				**14,617**	**7,308**
	Mar 2002	29,003	14,501				**29,003**	**14,501**
	Mar 2003			23,889	11,944		**23,889**	**11,944**
		43,620	21,809				**67,509**	**33,753**
Phil Hodkinson	Mar 2002	10,327	5,163				**10,327**	**5,163**
	Mar 2003			18,282	9,141		**18,282**	**9,141**
		10,327	5,163				**28,609**	**14,304**
Andy Hornby	Mar 2001	11,067	5,533				**11,067**	**5,533**
	Mar 2002	23,525	11,762				**23,525**	**11,762**
	Mar 2003			21,939	10,969		**21,939**	**10,969**
		34,592	17,295				**56,531**	**28,264**
Gordon McQueen	Mar 2003			18,406	9,203		**18,406**	**9,203**
							18,406	**9,203**
Colin Matthew	Mar 2002	11,384	5,692				**11,384**	**5,692**
	Mar 2003			18,282	9,141		**18,282**	**9,141**
		11,384	5,692				**29,666**	**14,833**
George Mitchell	Mar 2002	14,035	7,017				**14,035**	**7,017**
	Mar 2003			23,889	11,944		**23,889**	**11,944**
		14,035	7,017				**37,924**	**18,961**

Notes to Table 2

Note 1:

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

Plan	Share grant price £
Mar 2001 - Mar 2004	6.752
Mar 2002 - Mar 2005	7.68
Mar 2003 - Mar 2006	6.76

Note 2:

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

Appendix to Director's Report (continued)

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 31.12.02	Granted (G) or Lapsed (L) in year	Added as a result of performance	Dividend reinvestment shares	Vested in year	At 31.12.03
James Crosby	Jan 2000	62,684		62,684	16,492	141,860	
	Jan 2001	70,992					**70,992**
	Jan 2002	75,000					**75,000**
	Jan 2003		103,125 (G)				**103,125**
		208,676					**249,117**
Mike Ellis	Jan 2000	47,935		47,935	12,612	108,482	
	Jan 2001	53,435					**53,435**
	Jan 2002	56,250					**56,250**
	Jan 2003		76,562 (G)				**76,562**
		157,620					**186,247**
Andy Hornby	Jan 2000	80,752		80,752	21,246	182,750	
	Jan 2001	40,458					**40,458**
	Jan 2002	45,625					**45,625**
	Jan 2002		260,000 (G)				**260,000**
	Jan 2003		70,312 (G)				**70,312**
		166,835					**416,395**
Phil Hodkinson	Jan 2001	53,435					**53,435**
	Jan 2002	87,500					**87,500**
	Jan 2003		58,593 (G)				**58,593**
		140,935					**199,528**
Gordon McQueen	Jan 2002	45,625					**45,625**
	Jan 2003		61,718 (G)				**61,718**
		45,625					**107,343**
Colin Matthew	Jan 2002	45,625					**45,625**
	Jan 2003		58,593 (G)				**58,593**
		45,625					**104,218**
George Mitchell	Jan 2002	56,250					**56,250**
	Jan 2003		76,562 (G)				**76,562**
		56,250					**132,812**
Dennis Stevenson	July 1999	15,853		6,143	3,159	25,155	
	Jan 2000	36,873		36,873	9,700	83,446	
	Jan 2001	38,168					**38,168**
	Jan 2002	56,250					**56,250**
	Jan 2003		77,343 (G)				**77,343**
		147,144					**171,761**

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 and performance period	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
January 2003 – December 2005/07	6.40

Appendix to Director's Report (continued)

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:

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 has been released to the grant recipient.

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 have been released to grant recipients.

The shares granted in July 1999 and January 2000 vested on 3 March 2003. The closing market price of the Group's ordinary shares on that date was £6.68. In addition, dividend reinvestment shares have been released to grant recipients as set out in the table and as provided for under the rules of the Plans. The dividend reinvestment shares are the additional shares which would have accrued on the overall share grants actually released had dividends due during the performance period been reinvested in shares. The shares received by the Executive Directors and Lord Stevenson from those grants are, after any sales to discharge their personal tax and National Insurance liabilities on such shares, retained by them or on their behalf for at least an additional two years and are included in Table 1.

Note 5:

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, the shares granted under the long-term plan effective from January 2001 will be released to most individuals shortly after the three-year anniversary of the grant date. However, the shares receivable by the Executive Directors and Lord Stevenson from those grants will, after any sales to discharge their personal tax and National Insurance liabilities on such shares, be retained by them on their behalf for at least an additional two years.

For the 2002 and 2003 grants, all participants can choose to take any shares released after three years based on the three year performance outcome 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. This feature will not apply for the 2004 grants or for any grants in subsequent years.

Note 6:

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

Note 7:

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. For the grants effective from January 2002 and January 2003, a five year period can also apply. 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 and 2003 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.

Appendix to Director's Report (continued)

Shares will be released as follows:

HBOS Group's relative TSR performance	Amount released as a % of share grant
1999, 2000 and 2001 grants	
0% p.a. (or below)	0
+4% p.a.	100*
+8% p.a. (or above)	200
2002 and 2003 grants	
0% p.a. (or below)	0
+3% p.a.	100*
+6% p.a. (or above)	200

Intermediate positions are determined by interpolation.

* As shown as granted in the table.

Note 8:

The performance period for the January 2001 grant ended on 31 December 2003. HBOS's (and previously Halifax's) TSR over the performance period exceeded the weighted average of the comparator group by 13.45% pa, so 200% of share grants will be released to grant recipients, subject to Note 5 above.

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

Full details concerning these shares, which will be released to Lord Stevenson and the Executive Directors during 2004, will be contained in the 2004 Annual Report and Accounts.

Note 9:

The second grant effective from January 2002 for Andy Hornby relates to a different arrangement which applies only to him. Early in 2003, the Committee became aware of activity, principally from the retail sector, to secure Andy Hornby's services. Specifically, he had received a very attractive job approach to become Group Chief Executive of a major FTSE company. The Committee decided that, at that point in time, it would clearly be in the interests of shareholders to secure Andy Hornby's continued services but to do it on a basis where additional reward was performance contingent.

The Committee therefore decided to introduce a special incentive arrangement which gives Andy Hornby the opportunity to receive up to 260,000 shares in April 2005, dependent on growth in the profitability of HBOS Retail division over 2002 to 2004. In broad terms, the maximum release under this special arrangement is delivered in April 2005 only if there is at least a 60% increase in the profitability of HBOS Retail division, using a like for like comparison, over the three year period, and provided that Andy Hornby is in the service of HBOS Group at 31 March 2005 having not given notice on or before that date. The Committee established that the incentive would accrue in three equivalent tranches based on profitability performance to the ends of 2002, 2003 and 2004. At the time of establishment of the incentive, the satisfaction of performance criteria to the end of 2002 established an immediate retention feature within the scheme. Since then, performance criteria to the end of 2003 have also been satisfied.

If Andy Hornby leaves employment as a good leaver or in the event of a change of control before April 2005, shares will vest by reference to the performance targets and his period of employment during the performance period. If he leaves in certain other circumstances, he will not receive any shares. Changes to certain key terms of the arrangement, in future, will require shareholder approval.

The special incentive is not pensionable. At maturity it will be eligible for the 50% share enhancement if Andy Hornby retains the shares and remains in the service of HBOS Group until 31 March 2008.

Taken overall, this special incentive increases the maximum annual overall reward value for Andy Hornby by about 25% in each of the three years until the end of 2004 and by about 12.5% in each of the subsequent three years until the end of 2007.

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 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 applied 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 was satisfied on 31 December 2002 for all grants and consequently all approved options are exercisable in accordance with the rules of the plans.

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

Appendix to Director's Report (continued)

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

Table 4

	Grant effective from	At 31.12.02	Granted (G), exercised (E) or lapsed (L) in year	At 31.12.03	Share Option Price £	Exercisable
Gordon McQueen	October 1995	48,000		**48,000**	2.5983	Jan 2004 - Jun 2004
	October 1996	45,000		**45,000**	2.7367	Jan 2004 - Jun 2004
	October 1997	32,000		**32,000**	5.3533	Jan 2004 - Jun 2004
	October 1998	5,223		**5,223**	5.7433	Jan 2004 - Jun 2004
	October 1998	29,777		**29,777**	5.8350	Jan 2004 - Jun 2004
	May 2000	35,000		**35,000**	5.5150	Jan 2004 - Jun 2004
	October 2000	40,000		**40,000**	6.1000	Jan 2004 - Jun 2004
		235,000		**235,000**		
Colin Matthew	October 1995	48,000		**48,000**	2.5983	Jan 2004 - Oct 2005
	October 1996	50,000		**50,000**	2.7367	Jan 2004 - Oct 2006
	October 1997	28,000		**28,000**	5.3533	Jan 2004 - Oct 2007
	October 1998	5,223		**5,223**	5.7433	Jan 2004 - Oct 2008
	October 1998	29,777		**29,777**	5.8350	Jan 2004 - Oct 2008
	May 2000	40,000		**40,000**	5.5150	Jan 2004 - May 2010
	October 2000	40,000		**40,000**	6.1000	Jan 2004 - Oct 2010
		241,000		**241,000**		
George Mitchell	October 1996	50,000		**50,000**	2.7367	Jan 2004 - Oct 2006
	October 1997	35,000		**35,000**	5.3533	Jan 2004 - Oct 2007
	October 1998	40,000		**40,000**	5.8350	Jan 2004 - Oct 2008
	May 2000	5,572		**5,572**	5.3833	Jan 2004 - May 2010
	May 2000	39,428		**39,428**	5.5150	Jan 2004 - May 2010
	October 2000	50,000		**50,000**	6.1000	Jan 2004 - Oct 2010
		220,000		**220,000**		

Notes to Table 4

No Executive Directors' share options lapsed in the period 1 January 2004 to 24 February 2004, the date of approval of this Annual Report and Accounts. On 23 February 2004, Gordon McQueen, who retired as an Executive Director on 31 December 2003, exercised options over 29,777, 35,000 and 40,000 shares granted effective from October 1998, May 2000 and October 2000, respectively. The closing market price on the date of exercise was £7.555. Gordon McQueen retained ownership of these shares as at the date of this report. Details of the market price of the HBOS ordinary shares during 2003 are given in 1.1.7.

Appendix to Director's Report (continued)

1.1.5 Sharesave Plan

The sharesave plan is available to most HBOS 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, based on a market price or average market price determined shortly before the effective grant date and discounted by 20%.

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 31.12.02	Granted (G), lapsed (L) or exercised (E) in year	At 31.12.03	Initial exercise date	Expiry date
James Crosby	Sep 2002	2,748		**2,748**	Jan 2008	Jun 2008
Phil Hodkinson	Sep 2002	2,970		**2,970**	Jan 2010	Jun 2010
Andy Hornby	Oct 2000	2,362	2,362 (E)		Oct 2003	Apr 2004
	Sep 2003		1,607 (G)	**1,607**	Jan 2007	Jun 2007
Gordon McQueen	Nov 2000	3,571		**3,571**	Jan 2004	Jun 2004
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 £
October 2000	4.10
November 2000	4.7253
October 2001	5.62
September 2002	5.975
September 2003	5.74

Note 2:

Sharesave options for Andy Hornby were exercised in October 2003 and he has bought the number of shares under option. The market price on the date of exercise was £7.165.

Note 3:

In 2002 sharesave options over 2,980 shares were exercised by both James Crosby and Mike Ellis in October 2002 and December 2002 respectively. The market prices on the dates of exercise were £5.65 and £6.265 respectively.

Note 4:

Details of the market price of the HBOS ordinary shares during 2003 are given in 1.1.7.

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 2003 as being interested in the 9,884,870 ordinary shares (31 December 2002 – 8,606,603 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 and the HBOS 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. As such, they were each treated as at 31 December 2003 as being interested in the 10,154,710 ordinary shares (31 December 2002 - 14,626,075 ordinary shares) held by the trustee of this Trust. On 12 June 2002 HBOS plc purchased the shares held by the Halifax plc Qualifying Employee Share Ownership Trust for a consideration of £1,000 and on the same day HBOS plc issued the same number of new ordinary shares, at their nominal value of 25p per share, to the 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 Trust was established to satisfy the exercise of rights granted under the HBOS Sharesave Scheme and 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; and

Appendix to Director's Report (continued)

- 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 2002 and 31 December 2003 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.

All of the HBOS Group's share plans empower new issue shares to be allotted to satisfy share requirements. HBOS' current practice on releases in relation to share grants, namely conditional share awards for our most senior colleagues and both colleague financed and Group matched shares under the sharekicker arrangement, is to purchase shares in the market. For share interests through the HBOS Group's share option and sharesave plans, new shares are issued.

1.1.7 General

The market price of HBOS ordinary shares at 31 December 2003 was £7.235. The market price of HBOS ordinary shares at 31 December 2002 was £6.55. The range during the year was £5.38 to £8.12.

Other than as disclosed in the notes to Table 4, there has been no change in the Directors' interest in shares or options granted by HBOS plc between the end of the financial year and 24 February 2004, 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 28, 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; and
- 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 29 to 69.

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 Proprietors 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 page 27, 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, 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 2003 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 2004

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.

Basis of Consolidation

i) Consolidation

The consolidated accounts include the results of the Bank and its subsidiary undertakings. The accounts of all principal subsidiary undertakings are made up to 31 December.

ii) Associated Undertakings (including 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. 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. The attributable share of results of other associated undertakings, generally based on audited accounts, is included in consolidated profit using the equity method of accounting.

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 (including 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, not exceeding 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 Financial Reporting Standard ('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.

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 net 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 net 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.

Where the Group acts as intermediary, commission income net of provisions for expected future policy cancellations and claims handling are credited to fees and commissions 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 the 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 any 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 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 as a deduction 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 finance leases with third party lessors are included in customer accounts.

Accounting Policies (continued)

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 other operating income 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 in the balance sheet as debt securities where substantially all the risks and rewards do not pass to the Group. In this case, the purchase price is included within loans and advances to banks or loans and advances to customers. The difference between sale and repurchase prices for such transactions is reflected in the profit and loss account over the lives of the transactions, within interest payable or interest receivable as appropriate.

Equity Shares

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

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 operating expenses.

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), based on the corporation tax rate expected when the timing difference reverses.

Dated and Undated Loan Capital

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

Interest Receivable and Payable

Interest receivable and payable is recognised in the profit and loss account on an accruals basis.

Fees and Commissions

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.

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

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'.

Accounting Policies (continued)

Foreign Currencies

Assets, 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 and 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 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 the same basis as the underlying items being hedged.

In order to qualify as a hedge, a derivative must effectively reduce any risk inherent in the hedged item from potential movements in interest rates, exchange rates and market values. Changes in the fair value of the derivative must be highly correlated with changes in the fair value of the underlying hedged item over the life of the 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 remainder of the original life of the hedge contract. In other circumstances, where the underlying item subject to the hedge is extinguished, the hedge transaction is measured at fair value and any profit or loss is recognised immediately.

Consolidated Profit and Loss Account

For the year ended 31 December 2003

	Notes	31 December 2003 £ million	31 December 2003 £ million	31 December 2002 £ million	31 December 2002 £ million
Interest receivable					
Interest receivable and similar income arising from debt securities			617		567
Other interest receivable			11,004		9,518
			11,621		10,085
Interest payable			(8,785)		(7,710)
Net interest income			2,836		2,375
Fees and commissions receivable			1,149		1,054
Fees and commissions payable			(309)		(254)
Dealing profits	1		176		111
Other operating income			555		465
Net operating income (all from continuing operations)	1		4,407		3,751
Administrative expenses	2	(1,566)		(1,494)	
Depreciation and amortisation					
Tangible fixed assets	23	(94)		(89)	
Operating lease assets	24	(313)		(274)	
Goodwill amortisation	22	(18)		(12)	
		(425)		(375)	
Operating expenses			(1,991)		(1,869)
Provisions for bad and doubtful debts	17		(682)		(618)
Amounts written off fixed asset investments	18, 19		(29)		(33)
Operating profit (all from continuing operations)			1,705		1,231
Before exceptional items		1,762		1,308	
Exceptional items	3	(57)		(77)	
Share of operating profits of joint ventures			35		13
Share of operating profits of other associated undertakings			29		27
Profit on disposal of business					25
Profit on ordinary activities before taxation			1,769		1,296
Before exceptional items		1,826		1,373	
Exceptional items	3	(57)		(77)	
Tax on profit on ordinary activities	9		(550)		(402)
Profit on ordinary activities after taxation			1,219		894
Before exceptional items		1,259		949	
Exceptional items	3	(40)		(55)	
Minority interests (equity)			(28)		(36)
(non-equity)			(42)		(32)
Profit attributable to Proprietors			1,149		826
Dividends	10				
Ordinary		515		371	
Preference		37		37	
			552		408
Retained profit of the year	11		597		418
Underlying earnings per Ordinary Stock unit	12		76.2p		60.9p
Basic earnings per Ordinary Stock unit	12		72.4p		56.1p

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 29 to 31 and the notes on pages 38 to 69 form part of these accounts.

Consolidated Balance Sheet

As at 31 December 2003

	Notes	31 December 2003 £ million		31 December 2002 £ million	
Assets					
Cash and balances at central banks			1,081		1,049
Items in course of collection			442		596
Treasury bills and other eligible bills	13		7,926		5,836
Loans and advances to banks	14		45,980		45,211
Loans and advances to customers		131,121		104,323	
Less: non-returnable finance	15	(4,963)		(3,090)	
	15		126,158		101,233
Debt securities	18		49,827		42,836
Equity shares	19		216		223
Interests in joint ventures					
Share of gross assets		3,512		2,763	
Share of gross liabilities		(3,358)		(2,602)	
	20(i)		154		161
Interests in other associated undertakings	20(ii)		191		172
Intangible fixed assets	22		422		147
Tangible fixed assets	23		572		550
Operating lease assets	24		1,771		1,540
Other assets	26		6,795		6,246
Prepayments and accrued income			2,440		1,291
Total assets			243,975		207,091
Liabilities					
Deposits by banks	27		50,203		50,105
Customer accounts	28		69,325		57,712
Debt securities in issue	29		97,188		76,908
Notes in circulation			814		821
Corporate taxation			298		238
Dividends payable	10		329		383
Other liabilities	30		8,916		7,201
Accruals and deferred income			2,284		1,934
Provisions for liabilities and charges					
Deferred taxation	31(i)	253		348	
Other provisions	31(ii)	97		131	
			350		479
Subordinated liabilities	32				
Dated loan capital		3,663		3,046	
Undated loan capital		1,994		1,709	
			5,657		4,755
			235,364		200,536
Capital & reserves					
Called up share capital	33				
Ordinary stock		410		367	
Preference stock (non-equity)		400		400	
		810		767	
Share premium account	34	2,951		1,794	
Other reserves	34	(2)		(19)	
Profit and loss account	34	4,008		3,411	
Proprietors' funds (including non-equity interests)	35		7,767		5,953
Minority interests (equity)			11		202
Minority and other interests (non-equity)	36		833		400
			8,611		6,555
Total liabilities			243,975		207,091

Consolidated Balance Sheet (continued)

As at 31 December 2003

	Notes	31 December 2003 £ million	31 December 2002 £ million
Memorandum Items	37		
Contingent liabilities			
Acceptances and endorsements		**130**	156
Guarantees and assets pledged as collateral security		**3,193**	2,770
		3,323	2,926
Commitments			
Other commitments		**36,883**	31,887

Approved by the Board on 24 February 2004 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 29 to 31 and the notes on pages 38 to 69 form part of these accounts.

Balance Sheet

As at 31 December 2003

	Notes		31 December 2003 £ million		31 December 2002 £ million
Assets					
Cash and balances at central banks			881		895
Items in course of collection			442		596
Loans and advances to banks	14		22,038		14,719
Loans and advances to customers		89,628		74,262	
Less: non-returnable finance	15	(4,843)		(2,940)	
	15		84,785		71,322
Debt securities	18		596		934
Equity shares	19		55		58
Interests in associated undertakings	20(ii)		81		76
Interests in group undertakings	21		1,945		1,894
Intangible fixed assets	22		70		
Tangible fixed assets	23		389		373
Deferred tax asset	31(i)		145		127
Other assets			268		242
Prepayments and accrued income			693		546
Total assets			112,388		91,782
Liabilities					
Deposits by banks	27		52,162		41,946
Customer accounts	28		42,672		34,554
Debt securities in issue	29		2,960		2,540
Notes in circulation			814		821
Corporate taxation			186		164
Dividends payable	10		329		383
Other liabilities			846		683
Accruals and deferred income			612		557
Provisions for liabilities and charges					
Other provisions	31(ii)		81		113
Subordinated liabilities	32				
Dated loan capital		2,998		2,947	
Undated loan capital		2,347		2,062	
			5,345		5,009
			106,007		86,770
Capital & reserves					
Called up share capital	33				
Ordinary stock		410		367	
Preference stock (non-equity)		400		400	
		810		767	
Share premium account	34	2,951		1,794	
Other reserves	34	53		68	
Profit and loss account	34	2,567		2,383	
Proprietors' funds (including non-equity interests)	35		6,381		5,012
Total liabilities			112,388		91,782

Balance Sheet (continued)

As at 31 December 2003

	Notes	31 December 2003 £ million	31 December 2002 £ million
Memorandum Items	37		
Contingent liabilities			
Acceptances and endorsements		**55**	148
Guarantees and assets pledged as collateral security		**10,958**	4,065
		11,013	4,213
Commitments			
Other commitments		**29,247**	24,784

Approved by the Board on 24 February 2004 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 29 to 31 and the notes on pages 38 to 69 form part of these accounts.

Consolidated Statement of Total Recognised Gains and Losses

For the year ended 31 December 2003

	Year ended 31 December 2003 £ million	Year ended 31 December 2002 £ million
Profit attributable to Proprietors	**1,149**	826
Exchange translation	**17**	3
Total recognised gains and losses in the year	**1,166**	829

Consolidated Cash Flow Statement

For the year ended 31 December 2003

	Notes	Year ended 31 December 2003 £ million	Year ended 31 December 2002 £ million
Net cash (outflow)/inflow from operating activities	45	**(6,622)**	41,544
Dividends received from joint ventures		**41**	39
Dividends received from other associated undertakings		**3**	2
Returns on investments and servicing of finance	46(i)	**(400)**	(341)
Taxation		**(445)**	(244)
Capital expenditure and financial investment	46(ii)	**(5,779)**	(15,472)
		(13,202)	25,528
Acquisitions and disposals	46(iii)	**(129)**	(106)
Equity dividends paid		**(569)**	(246)
Net cash (outflow)/inflow before financing		**(13,900)**	25,176
Financing	46(iv)	**2,060**	2,299
(Decrease)/increase in cash	48	**(11,840)**	27,475

The statement of accounting policies on pages 29 to 31 and the notes on pages 38 to 69 form part of these accounts.

Notes on the Accounts

1. Net Operating Income

		2003 £ million		2002 £ million
Net operating income includes:				
Dividend income from equity shares		8		6
Finance lease rental income		728		702
Operating lease rental income		452		410
Profit on sale of investment securities		34		31
Mortgage incentives		(163)		(76)
Interest payable on subordinated liabilities		(310)		(259)
Dealing profits				
Foreign exchange	64		58	
Interest related	112	176	53	111

Dealing profits arise from the Group's trading book. The types of instrument in which the Group trades are as set out in Note 38.

2. Administrative Expenses

	Notes	2003 £ million	2002 £ million
Administrative expenses includes:			
Staff costs	4	791	680
Property rentals		48	36

3. Exceptional Items

Included within administrative expenses, exceptional costs have been charged as follows:

	Notes	2003 £ million	2002 £ million
HBOS merger integration costs	(a)	(57)	(77)
Tax effect		17	22
		(40)	(55)

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

Notes on the Accounts (continued)

4. Staff

	2003 Number	2002 Number
The average number of persons employed by the Group during the year was:		
Full time	19,026	17,811
Part time	4,879	4,347
	23,905	22,158

	2003 £ million	2002 £ million
The aggregate remuneration payable to those employees comprises:		
Wages and salaries	672	571
Social security costs	56	49
Other pension costs (Note 8)	63	60
Staff cost charged to administrative expenses	791	680

5. Directors' Remuneration

The directors of Bank of Scotland during the year were also directors of HBOS plc. No director received emoluments for qualifying services to Bank of Scotland in the year ended 31 December 2003 or the comparative period. Full details of the directors remuneration are disclosed in the 2003 HBOS plc Annual Report and Accounts within the 'Report of the Board in relation to remuneration policy and practice'.

Notes on the Accounts (continued)

6. Auditors' Remuneration

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

	2003			2002		
	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**	1.4	0.4	1.8
As auditors or reporting accountants	**0.9**	**0.2**	**1.1**	0.8	0.2	1.0
	2.3	**0.6**	**2.9**	2.2	0.6	2.8
Accounting, advisory and consultancy	**0.4**	**0.4**	**0.8**	1.0	0.1	1.1
Tax advisory	**0.2**	**0.2**	**0.4**	0.3	0.2	0.5
	2.9	**1.2**	**4.1**	3.5	0.9	4.4
Bank						
Statutory audit	**0.2**		**0.2**	0.2		0.2
Other	**0.1**	**0.2**	**0.3**	1.6		1.6

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.

The Committee reviews the auditors' independence and an audit tender process will be undertaken at least every 5 years commencing in 2005.

7. Operating Leases

	Group				Bank			
	2003		2002		2003		2002	
	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		**2**	1	2			1	
between 1 and 5 years	**8**	**22**	7	35	**2**	**20**	2	33
after 5 years	**38**		30		**26**		18	
	46	**24**	38	37	**28**	**20**	21	33

Notes on the Accounts (continued)

8. 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 82 per cent of the Group's pensionable employees in a scheme providing 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 independently 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 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 installments plus interest on the reducing balance. These elements, together with interest on the opening balance sheet position result in a charge of £54 million (2002 – £54 million). Included in the charge is an exceptional charge of £1 million (2002 - £1 million).

Contributions to the Scheme of £61 million were paid over the year. As contributions differ from the amount charged in the Profit and Loss Account a provision of £75 million (2002 – £82 million) 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 £9 million (2002 – £6 million) relating to schemes other than the Scheme.

Notes on the Accounts (continued)

8. Pension Costs (continued)

FRS 17

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 FRS17 and to assess the assets and liabilities of the scheme as at 31 December 2003, have been used in assessing the FRS17 disclosures. Scheme assets are stated at their market value at 31 December 2003.

The liabilities of the Schemes under FRS 17 were calculated using the Projected Unit method and the following financial assumptions:

	Rates per annum at 31 December 2003	Rates per annum at 31 December 2002	Rates per annum at 31 December 2001
Future price inflation	2.8 per cent	2.4 per cent	2.5 per cent
Discount rate	5.6 per cent	5.8 per cent	6.0 per cent
Increases in earnings*	3.8 per cent	3.4 per cent	3.5 per cent
Increases in pensions**	2.8 per cent	2.4 per cent	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 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:

	Expected rate of return per annum at 31 December 2003	Value at 31 December 2003 £ million	Expected rate of return per annum at 31 December 2002	Value at 31 December 2002 £ million	Expected rate of return per annum at 31 December 2001	Value at 31 December 2001 £ million
Equities	8.50 per cent	962	8.50 per cent	864	7.75 per cent	1,050
Bonds	5.20 per cent	246	5.00 per cent	254	5.25 per cent	286
Cash	3.80 per cent	165	3.80 per cent	55	4.50 per cent	73
Total market value of assets		1,373		1,173		1,409
Present value of liabilities of the Scheme		1,903		1,567		1,423
Deficit in the Scheme		530		394		14
Potential deferred tax asset		(159)		(118)		(4)
Net pension liability		371		276		10

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

	Year ended 31 December 2003 £ million	Year ended 31 December 2002 £ million
Deficit in the Scheme at beginning of year	(394)	(14)
Contributions paid	61	50
Current service cost	(68)	(55)
Past service cost		(12)
Other finance income		15
Actuarial loss	(129)	(378)
Deficit in the Scheme at end of year	(530)	(394)

Notes on the Accounts (continued)

8. Pension Costs (continued)

Components of defined benefit cost for the year

Analysis of amounts that would be charged to operating profit	Year ended 31 December 2003 £ million	Year ended 31 December 2002 £ million
Current service cost	68	55
Past service cost		12
Total that would be charged to operating profit	68	67

Analysis of amount that would be charged to other finance income

Interest on pension scheme liabilities	89	83
Expected return on assets in pension scheme	(89)	(98)
Net amount that would be credited to other finance income		(15)
Total potential profit and loss charge before deduction for tax	68	52

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

	Year ended 31 December 2003 £ million	Year ended 31 December 2002 £ million
(Gain)/Loss on assets	(103)	329
Experience loss on liabilities	9	19
Loss on change of assumptions (financial and demographic)	223	30
Total potential loss recognised in STRGL before tax	129	378

History of experience gains and losses

	Year ended 31 December 2003	Year ended 31 December 2002
(Gain)/Loss on Scheme assets		
Amount (£ million)	(103)	329
% of Scheme assets at end of year	8%	28%
Experience loss on Scheme liabilities		
Amount (£ million)	9	19
% of Scheme liabilities at end of year	Nil	1%
Total actuarial loss recognised in Statement of Total Recognised Gains and Losses		
Amount (£ million)	129	378
% of Scheme liabilities at end of year	7%	24%

9. Taxation

	2003 £ million	2002 £ million
UK Corporation Tax at 30 per cent (2002 – 30 per cent)	420	308
Relief for overseas taxation	(21)	(17)
	399	291
Overseas taxation	104	87
Share of joint ventures' taxation	23	9
Share of other associated undertakings' taxation	6	5
Total current corporation tax	532	392
Deferred taxation (Note 31(i))	18	10
Tax on profit on ordinary activities	550	402

Notes on the Accounts (continued)

9. Taxation (continued)

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

	2003 £ million	2002 £ million
Profit on ordinary activities before taxation	**1,769**	1,296
Profit on ordinary activities multiplied by the standard rate of corporation tax in the UK of 30 per cent (2002 – 30 per cent)	**531**	389
Effects of:		
Expenses not deductible for tax purposes	**26**	12
Capital allowances in excess of depreciation	**(20)**	(31)
Net effect of differing tax rates overseas	**(11)**	(2)
Book gains covered by capital losses/indexation	**(1)**	(5)
Deductible interest on innovative tier 1 capital	**(10)**	(10)
Expenditure qualifying for capital allowances		6
Amounts written off fixed asset investments	**2**	10
Other timing differences	**35**	3
Adjustments in respect of previous periods	**(22)**	20
Others	**2**	
Current corporation tax charge for year	**532**	392

10. Dividends

	2003 £ million	2002 £ million
Preference dividends paid	**25**	25
payable	**12**	12
	37	37
Ordinary dividend		
Interim dividend	**198**	
Proposed final dividend	**317**	371
	515	371
	552	408

11. Retained Profit

	2003 £ million	2002 £ million
The profit of the Group has been retained by		
Bank of Scotland	**184**	302
Subsidiary undertakings	**422**	131
	606	433
Joint ventures and other associated undertakings	**(9)**	(15)
	597	418

Of the profit attributable to Proprietors, £736m (2002 - £710m) is dealt with within the accounts of the Company. 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)

12. Earnings per ordinary stock unit

Basic earnings per ordinary stock unit are based upon Group profit attributable to Proprietors of £1,112 million (2002 – £789 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 £1,170 million (2002 – £856 million). For the basic and underlying earnings per ordinary stock unit the weighted average number of 25p ordinary stock units of 1,535 million (2002 – 1,406 million) is used. Group profit attributable to Proprietors equals profit attributable to Proprietors of £1,149 million (2002 – £826 million) less preference dividends of £37 million (2002 – £37 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.

	2003 pence	2002 pence
Basic earnings per ordinary stock unit	72.4	56.1
Exceptional items:		
Exceptional merger costs and administrative expenses	2.6	3.9
Goodwill amortisation	1.2	0.9
Underlying earnings per ordinary stock unit	76.2	60.9

13. Treasury Bills and other Eligible Bills

	2003		2002	
	Book Value £ million	Market Value £ million	Book Value £ million	Market Value £ million
Investment securities				
Treasury bills and similar securities	6,088	6,087	3,576	3,577
Other eligible bills	387	390	302	303
	6,475	6,477	3,878	3,880
Other securities				
Treasury bills and similar securities	1,315	1,315	1,118	1,118
Other eligible bills	136	136	840	840
	1,451	1,451	1,958	1,958
	7,926	7,928	5,836	5,838

	Group £ million
The movement on treasury bills and other eligible bills held for investment purposes was as follows:	
At 1 January 2003	3,878
Exchange translation	128
Additions and transfers	10,319
Disposals	(7,987)
Amortisation	137
At 31 December 2003	6,475
Aggregate unamortised discounts net of premiums at 31 December 2003	33

Notes on the Accounts (continued)

14. Loans and Advances to Banks

	Group		Bank	
	2003 £ million	2002 £ million	2003 £ million	2002 £ million
Repayable on demand or at short notice	16,137	28,009	10,131	5,287
Other loans and advances repayable				
in 3 months or less excluding on demand or at short notice	23,821	14,012	5,312	2,892
1 year or less but over 3 months	5,158	2,007	530	735
5 years or less but over 1 year	494	406	309	694
over 5 years	370	777	5,756	5,111
Loans and advances to banks	45,980	45,211	22,038	14,719
Included above are loans to subsidiary undertakings				
Subordinated			1,442	1,300
Unsubordinated			19,517	12,476
Fellow subsidiary undertakings – unsubordinated	31,757	34,695	14	49

15. Loans and Advances to Customers

	Group		Bank	
	2003 £ million	2002 £ million	2003 £ million	2002 £ million
Repayable on demand or at short notice	18,246	15,627	15,864	14,660
Other loans and advances repayable				
in 3 months or less excluding on demand or at short notice	29,088	22,730	24,675	18,680
1 year or less but over 3 months	9,602	8,181	5,136	4,498
5 years or less but over 1 year	19,681	19,086	10,067	10,080
over 5 years	51,097	37,074	30,137	24,386
	127,714	102,698	85,879	72,304
Provisions for bad and doubtful debts (Note 17)	(1,408)	(1,324)	(1,002)	(900)
Interest in suspense	(148)	(141)	(92)	(82)
Loans and advances to customers	126,158	101,233	84,785	71,322

Included above are loans to:

	Group 2003	Group 2002	Bank 2003	Bank 2002
Subsidiary undertakings			2,433	2,052
Fellow subsidiary undertakings	245	153	245	35
Ultimate parent undertaking	10	3	10	3
Joint Ventures and associated undertakings	6,008	4,133	3,949	2,600

Group loans and advances to customers include finance lease receivables of £3,078 million (2002 – £3,064 million). Assets acquired in the year for letting under finance leases amounted to £882 million (2002 – £827 million).

The Group's lending exposure, after the deduction of non-returnable finance and before the deduction of provisions for bad and doubtful debts and interest in suspense, is analysed below.

	2003 £ million	2002 £ million
Agriculture, forestry and fishing	1,194	1,095
Energy	1,511	1,491
Manufacturing industry	6,010	5,630
Construction and property	23,914	16,435
Hotels, restaurants and wholesale and retail trade	8,889	8,128
Transport, storage and communication	2,764	2,863
Financial	11,867	6,532
Other services	14,321	11,712
Individuals		
Home mortgages	38,625	28,517
Other personal lending	9,244	10,200
Overseas residents	9,375	10,095
	127,714	102,698

Notes on the Accounts (continued)

15. Loans and Advances to Customers (continued)

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

		At 31 December 2003				At 31 December 2002			
		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	120		120		150		150	
Mound Financing (No. 1) PLC	Mortgages	617	617	616	616	750	750	748	748
Mound Financing (No. 2) PLC	Mortgages	525	525	524	524	750	750	748	748
Melrose Financing No. 1 plc	Corporate Loans	1,500	1,500	1,445	1,445	1,500	1,500	1,444	1,444
Mound Financing (No. 3) PLC	Mortgages	2,261	2,261	2,258	2,258				
		5,023	4,903	4,963	4,843	3,150	3,000	3,090	2,940

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 are required to support any losses that may be suffered by the noteholders in accordance with the terms of the notes nor is it intended to do so. Repayment of the non-recourse funding facilities will be made solely from the cashflows generated by the underlying loan portfolios. 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.

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 June 2003 £2,261 million of mortgage loans were securitised through Mound Financing (No. 3) PLC.

In aggregate the securitisation undertakings had net interest income of £15.1 million (2002 – £6.1 million), operating expenses of £5.4 million (2002 – £3.6 million), provisions for bad and doubtful debts of £9.8 million (2002 – £2.5 million), resulting in a loss for the year of £0.1 million (2002 – £nil).

16. Non-Performing assets

Non-performing loans and advances amount to £2,965 million (2002 – £2,615 million) including £1,077 million (2002 – £1,145 million) of advances on which interest is being held in suspense. Net of provisions and interest in suspense, non-performing loans amount to £1,409 million (2002 – £1,150 million).

17. Provisions for Bad and Doubtful Debts

	Group			Bank		
	Specific £ million	General £ million	Total £ million	Specific £ million	General £ million	Total £ million
At 1 January 2003	854	470	1,324	591	309	900
Exchange movements	4	12	16	(4)		(4)
Disposal of subsidiary undertakings and transfers	(27)	(4)	(31)	(4)	1	(3)
New provisions less releases	669	46	715	549	31	580
Amounts written off	(616)		(616)	(471)		(471)
Cumulative provisions as at 31 December 2003	884	524	1,408	661	341	1,002
New provisions less releases	669	46	715	549	31	580
Recoveries of amounts previously written off	(33)		(33)	(13)		(13)
Net charge to profit and loss account	636	46	682	536	31	567

Notes on the Accounts (continued)

18. Debt Securities

	2003				2002			
	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	211		211	210	232		232	233
Others	1,426	16,552	17,978	17,990	1,318	13,840	15,158	15,151
Unlisted								
Certificates of deposit issued by banks and building societies		3,040	3,040	3,040		1,962	1,962	1,963
Others		6,847	6,847	6,847	14	6,314	6,328	6,271
Total investment securities	1,637	26,439	28,076	28,087	1,564	22,116	23,680	23,618
Other securities								
Listed	540	2,749	3,289	3,289	486	1,826	2,312	2,312
Unlisted		18,462	18,462	18,462		16,844	16,844	16,844
	2,177	47,650	49,827	49,838	2,050	40,786	42,836	42,774
of which:								
maturing within 1 year			23,706				21,217	
in more than 1 year			26,121				21,619	
			49,827				42,836	
Bank								
Investment securities								
Listed								
Others		200	200	200	2	382	384	384
Unlisted								
Certificates of deposit issued by banks and building societies		112	112	112		282	282	282
Others		284	284	284		268	268	269
Total investment securities		596	596	596	2	932	934	935
of which:								
maturing within 1 year			112				282	
maturing in 1 year and over			484				652	
			596				934	

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 2003	23,697	(17)	23,680	945	(11)	934
Exchange translation	(759)		(759)	(38)		(38)
Additions	22,655		22,655	147		147
Amortisation	3		3			
Disposals	(17,489)		(17,489)	(437)		(437)
Amounts written off		(14)	(14)		(10)	(10)
At 31 December 2003	28,107	(31)	28,076	617	(21)	596
Aggregate unamortised discount at 31 December 2003	(38)					

Debt securities include securities pledged as collateral amounting to £11,030 million (2002 – £12,416 million).

Debt securities include securities with a market value of £6,467 million (2002 – £662 million) for the Group, sold subject to repurchase.

Debt securities include asset backed securities of £12,824 million (2002 – £9,320 million) which have been sold to bankruptcy remote special purpose vehicles funded by the issue of commercial paper on terms whereby some of the rewards and some of the risks of the portfolio have been retained by the Group. The transaction 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 29).

Notes on the Accounts (continued)

19. Equity Shares

Investment Securities	Listed Cost £ million	Listed Aggregate amount written off £ million	Listed Book Value £ million	Unlisted Cost £ million	Unlisted Aggregate amount written off £ million	Unlisted Book Value £ million	Total Book Value £ million
Group							
At 1 January 2003	69	(12)	57	196	(30)	166	223
Exchange translation	1		1	(1)		(1)	
Additions	1		1	49		49	50
Disposals	(15)	4	(11)	(31)		(31)	(42)
Amounts written off		(5)	(5)		(10)	(10)	(15)
At 31 December 2003	**56**	**(13)**	**43**	**213**	**(40)**	**173**	**216**

	Listed Cost £ million	Listed Aggregate amount written off £ million	Listed Book Value £ million	Unlisted Cost £ million	Unlisted Aggregate amount written off £ million	Unlisted Book Value £ million	Total Book Value £ million
Bank							
At 1 January 2003	12		12	68	(22)	46	58
Additions							
Disposals				(2)		(2)	(2)
Amounts written off		(2)	(2)		1	1	(1)
At 31 December 2003	**12**	**(2)**	**10**	**66**	**(21)**	**45**	**55**

The total value of equity shares as at 31 December 2003 for the Group was £393 million (2002 – £274 million) and for the Bank £128 million (2002 – £117 million) including for the Group £105 million (2002 – £96 million) and for the Bank £79 million (2002 – £66 million) in respect of the market value of listed equity shares.

20. Interests in Associated Undertakings

(i) Interests in Joint Ventures	Group Acquired Book Value £ million	Group Equity Adjustments £ million	Group Share of Net Tangible Assets £ million	Group Goodwill £ million	Group Book Value £ million
At 1 January 2003	179	(20)	159	2	161
Acquisitions and subscriptions of capital	69		69		69
Disposals	(48)	1	(47)		(47)
Equity accounting adjustments		(29)	(29)		(29)
At 31 December 2003	**200**	**(48)**	**152**	**2**	**154**

All the interests in joint ventures are unlisted.

(ii) Interests in Other Associated Undertakings	Group Acquired Book Value £ million	Group Equity Adjustments £ million	Group Share of Net Tangible Assets £ million	Group Goodwill £ million	Group Book Value £ million	Bank Cost £ million
At 1 January 2003	147	25	172		172	76
Acquisitions and subscriptions of capital	17		17		17	5
Disposals	(19)	1	(18)		(18)	
Equity accounting adjustments		20	20		20	
At 31 December 2003	**145**	**46**	**191**		**191**	**81**

All the interests in other associated undertakings are unlisted.

The main joint ventures and other associated undertakings are listed in Note 51 on page 67.

Notes on the Accounts (continued)

21. Interests in Group Undertakings

	Banks £ million	Others £ million	Total £ million
At cost at 1 January 2003	922	972	1,894
Disposals	(14)	(1)	(15)
Reclassification	(45)	45	
Exchange translation		66	66
At cost at 31 December 2003	863	1,082	1,945

The main subsidiary undertakings of the Bank are listed in Note 52 on page 68.

22. Intangible Fixed Assets

	Group Goodwill £ million	Bank Goodwill £ million
Cost		
At 1 January 2003	176	
Additions	283	73
Exchange translation	10	
At 31 December 2003	469	73
Amortisation		
At 1 January 2003	29	
Amortisation charged in year	18	3
At 31 December 2003	47	3
Net Book Value		
At 31 December 2003	422	70
At 31 December 2002	147	

Goodwill on acquisitions is capitalised and amortised by equal installments over its estimated useful life, not exceeding 20 years.

During the year, a further £283 million of goodwill arose primarily from the acquisition of minority interests.

Notes on the Accounts (continued)

23. Tangible Fixed Assets

	Group			Bank		
	Cost £ million	Depreciation £ million	Book Value £ million	Cost £ million	Depreciation £ million	Book Value £ million
Property						
At 1 January 2003	**304**	**(46)**	**258**	**178**	**(29)**	**149**
Exchange translation	**7**		**7**			
Additions	**59**		**59**	**50**		**50**
Disposals	**(19)**	**2**	**(17)**	**(8)**	**3**	**(5)**
Depreciation for year		**(11)**	**(11)**		**(7)**	**(7)**
At 31 December 2003	**351**	**(55)**	**296**	**220**	**(33)**	**187**
Equipment						
At 1 January 2003	**713**	**(421)**	**292**	**483**	**(259)**	**224**
Exchange translation	**19**	**(14)**	**5**			
Additions	**75**		**75**	**40**		**40**
Disposals	**(65)**	**52**	**(13)**	**(39)**	**35**	**(4)**
Depreciation for year		**(83)**	**(83)**		**(58)**	**(58)**
At 31 December 2003	**742**	**(466)**	**276**	**484**	**(282)**	**202**
Total tangible fixed assets at 31 December 2003	**1,093**	**(521)**	**572**	**704**	**(315)**	**389**
Total tangible fixed assets at 31 December 2002	1,017	(467)	550	661	(288)	373
Included above:						
Assets in the course of construction	51			46		
In 2002 Equipment included amounts held under finance leases as follows:	32	(31)	1	32	(31)	1

Property comprises:	Group 2003	Group 2002	Bank 2003	Bank 2002
Freehold	**230**	240	**132**	138
Long leasehold	**4**	4	**4**	4
Short leasehold	**62**	14	**51**	7
	296	258	**187**	149
Occupied for own activities	**283**	245	**174**	136

24. Operating Lease Assets

	Group Cost £ million	Group Depreciation £ million	Group Book Value £ million
At 1 January 2003	**2,088**	**(548)**	**1,540**
Additions	**1,183**		**1,183**
Disposals	**(843)**	**204**	**(639)**
Depreciation for year		**(313)**	**(313)**
At 31 December 2003	**2,428**	**(657)**	**1,771**

Notes on the Accounts (continued)

24. 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	
	2003 £ million	2002 £ million
On operating leased assets where the residual value is expected to be recovered in:		
1 year or less	449	381
2 years or less but over 1 year	173	166
5 years or less but over 2 years	160	161
Over 5 years	40	
Total	822	708

25. Capital and Other Commitments

	Group		Bank	
	2003 £ million	2002 £ million	2003 £ million	2002 £ 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	6	2	5	1
Commitments for which contracts have been placed in relation to operating leased assets	9	6		
Included in other liabilities are net obligations under finance leases payable as follows:				
1 year or less	5	7		
5 years or less but over 1 year	3	7		

26. Other Assets

	Group	
	2003 £ million	2002 £ million
Positive market values of trading derivative contracts	5,480	5,885
Other assets	1,315	361
	6,795	6,246

Other assets includes £560m (2002 Nil) due by HBOS plc.

Notes on the Accounts (continued)

27. Deposits by Banks

	Group 2003 £ million	Group 2002 £ million	Bank 2003 £ million	Bank 2002 £ million
Repayable on demand	6,781	14,630	2,654	9,477
Repayable:				
3 months or less but not repayable on demand	32,190	26,323	35,089	22,414
1 year or less but over 3 months	5,613	8,509	7,086	5,545
5 years or less but over 1 year	1,681	141	3,922	2,788
over 5 years	3,938	502	3,411	1,722
	50,203	50,105	52,162	41,946
Amounts above include:				
Subsidiary undertakings			47,908	39,604
Fellow subsidiary undertakings	9,967	4,789	2,025	
Other associated undertakings	155	352	13	4

28. Customer Accounts

	Group 2003 £ million	Group 2002 £ million	Bank 2003 £ million	Bank 2002 £ million
Repayable on demand	43,983	37,903	39,122	31,487
Repayable:				
3 months or less but not repayable on demand	17,916	16,209	1,976	2,494
1 year or less but over 3 months	4,236	2,724	736	313
5 years or less but over 1 year	1,306	708	303	260
over 5 years	1,884	168	535	
	69,325	57,712	42,672	34,554
Amounts above include:				
Subsidiary undertakings			1,046	897
Fellow subsidiary undertakings	3,667	779	1,298	540
Ultimate parent undertaking	121	956	121	182
Other associated undertakings	64	31	64	31
Joint ventures	57	71	57	71

On 21 July 2003 £3,052m of customer deposits were transferred to Halifax plc using the banking business transfer provisions of part VII of the Financial Services and Markets Act 2002.

29. Debt Securities in Issue

	Group 2003 £ million	Group 2002 £ million	Bank 2003 £ million	Bank 2002 £ million
Bonds and Medium Term Notes				
Repayable:				
1 year or less or on demand	8,203	2,867		250
2 years or less but over 1 year	9,550	7,720		
5 years or less but over 2 years	9,840	5,993	273	
over 5 years	5,576	1,170	535	268
	33,169	17,750	808	518
Other Debt Securities				
Repayable:				
3 months or less	53,600	47,339	1,026	1,019
1 year or less but over 3 months	10,299	11,761	1,042	987
2 years or less but over 1 year	115	54	84	16
5 years or less but over 2 years	5			
over 5 years		4		
	64,019	59,158	2,152	2,022
Total debt securities in issue	97,188	76,908	2,960	2,540

Bonds and Medium Term Notes at Group include £290 million (2002 - £300 million) in respect of the funding of a portfolio of mortgage advances securitised in 2002 which are not available for linked presentation. The portfolios of mortgage advances continue to be reported in Loans and Advances to Customers (Note 15). Bonds and Medium Term Notes also include £288 million (2002 - £303 million) secured on advances to customers and certain other assets of the Group.Other Debt Securities at Group include £12,895 million (2002 - £9,286 million) in respect of commercial paper issued to fund the purchase of asset backed securities by special purpose vehicles (Note 18).

Notes on the Accounts (continued)

30. Other Liabilities

	Group 2003 £ million	Group 2002 £ million
Negative market values of trading derivative contracts	**7,675**	6,134
Other liabilities	**1,241**	1,067
	8,916	7,201

31. Provisions for Liabilities and Charges

(i) Deferred Taxation	Group £ million	Bank £ million
At 1 January 2003	348	(127)
Charge in year (Note 9)	18	7
Other movements	(113)	(25)
At 31 December 2003	253	(145)

Deferred taxation comprises:	2003 £ million	2002 £ million
Group		
Capital allowances:		
on assets leased to customers	**452**	450
on other assets	**33**	28
General provisions	**(157)**	(141)
Other timing differences	**(75)**	11
	253	348
Bank		
Capital allowances on fixed assets	**5**	1
General provisions	**(102)**	(93)
Other timing differences	**(48)**	(35)
	(145)	(127)

(ii) Other Provisions

Group	Pensions and other similar obligations £ million	Merger integration provision £ million	Other provisions £ million	Total provisions £ million
At 1 January 2003	81	37	13	131
Exchange movement			2	2
Charge for year	54	57		111
Utilised in year	(60)	(87)		(147)
At 31 December 2003	**75**	**7**	**15**	**97**

Bank	Pensions and other similar obligations £ million	Merger integration provision £ million	Other provisions £ million	Total provisions £ million
At 1 January 2003	78	35		113
Charge for year	40	57	2	99
Utilised in year	(46)	(85)		(131)
At 31 December 2003	**72**	**7**	**2**	**81**

Notes on the Accounts (continued)

32. Subordinated Liabilities

	Group 2003 £ million	Group 2002 £ million	Bank 2003 £ million	Bank 2002 £ million
Dated Loan Capital				
US$300 million 8.80% Notes 2004	**168**	186	**168**	186
US$150 million 8.85% Notes 2006	**84**	93	**84**	93
£60 million 9.00% Instruments 2006	**60**	60		
€500 million 5.50% Instruments 2009	**353**	325	**353**	325
US$500 million Notes 2010	**280**	310	**280**	310
£75 million Floating Rate Instruments 2010	**75**	75	**75**	75
US$150 million Notes 2011	**84**	93	**84**	93
€7 million Floating Rate Notes 2011	**5**	5		
€12.8 million 6.25% Instruments 2012	**9**	8		
€325 million 6.125% Notes 2013	**229**	212	**229**	212
€1,000 million subordinated Callable Fixed/Floating rate instruments 2013	**706**	651	**706**	651
£250 million 6.375% Instruments 2019	**250**	250	**250**	250
€750 million 5.5% Notes 2012	**530**	488	**530**	488
US$450 million Subordinated Floating Rate Notes 2012	**252**	279	**252**	279
A$75 million Callable Notes 2012	**31**	26		
US$1,000 million 4.25% Subordinated Guaranteed Notes 2013 (1)	**560**			
unamortised Premiums, Discounts and Issue Costs	**(13)**	(15)	**(13)**	(15)
	3,663	3,046	**2,998**	2,947
Repayable:				
in 1 year or less	**168**		**168**	
in more than 1 year but not more than 5 years	**144**	339	**84**	279
after 5 years	**3,351**	2,707	**2,746**	2,668
	3,663	3,046	**2,998**	2,947

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.

(1) On 23 May 2003, a subsidiary of the Bank issued US$1,000 million 4.25% Subordinated Guaranteed Notes 2013 at an issue price of 99.750% of the principal amount. The proceeds of these Notes have been on-lent to the Bank's parent undertaking HBOS plc. The Notes pay interest semi-annually in arrears commencing 23 November 2003.

Notes on the Accounts (continued)

32. Subordinated Liabilities (continued)

	Group 2003 £ million	Group 2002 £ million	Bank 2003 £ million	Bank 2002 £ million
Undated Loan Capital				
US$300 million Reset Notes	**168**	186	**168**	186
£200 million Perpetual Notes	**200**	200	**200**	200
£300 million Perpetual Regulatory tier One Securities	**300**	300	**300**	300
€500 million Instruments	**353**	325	**353**	325
US$250 million Floating Rate Primary Capital Notes	**140**	155	**140**	155
£150 million Instruments	**150**	150	**150**	150
£150 million Instruments	**150**	150	**150**	150
JPY 17 billion Instruments	**90**	100	**90**	100
£100 million Instruments	**100**	100	**100**	100
JPY 9 billion Instruments	**47**	47		
£300 million Instruments [1]	**300**		**300**	
£250 million Perpetual Preferred Notes			**250**	250
£150 million Perpetual Preferred Notes			**150**	150
unamortised Premiums, Discounts and Issue Costs	**(4)**	(4)	**(4)**	(4)
	1,994	1,709	**2,347**	2,062

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.

[1] On 30 June 2003, £300 million Instruments were issued by the Bank, at par, to its parent undertaking HBOS plc. The Instruments bear interest at the three months LIBOR rate plus 1.9% per annum.

Notes on the Accounts (continued)

33. SHARE CAPITAL

	Ordinary Stock 25p each £ million	9 1/4% Non-Cumulative Irredeemable Preference Stock £1 each £ million	9 3/4% 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 2003	446	375	125	2.5	1.5
Authorised during the year					
At 31 December 2003	**446**	**375**	**125**	**2.5**	**1.5**
Allotted, called up and fully paid					
At 1 January 2003	367	300	100		
Issued	43				
At 31 December 2003	**410**	**300**	**100**		

On 30 April 2003 the Bank issued 53,846,000 ordinary stock units of 25p each for a consideration of £350 million. On 30 September 2003 the Bank issued 118,900,000 ordinary stock units of 25p each for a consideration of £850 million.

34. Reserves

	Share Premium £ million	Other Reserves £ million	Profit and Loss Account £ million
Group			
At 1 January 2003	1,794	(19)	3,411
Premium arising on the issue of new stock	1,157		
Exchange translation		17	
Retained profit			597
At 31 December 2003	**2,951**	**(2)**	**4,008**
Bank			
At 1 January 2003	1,794	68	2,383
Premium arising on the issue of new stock	1,157		
Exchange translation		(15)	
Retained profit			184
At 31 December 2003	**2,951**	**53**	**2,567***

* Of which £2,372 million is distributable.

Exchange losses of £91 million (2002 - £1 million) arising on foreign currency borrowings used to hedge investments in overseas operations have been taken to the Group's other reserves and are offset against exchange differences arising on the translation of the Group's investments in overseas operations. The cumulative amount of positive goodwill on acquisitions of subsidiary undertakings written off in the Group reserves is £228 million (2002 – £228 million).

35. Reconciliation of proprietors' Funds

	Group		Bank	
	2003 £ million	2002 £ million	**2003 £ million**	2002 £ million
Profit attributable to Proprietors	**1,149**	826	**736**	710
Dividends	**(552)**	(408)	**(552)**	(408)
Other recognised gains and losses	**17**	3	**(15)**	53
Ordinary capital subscribed	**1,200**	1,250	**1,200**	1,250
	1,814	1,671	**1,369**	1,605
Proprietors' Funds at 1 January 2003	**5,953**	4,282	**5,012**	3,407
Proprietors' Funds at 31 December 2003	**7,767**	5,953	**6,381**	5,012
of which:				
Attributable to non-equity interests	**400**	400	**400**	400
Attributable to equity interests	**7,367**	5,553	**5,981**	4,612
	7,767	5,953	**6,381**	5,012

Notes on the Accounts (continued)

36. Minority and Other Interests (non-equity)

The principal minority and other interests (non-equity) are set out below.

	Group 2003 £ million	Group 2002 £ million
£250 million preferred securities	250	250
£150 million preferred securities	150	150
A$1,025 million Redeemable Preference Shares	433	
Total	833	400

A subsidiary of the company issued A$1,025 million Redeemable Preference Shares to a fellow subsidiary in connection with the acquisition of the minority interest in BankWest. The shares were subsequently sold to and are held by HBOS plc, the Group's parent undertaking.

37. 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.

	2003 Contract Amount £ million	2002 Contract Amount £ million
Group		
Contingent Liabilities		
Acceptances and endorsements	130	156
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	3,193	2,770
	3,323	2,926
Commitments		
Other commitments		
Short-term trade related transactions	146	129
Undrawn formal standby facilities, credit lines and commitments to lend		
up to and including 1 year	25,421	21,417
over 1 year	11,316	10,341
	36,883	31,887
Bank		
Contingent Liabilities		
Acceptances and endorsements	55	148
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	10,958	4,065
	11,013	4,213
Amounts included above in respect of guarantees to subsidiary undertakings	8,002	1,663
Commitments		
Other commitments		
Short-term trade related transactions	127	120
Undrawn formal standby facilities, credit lines and commitments to lend		
up to and including 1 year	19,332	15,672
over 1 year	9,788	8,992
	29,247	24,784
Amounts included above in respect of commitments to subsidiary undertakings	103	128

Notes on the Accounts (continued)

38. 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.

	2003			2002		
	Notional Principal Amount £ million	Year End Fair Value Asset £ million	Year End Fair Value Liability £ million	Notional Principal Amount £ million	Year End Fair Value Asset £ million	Year End Fair Value Liability £ million
Group						
Non Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	186	8	3	411	8	11
Cross currency swaps	51,669	1,127	2,209	33,085	555	1,044
	51,855	1,135	2,212	33,496	563	1,055
Interest Rate Related Contracts						
Interest rate swaps	44,526	774	1,060	51,902	1,223	1,476
Options	342	2	1	984	6	5
Futures				2,678	1	1
	44,868	776	1,061	55,564	1,230	1,482
Equity and Commodity Related Contracts						
Options and swaps	803	50	36	935	32	40
Total Non Trading Derivatives	97,526	1,961	3,309	89,995	1,825	2,577
Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	64,943	1,348	3,376	49,471	682	1,674
Cross currency swaps	546	23	87	142	5	7
Options	558	15	16	12,728	9	9
	66,047	1,386	3,479	62,341	696	1,690
Interest Rate Related Contracts						
Interest rate swaps	387,041	3,789	3,673	251,359	3,800	3,654
Forward rate agreements	19,976	5	5	9,856	2	2
Options	71,893	165	238	58,120	128	190
Futures	100,421	18	28	190,017	49	74
	579,331	3,977	3,944	509,352	3,979	3,920
Equity and Commodity Related Contracts						
Options and swaps	831	89	78	563	37	28
Total Trading Derivatives	646,209	5,452	7,501	572,256	4,712	5,638
Total Group Derivatives	743,735	7,413	10,810	662,251	6,537	8,215

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

	2003		2002	
	Notional Principal Amount £ million	Replacement Cost £ million	Notional Principal Amount £ million	Replacement Cost £ million
Group				
Contracts maturing:				
In 1 year or less	244,206	2,098	228,345	1,371
In more than 1 year but not more than 5 years	265,218	2,363	159,317	2,156
In more than 5 years	133,890	2,934	81,894	2,960
	643,314	7,395	469,556	6,487

Notes on the Accounts (continued)

38. Derivatives (continued)

	2003 Notional Principal Amount £ million	2003 Year End Fair Value Asset £ million	2003 Year End Fair Value Liability £ million	2002 Notional Principal Amount £ million	2002 Year End Fair Value Asset £ million	2002 Year End Fair Value Liability £ million
Bank						
Non Trading						
Exchange Rate Related Contracts						
Cross currency swaps	89	18		89	13	
	89	18		89	13	
Interest Rate Related Contracts						
Interest rate swaps	21,609	185	502	19,578	786	127
	21,609	185	502	19,578	786	127
Equity and Commodity Related Contracts						
Options and swaps	148	3	4	184	4	5
Total Non Trading Derivatives	21,846	206	506	19,851	803	132
Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	1,097	26	26	904	22	22
Total Trading Derivatives	1,097	26	26	904	22	22
Total Bank Derivatives	22,943	232	532	20,755	825	154

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

	2003 Notional Principal Amount £ million	2003 Replacement Cost £ million	2002 Notional Principal Amount £ million	2002 Replacement Cost £ million
Bank				
Contracts maturing:				
In 1 year or less	4,703	40	3,649	52
In more than 1 year but not more than 5 years	6,856	39	9,090	263
In more than 5 years	11,384	153	8,016	510
	22,943	232	20,755	825

Notes on the Accounts (continued)

38. 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 2003 £ million	Group 2002 £ million	Bank 2003 £ million	Bank 2002 £ million
Institutional				
Financial Institutions	6,420	5,542	217	810
Non-financial Institutions	975	945	15	15
	7,395	6,487	232	825
Geographical				
UK	7,098	6,308	232	825
Rest of World	297	179		
	7,395	6,487	232	825

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 10 to 16 of the Financial Review and Risk Management section of the Business and Financial Review.

39. 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 38 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:

	2003				2002			
	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	6,475	6,477			3,878	3,880		
Debt securities	28,076	28,087			23,680	23,618		
Equity shares	216	393			223	274		
Debt securities in issue			96,020	96,478			76,661	77,004
Dated loan capital			3,663	3,891			3,046	3,273
Undated loan capital			1,994	2,254			1,709	1,923
Minority and other interests (non-equity)			833	903			400	470
Derivatives	337	1,961	684	3,309	298	1,825	453	2,577
Total Non Trading	35,104	36,918	103,194	106,835	28,079	29,597	82,269	85,247
Trading								
Treasury bills and other eligible bills	1,451	1,451			1,958	1,958		
Loans and advances to banks	1,151	1,151			1,348	1,348		
Loans and advances to customers	289	289			709	709		
Debt securities	21,751	21,751			19,156	19,156		
Other assets	43	43			63	63		
Debt securities in issue			1,168	1,168			247	247
Deposits by banks			8,785	8,785			11,650	11,650
Customer accounts			5,479	5,479			2,309	2,309
Other liabilities			156	156			66	66
Derivatives	5,452	5,452	7,501	7,501	4,712	4,712	5,638	5,638
Total Trading	30,137	30,137	23,089	23,089	27,946	27,946	19,910	19,910

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 2003.

Notes on the Accounts (continued)

40. 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:

	2003		
	Gains £ million	Losses £ million	Total Net Gains/(Losses) £ million
Unrecognised gains and losses on hedges at 1 January 2003	**1,550**	**2,147**	**(597)**
Gains and losses arising in previous years that were recognised in the year ended 31 December 2003	**444**	**1,327**	**(883)**
Gains and losses arising before 1 January 2003 that were not recognised in the year ended 31 December 2003	**1,106**	**820**	**286**
Gains and losses arising in the year ended 31 December 2003 that were not recognised in that year	**647**	**1,934**	**(1,287)**
Unrecognised gains and losses on hedges at 31 December 2003	**1,753**	**2,754**	**(1,001)**
of which:			
Gains and losses expected to be recognised in the year ending 31 December 2004	**551**	**1,003**	**(452)**
Gains and losses expected to be recognised after 31 December 2004	**1,202**	**1,751**	**(549)**

	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 ending 31 December 2003	**456**	**778**	**(322)**
Gains and losses expected to be recognised after 31 December 2003	**1,094**	**1,369**	**(275)**

Notes on the Accounts (continued)

41. Interest Rate Sensitivity Gap

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

As at 31 December 2003	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	6,165	310					1,451	7,926
Loans and advances to banks	39,478	1,738	2,826	440	319	28	1,151	45,980
Loans and advances to customers	101,937	5,845	4,456	12,060	1,473	98	289	126,158
Debt securities and equity shares	22,390	1,575	1,721	756	857	993	21,751	50,043
Other assets	22					13,803	43	13,868
	169,992	9,468	9,003	13,256	2,649	14,922	24,685	243,975
Liabilities								
Deposits by banks	38,716	47	825	1,536	115	179	8,785	50,203
Customer accounts	58,490	1,126	1,360	570	2,085	215	5,479	69,325
Debt securities in issue	76,963	11,541	1,137	2,342	4,037		1,168	97,188
Other liabilities	1	1	2	3		12,828	156	12,991
Subordinated liabilities	1,196	140	168	938	3,215			5,657
Minority interests and Proprietors' funds					833	7,778		8,611
Internal funding of trading business	(9,984)	491	31	223	142		9,097	
	165,382	13,346	3,523	5,612	10,427	21,000	24,685	243,975
On-balance sheet gap	4,610	(3,878)	5,480	7,644	(7,778)	(6,078)		
Non trading derivatives	(420)	(4,169)	(2,537)	(857)	7,983			
Net interest rate repricing gap at 31 December 2003	4,190	(8,047)	2,943	6,787	205	(6,078)		
Cumulative gap at 31 December 2003	4,190	(3,857)	(914)	5,873	6,078			

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			

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)

42. 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 15 of the Financial Review and Risk Management Review Section. The Group's trading market risk exposure for the year ended 31 December 2003 is analysed below.

	Exposure							
	As at 31 December 2003 £ million	As at 31 December 2002 £ million	Average 2003 £ million	Average 2002 £ million	Highest 2003 £ million	Highest 2002 £ million	Lowest 2003 £ million	Lowest 2002 £ million
Total Value at Risk	**6.1**	7.9	**11.9**	6.9	**23.0**	13.9	**6.1**	0.9

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

43. 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.

	2003			2002		
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	**72**	**53**	**19**	222	185	37
Euro	**442**	**393**	**49**	282	190	92
Australian Dollar	**1,000**	**847**	**153**	371	315	56
Other	**7**		**7**	2	2	
Total	**1,521**	**1,293**	**228**	877	692	185

As at 31 December 2003 and 31 December 2002 there were no material net currency exposures in the non trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses. Additional information on the Group's foreign exchange exposures is set out on page 14 of the Financial Review and Risk Management Review Section.

44. Assets and Liabilities in Foreign Currencies

	Group		Bank	
	2003 £ million	2002 £ million	**2003 £ million**	2002 £ million
The aggregate amounts of assets and liabilities denominated in currencies other than sterling were:				
Assets	**76,926**	60,982	**22,888**	13,310
Liabilities	**107,676**	103,085	**22,800**	9,468

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)

45. Reconciliation of Operating Profit to Net Cash (outflow)/ Inflow from Operating Activities

	2003 £ million	2002 £ million
Group operating profit	**1,705**	1,231
Increase in prepayments and accrued income	**(1,149)**	(369)
Increase in accruals and deferred income	**348**	613
Provision for bad and doubtful debts	**682**	618
Depreciation and goodwill amortisation	**425**	375
Amortisation of debt securities	**(3)**	28
Decrease in the value of long-term assurance business		47
Interest on subordinated liabilities	**310**	259
Profits on sale of investment securities`	**(34)**	(31)
Provisions for liabilities and charges	**(36)**	8
Amounts written off fixed asset investments	**29**	33
Exchange differences	**832**	500
Profit on sale of fixed assets	**(9)**	(1)
Other non-cash movements	**(113)**	
Net cash inflow from trading activities	**2,987**	3,311
Net (decrease)/increase in notes in circulation	**(7)**	84
Net decrease/(increase) in items in course of collection	**154**	(134)
Net increase in treasury and other eligible bills	**(2,090)**	(5,331)
Net increase in loans and advances to banks and customers	**(38,251)**	(36,554)
Net increase in deposits by banks and customer accounts	**11,711**	56,252
Net increase in debt securities in issue	**20,280**	41,725
Net increase in other assets	**(522)**	(4,450)
Net increase in other liabilities	**1,711**	5,118
Net increase in debt securities	**(2,595)**	(18,477)
Net cash (outflow)/ inflow from operating activities	**(6,622)**	41,544

46. Gross Cash Flows

		Notes	2003 £ million	2002 £ million
(i)	**Returns on investments and servicing of finance**			
	Interest paid on subordinated liabilities		**(308)**	(254)
	Preference dividends paid		**(37)**	(37)
	Dividends paid to minority shareholders in subsidiary undertakings		**(55)**	(50)
			(400)	(341)
(ii)	**Capital expenditure and financial investment**			
	Purchase of investment securities		**(22,705)**	(30,812)
	Sale and maturity of investment securities		**17,565**	15,874
	Purchase of property and equipment		**(134)**	(102)
	Sale of property and equipment		**39**	28
	Purchase of operating lease assets		**(1,183)**	(871)
	Sale of operating lease assets		**639**	411
			(5,779)	(15,472)
(iii)	**Acquisitions and disposals**			
	Disposal of minority interests		**(10)**	
	Investment in subsidiary undertakings and business interests		**(532)**	
	Investment in associated undertakings and joint ventures		**(86)**	(135)
	Disposal of associated undertakings, joint ventures and business interests		**65**	27
	Minority interest acquired		**434**	2
			(129)	(106)
(iv)	**Financing**			
	Issue of ordinary stock	49	**1,200**	1,250
	Issue of subordinated liabilities	49	**860**	1,115
	Repayments of subordinated liabilities	49		(66)
			2,060	2,299

Notes on the Accounts (continued)

47. Acquisitions

On 4 April 2003 the Group acquired the business of the Joint Affinity Credit Card Business developed through Transnational Group Services International Inc. and its UK based subsidiary, Transnational Financial Services Ltd ("Transnational"), for a cash consideration of £96 million including costs of acquisition. The book value of net assets acquired was £23 million with no material fair value adjustments required creating a balance of goodwill on the acquisition of £73 million.

On 26 August 2003, HBOS plc, through the Bank's subsidiary undertaking Scottish Western Australia Holdings Pty Ltd acquired all of the ordinary shares of Bank of Western Australia Ltd ("BankWest") which it did not already own. The total cost of acquisition including costs of acquisition amounted to £436 million. The minority interest acquired amounted to £229 million with no material fair value adjustments being required creating a balance of goodwill on the acquisition of the minority interest of £207 million.

The acquisition method of accounting has been applied to each of these acquisitions. Goodwill is being amortised over 20 years in respect of Transnational and BankWest reflecting the periods over which the economic benefits are expected to arise.

The following table summarises the effects of these acquisitions.

	Acquired book value and fair value to the Group		
	Transnational £ million	BankWest £ million	Total £ million
Other assets	27		27
Total assets	27		27
Other liabilities	(4)		(4)
Net assets	23		23
Minority interests		229	229
Goodwill	73	207	280
Consideration	96	436	532
Satisfied by:			
Cash	96	433	529
Acquisition costs		3	3
	96	436	532

The effect on the Group's profit and loss account from the respective dates of acquisition to 31 December 2003 is not material.

48. Analysis of the Balances of Cash as shown in the Balance Sheet

	As at 1 January 2003 £ million	**Cashflow £ million**	**As at 31 December 2003 £ million**	As at 1 January 2002 £ million	Cashflow £ million	As at 31 December 2002 £ million
Cash and balances at central banks	**1,049**	**32**	**1,081**	917	132	1,049
Loans and advances to other banks repayable on demand	**28,009**	**(11,872)**	**16,137**	666	27,343	28,009
	29,058	**(11,840)**	**17,218**	1,583	27,475	29,058

The Group maintains balances with the Bank of England which, at 31 December 2003, amounted to £686 million (2002 – £681 million).

Notes on the Accounts (continued)

49. Analysis of the Changes in Financing during the Year

	2003 Share Capital (including Premium) £ million	2003 Loan Capital £ million	2002 Share Capital (including Premium) £ million	2002 Loan Capital £ million
At 1 January	**2,561**	**4,755**	1,311	3,753
Effect of foreign exchange differences		**42**		(47)
Proceeds of capital issues (including premium) – ordinary stock	**1,200**		1,250	
Repayments of subordinated liabilities				(66)
Proceeds of loan capital issues		**860**		1,115
At 31 December	**3,761**	**5,657**	2,561	4,755

50. Related Party Transactions

In the year ended 31 December 2003, 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 £20 million (2002 – £28 million), of which £7 million was outstanding at the year end (2002 – £4 million).

During the year, IBM United Kingdom (Systems Operations) Limited, a non consolidated subsidiary undertaking, provided systems operations services to the Group. The amounts in respect of these services payable from Bank of Scotland Group during the year were £126 million (2002 – £147 million) including an exceptional charge arising from termination of the service contract on 20 August 2003.

51. Main Associated Undertakings (including Joint Ventures)

	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 2003	UK
		loan	£1,000,000	50.0%*		
NFU Mutual Finance Limited	Finance	ordinary	£500,002	50.0%*	December 2003	UK
RFS Limited	Finance	ordinary	£6,000,006	50.0%*	December 2003	UK
Other Associated Undertaking:						
Sainsbury's Bank plc	Banking	ordinary	£140,000,000	45.0%	March 2003^	UK
		loan	£60,000,000	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 2003.

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	100%#	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 2003 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	1,424
Credit card accounts	7	45

54. Segmental Analysis

Business Sector

The Group reported throughout the year through five divisions: Retail, Business, Corporate, Treasury, Insurance & Investment plus BankWest and Group Items.

	Year ended 31 December 2003			Year ended 31 December 2002		
	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	**495**	**(5)**	**490**	319	(4)	315
Business	**355**	**(6)**	**349**	261	(16)	245
Corporate	**673**		**673**	556		556
Treasury	**232**	**(3)**	**229**	163	(6)	157
Insurance & Investment	**56**		**56**	87		87
BankWest	**113**		**113**	75		75
Group Items	**(98)**	**(43)**	**(141)**	(88)	(51)	(139)
Profit on ordinary activities before tax	**1,826**	**(57)**	**1,769**	1,373	(77)	1,296

	Net Assets		Total Assets	
	2003 £ million	2002 £ million	**2003 £ million**	2002 £ million
Retail	**1,518**	1,182	**42,377**	34,372
Business	**1,852**	1,301	**34,250**	25,869
Corporate	**2,892**	2,457	**45,193**	41,800
Treasury	**932**	771	**110,010**	96,484
Insurance & Investment			**35**	30
BankWest	**573**	242	**12,110**	8,536
	7,767	5,953	**243,975**	207,091

Notes on the Accounts (continued)

54. 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.

	2003			2002		
	UK £ million	Rest of World £ million	Group Total £ million	UK £ million	Rest of World £ million	Group Total £ million
Interest receivable	9,950	1,671	11,621	8,861	1,224	10,085
Fees and commissions receivable	922	227	1,149	886	168	1,054
Dealing profits	165	11	176	103	8	111
Other operating income	496	59	555	441	24	465
Gross income	11,533	1,968	13,501	10,291	1,424	11,715
Operating profit before exceptional items	1,379	383	1,762	1,032	276	1,308
Share of operating profits of joint ventures	39	(4)	35	24	(11)	13
Share of operating profits of other associated undertakings	17	12	29	19	8	27
Profit on disposal of business				25		25
Exceptional items	(57)		(57)	(77)		(77)
Group profit before taxation	1,378	391	1,769	1,023	273	1,296
Total assets	209,754	33,876	243,630	182,359	24,399	206,758
Joint ventures			154			161
Associated undertakings			191			172
Group total assets			243,975			207,091
Net assets (excluding minority interests)	6,489	1,278	7,767	4,779	1,174	5,953

55. 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.

56. 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 2004.