BANK OF SCOTLAND
REPORT AND ACCOUNTS

FOR THE YEAR ENDED 31 DECEMBER 2004

CONTENTS

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Business and Financial Review – Introduction

Introduction

The Directors are pleased to present the consolidated results of the Bank of Scotland Group for the year ended 31 December 2004. The Bank of Scotland Group is a directly held subsidiary of HBOS plc.

Group profit before tax amounts to £2,321 million (2003 – £1,769 million). Group profit before tax and exceptional items amounts to £2,344 million (2003 – £1,826 million) and is analysed by business sector below.

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.

Following an internal reorganisation, from 1 January 2004, the Bank of Scotland Group reported throughout the year through five divisions, plus Group items. 2003 figures have been restated to reflect the new structure. The business sectors reported are aligned with those of the HBOS Group and comprise:-

- Retail
- Insurance and Investment
- Corporate
- Treasury
- International

BUSINESS AND FINANCIAL REVIEW

Retail

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m Restated
Net interest Income	**957**	1,003
Non-interest Income	**254**	164
Operating Income	**1,211**	1,167
Operating Expenses *	**(389)**	(535)
Operating profit before provisions	**822**	632
Provisions for bad & doubtful debts	**(181)**	(190)
Share of profits in joint ventures	**34**	39
Profit on sale of fixed assets	**13**	
Pre-tax profit *	**688**	481
Advances to customers **	**£45.8bn**	£43.6bn
Customer deposits	**£12bn**	£11bn
Net interest margin ***	**2.07%**	2.36%
Cost income ratio *	**32.1%**	45.8%

* Excluding exceptional items

** Before deduction of non-returnable finance of £3.4bn (2003 £3.4bn)

*** Certain loans and advances to customers have been securitised. Where 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 has delivered a 43% growth in profit before tax and exceptional items in 2004 to £688m, driven by a 4% growth in income together with a 27% reduction in costs. As integration of the Retail activities following the merger with Halifax continues, less of Retail's costs are being incurred within the Bank of Scotland Group, however these decreases are mirrored by increases in costs in other entities within the HBOS Group. Across the HBOS Group, Retail's operating expenses show 0.5% growth compared with 2003.

Advances growth of 5% has been offset by a 29 basis point reduction in the net interest margin, resulting in a 5% decrease in net interest income to £957m. The decline in the net interest margin principally reflects the impact of higher LIBOR related funding costs as, for most of the year, money markets anticipated interest rate rises. However, with non-interest income increasing by 54% and operating expenses benefiting from internal reorganisations, resulting principally in lower technology and staff costs, the cost income ratio fell to 32.1%.

The provisions charge decreased by 5% year on year and represented 0.40% (2003 0.49%) of average loans and advances. Closing provisions as a percentage of year end advances was in line with last year at 1.21% (2003 1.22%).

The £13m profit on sale of fixed assets represents the gain arising on the disposal of cash machines situated in locations remote from the bank branches.

BUSINESS AND FINANCIAL REVIEW

Insurance and Investment

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m Restated
Net interest income	(1)	
Non-interest income	32	54
Operating income	31	54
Operating expenses*		(1)
Amounts written off fixed asset investments	1	
Operating profit before provisions	32	53
Share of profits in joint ventures		1
Pre-tax profit*	32	54

* Excluding exceptional items

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

Corporate

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m Restated
Net interest Income	**1,441**	1,247
Non-interest Income	**1,281**	1,030
Operating Income	**2,722**	2,277
Operating Expenses*	**(1,053)**	(951)
Operating profit before provisions	**1,669**	1,326
Provisions for bad & doubtful debts	**(518)**	(448)
Share of profits in joint ventures	**57**	23
Pre-tax profit*	**1,208**	901
Advances to customers **	**£73.4bn**	£63.4bn
Customer deposits	**£40bn**	£31bn
Net interest margin ***	**2.13%**	2.09%
Cost income ratio ****	**28.5%**	31.8%

* Excluding exceptional items

** Before deduction of non-returnable finance of £0.8bn (2003 £1.5bn)

*** Certain loans and advances to customers have been securitised. Where 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 and amounts written off fixed asset investments against operating income.

Corporate has delivered another set of excellent results with profit before tax and exceptional items increasing by 34% to £1,208m, due to continued controlled asset growth, improved returns and stable credit quality.

During the year we integrated our Corporate Division and most of the Business Banking Division into one larger Corporate Division with a structure that is more closely aligned with our customers. This has already delivered significant cross selling benefits, as well as a reduction in the rate of expenses growth and a fall in our cost:income ratio from 31.8% to 28.5%.

New business helped loans and advances grow by 16% to £73.4bn. Our largest overall concentration continues to be property, which represents around one third of our total lending. Our property development exposure is largely supported by pre-lets, pre-sales or suitable additional security.

Customer deposits continued to grow strongly, increasing by 29% to £40.0bn and further improving our self-funding ratio to 54%. The total charge for bad and doubtful debts was £518m, equivalent to 0.76% of average advances (2003 0.77%).

We continue to lead the market in many areas with integrated, joint venture, structured and acquisition finance businesses. We still work closely with the public sector in the provision of social and economic infrastructure, while our motor business – including our successful joint venture with Renault, strengthens year on year. We have offices in Amsterdam, Frankfurt, Madrid and Paris and a network of seven offices in the USA. We have recently increased our shareholding in Drive Financial Services, a highly successful motor finance business based in Dallas, from 49.0% to 64.5%.

Going forward the corporate sector looks encouraging with sustained economic growth. With credit quality improving we are confident in the outlook for 2005.

BUSINESS AND FINANCIAL REVIEW

Treasury

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m Restated
Net interest Income	**168**	179
Non-interest Income	**193**	144
Operating Income	**361**	323
Operating Expenses *	**(112)**	(91)
Operating profit before provisions	**249**	232
Pre-tax profit *	**249**	232
Advances to customers	**£21.2bn**	£5.2bn
Customer deposits	**£34bn**	£19bn
Net interest margin excluding trading assets	**0.19%**	0.13%
Cost:income ratio	**31%**	28.2%

* Excluding exceptional items.

Within our Treasury business we established a branch of HBOS Treasury Services plc in New York during the first half of 2004 as part of our strategy to use the US market as a long term and reliable source of funding.

Net interest income decreased 6% to £168m (2003 £179m), while non-interest income increased 34% to £193m (2003 £144m). However, costs for the period were £112m, up 23% (2003 £91m), reflecting significant investment in the business and its infrastructure.

Treasury continued to diversify the range and sources of funding during 2004. The Group maintains a number of programmes in order to meet the continuing growth in wholesale funding. The mortgage backed covered bond programme established in July 2003 was supplemented in December 2004 with a new covered bond programme backed by social housing loans. The combined issuance from these programmes in 2004 was £5.25bn and £1bn with average lives of 9 and 15 years respectively.

Other notable bond issues in 2004 include €2bn Floating Rate Notes due 2007, JPY60bn 0.25% Fixed Rate Notes due 2006, US$2.5bn Extendible Floating Rate Notes due 2009 and US$750m 4% Fixed Rate Notes due 2009.

The strategy for 2005 aims to develop even further our product services and the provision of treasury related advice to the HBOS Group and its customers, to secure and improve on the current year's performance whilst maintaining asset quality. Our position within the HBOS Group and increased sales penetration means that we can continue to benefit from the growth potential of the HBOS Group businesses.

BUSINESS AND FINANCIAL REVIEW

International

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m Restated
Net interest Income	**450**	408
Non-interest Income	**193**	178
Operating Income	**643**	586
Operating Expenses *	**(303)**	(286)
Operating profit before provisions	**340**	300
Provisions for bad & doubtful debts	**(30)**	(44)
Share of profits in joint ventures	**1**	1
Pre-tax profit *	**311**	257
Advances to customers **	**£24.1bn**	£18.9bn
Customer deposits	**£10bn**	£8bn
Net interest margin ***	**2.04%**	2.34%
Cost:income ratio	**45.9%**	47.7%

* Excluding exceptional items

** Before deduction of non-returnable finance of £0.1bn (2003 £0.1bn)

*** Certain loans and advances to customers have been securitised. Where 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.

In sterling terms, the combined results of Australia and Ireland disclosed a strong increase in profit before tax and exceptional items of 21% to £311 million (2003 - £257 million), this despite the unfavourable movement of the Australian Dollar during 2004. The performance of Australia and Ireland is described below in local currency terms to remove the distortion created by exchange rate fluctuations.

In 2004 our Australian operations performed strongly with profit before tax and exceptional items of A$506m, 17% ahead of 2003. Total operating income rose 9%. Net interest income increased 10% as a result of 15% loan growth offset by a fall in interest margins. We formed HBOS Australia and appointed David Willis to be Group CEO. We have also seconded a number of executives from HBOS UK to help our Australian expansion plans.

Non-interest income increased by 6% reflecting growth in the underlying business particularly in relation to housing, asset finance and insurance related underwriting fees. Expenses growth was restricted to 8%, whilst also pursuing growth and integration initiatives, with the cost:income ratio improving to 49.5%.

The HBOS Australia loan portfolio continues to strengthen and the quality of the book is high, with a reduction in non-performing assets to 0.5% as a percentage of total lending to customers, down from 0.7% in 2003 and a reduced charge for bad debt provisions. HBOS Australia is now positioned to achieve significant growth based on a strategy to offer differentiated customer focused products and services.

Bank of Scotland Ireland (BoSI) continued to grow. Profit before tax of €148m was 41% ahead of 2003. Loans to customers increased by 59% due to strong growth within our Business Banking franchise unmatched by our competitors and the transfer of the €2.1bn residential mortgage book from Retail Banking division in July. Operating income grew 29%, with net interest income up 30%. Margin reduced from 2.12% to 1.84%. The cost:income ratio improved to 37.2% from 39.2%.

2004 marked another year of success for BoSI Business Banking activity. We continued to deliver on our objective to become the Number One Business Bank in the Irish market with growth in assets of 31% year on year. Deposits were also a major focus in the year and at €5.6bn at year end represented annual growth of 32% in commercial deposits.

Earlier in the year we outlined plans for expansion into Retail markets in Ireland. 2005 will see the launch of new retail products as we invest in and develop further our retail franchise in Ireland.

BUSINESS AND FINANCIAL REVIEW – FINANCIAL REVIEW AND RISK MANAGEMENT

Overview of Results

Group profit before tax and exceptional items amounts to £2,344 million (2003 – £1,826 million) and is derived as follows:-

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m
Group profit before tax	2,321	1,769
Add back:		
Exceptional items – merger costs *	23	57
Group profit before tax and exceptional items	2,344	1,826

* The HBOS merger integration costs relate to the costs of integration and reorganising Bank of Scotland Group following the merger with Halifax Group plc.

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

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m Restated
Retail	688	481
Insurance & Investment	32	54
Corporate	1,208	901
Treasury	249	232
International	311	257
Group Items *	(144)	(99)
	2,344	1,826

* 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 £3,016 million is up £180 million, reflecting strong asset led growth. The decline in net interest margin is principally due to a change in business mix, as following a change in certain Group funding arrangements during the year, the majority of derivatives held with fellow HBOS subsidiaries were replaced with term loans and deposits.

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m
Interest receivable	15,115	11,621
Interest payable	(12,099)	(8,785)
Net interest income	3,016	2,836
Average balances *		
Interest earning assets:		
– Loans and advances	186,413	123,425
– Securities and other liquid assets	33,851	29,987
	220,264	153,412
Securitised assets	4,811	4,255
	225,075	157,667
Net interest margin	1.34%	1.80%

* Certain loans and advances to customers have been securitised. Where 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. Trading assets within treasury operations are excluded from the net interest margin calculation.

Non-interest income amounted to £1,955 million (2003 – £1,571 million) and is made up as follows:-

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m
Net fees and commissions receivable	966	840
Operating lease rental income	526	452
Dealing profits	208	176
Profit on sale of investment securities	105	34
Other operating income	150	69
	1,955	1,571

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

Tight cost control restricted growth in operating expenses, excluding exceptional items, to 2%.

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m
Staff	**857**	791
Depreciation:		
– Tangible fixed assets	**96**	94
– Operating lease assets	**377**	313
Goodwill amortisation	**29**	18
Other	**620**	718
	1,979	1,934

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 34.4% as shown in the table below:-

	Year Ended 31 December 2004 £m	Year Ended 31 December 2003 £m
Operating expenses	**2,002**	1,991
Exceptional items	**(23)**	(57)
Goodwill amortisation	**(29)**	(18)
Operating lease depreciation	**(377)**	(313)
Underlying operating expenses	**1,573**	1,603
Net operating income	**4,971**	4,407
Amounts written off fixed asset investments	**(24)**	(29)
Operating lease depreciation	**(377)**	(313)
Underlying operating income	**4,570**	4,065
Cost:income ratio	**34.4%**	39.4%

Taxation

The tax charge for the year of £668 million (2003 – £550 million), represents 29% (2003 – 31%) of profit before tax compared with a UK corporation tax rate of 30% applicable to both periods. The difference in tax rates is explained in Note 9 on page 46.

Balance Sheet

Advances to customers increased by 25% to £164 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 14 on page 49.

	31 December 2004		31 December 2003	
Gross Advances before provisions	**£bn**	**%**	£bn	%
Commercial *	**109**	**68**	80	63
Residential Mortgages *	**41**	**25**	39	30
Other Personal	**11**	**7**	9	7
Total	**161**	**100**	128	100

* After securitisation.

Customer deposits grew by £27 billion, a rise of 39%, to £96 billion. £15 billion of the increase is within Treasury, and is mainly due to a change in certain Group funding arrangements which resulted in the majority of derivatives held with fellow HBOS subsidiaries being replaced with term loans and deposits.

Bad Debt Provisions

The combined specific and general provisions for bad and doubtful debts charged against Group profits totalled £729 million (2003 – £682 million). Within this the charge for specific provisions increased 15% to £733 million (2003 – £636 million) but this represented only 0.51% (2003 – 0.54%) of average customer lending.

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

Closing provisions as a % of customer advances (before deduction of advances subject to non-returnable finance) are analysed in the following table:-

	31 December 2004		31 December 2003	
	£m	**As % of customer Advances**	£m	As % of customer Advances
Specific provisions	**894**	**0.54**	884	0.67
General provisions	**517**	**0.32**	524	0.40
	1,411	**0.86**	1,408	1.07

Capital Structure

Regulatory Capital	**31 December 2004 £m**	31 December 2003 £m
Risk weighted assets – on balance sheet	**132,383**	116,600
Risk weighted assets – off balance sheet	**16,050**	14,683
	148,433	131,283
Tier 1		
Share capital	**810**	810
Perpetual securities	**297**	297
Eligible reserves	**8,110**	6,956
Minority interests (equity)	**411**	287
Minority and other interests (non-equity):		
Preferred securities	**400**	400
Less: Goodwill	**(496)**	(474)
Total Tier 1 Capital	**9,532**	8,276
Tier 2		
Perpetual subordinated debt	**2,318**	1,697
Term subordinated debt	**3,711**	3,499
Other minority interest (non-equity)	**458**	431
General provisions	**545**	548
Total Tier 2 Capital	**7,032**	6,175
Supervisory deductions		
Unconsolidated investments – other	**(5)**	(3)
Investments in other banks	**(18)**	(83)
Other deductions	**(706)**	(678)
Total supervisory deductions	**(729)**	(764)
Total capital	**15,835**	13,687
Tier 1 capital ratio (%)	**6.4**	6.3
Total capital ratio (%)	**10.7**	10.4

European Economic and Monetary Union (EMU)

Whilst the government did not propose a euro assessment at the time of the Budget in 2004, it announced that it intends to again review progress at the time of the budget in 2005.

HBOS 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 the 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.

Bank of Scotland has established a comprehensive framework of internal controls for the management of risk within its businesses. The Board has overall responsibility for the Group's system of control. Aspects are delegated to Board Committees and Executive Committees and to senior management within the Group, but approval of the principal risk policies and standards, and of the terms of reference of Board Committees, is reserved to the Board. The Board is also responsible for reviewing the effectiveness of the systems and controls in place.

The system of controls described in this section has been in place in the Bank of Scotland group throughout the period to the date of approval of the Annual Report and Accounts. It accords with the Turnbull guidance on internal control, and has also been reviewed by the Board specifically for the purposes of this statement.

Management and Controls

Principles

The system of internal control 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. The Group also has processes in place to provide similar assurance in respect of joint ventures. More information about the particular types of risks faced by the Group is given on page 13 below.

The control system continues to evolve, and specialist risk managers are tasked with carrying out research to identify industry best practice, and with ensuring that standards and policies within the Group are progressively developed to improve risk management practice.

The Group seeks to maintain high standards for the management of risk, in accordance with the following principles:

- Key risks are identified, measured where appropriate, and managed to achieve a balance between risk and reward which is acceptable to the Board. Each year the Board carries out a formal strategic review of risk management, and also reassesses its appetite for risk during the preparation of the Group's annual business plan. This focus on aligning the taking of risk with the achievement of business objectives means that the control system is designed to manage, rather than eliminate, risk and can provide only reasonable – and not absolute – assurance against material misstatement or loss.

- Management of risk is a key element of all managers' competencies. For each major risk type, centres of expertise have been established where appropriate, both in the divisions and at Group level, to ensure that guidance is available for managers within the Group.

- Risk management reporting must be comprehensive and accurate, reflecting the true position at any given time. Staff and systems resources are dedicated to ensuring that risk management information is accurate, timely and relevant to the business.

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

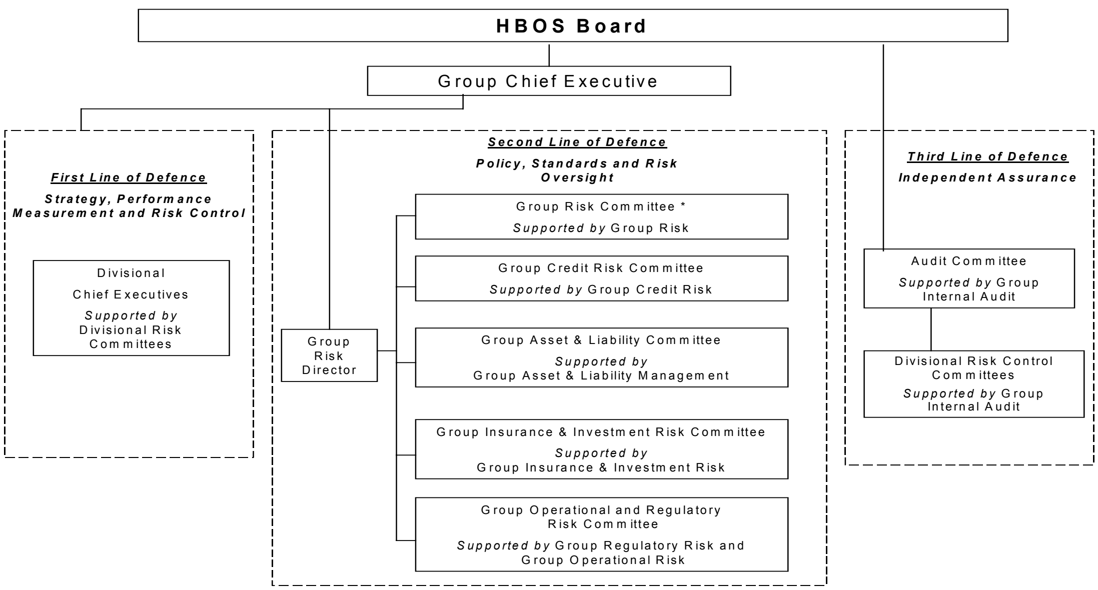
The Risk Management Framework

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

1) Primary management responsibility for strategy, performance management and risk control lies with the Board, the Group Chief Executive and the Chief Executive of each division (*first line of defence*);
2) Centralised policies and standards are developed, and objective oversight of risk management is exercised by specialist risk functions, supporting the Group's Executive Risk Committees (*second line of defence*); and
3) Independent and objective assurance on the effectiveness of control systems is provided by internal audit functions and the Group Audit Committee (*third line of defence*).

This is achieved through a formal governance structure, comprising committees with specified areas of responsibility, supported by management functions with a similar remit. The diagram "Risk Management Structure" below illustrates this approach, showing the committee structure and executive responsibilities in place with effect from 1st January 2005:

Risk Management Structure



** The Group Risk Committee was established with effect from 1st January 2005*

Strategy, Performance Measurement and Risk Control

The risk appetite of the Group is set by the Board. The strategy for managing risk is formulated by the Executive and recommended to the Board for approval. The HBOS Executive Committee (known until 31st December 2004 as the Group Management Board) also reviews the effectiveness of risk management systems through reports from management and from the Group Executive Risk Committees.

Management has prime responsibility for identifying and evaluating significant risks to the business and for designing and operating suitable controls. Internal and external risks are assessed, including control breakdowns, disruption of information systems, competition and regulatory requirements. The assessment process is designed to be consistent across the divisions and 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 budget.

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

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

Policy, Performance and Risk Oversight

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

The Group Executive Risk Committees are Executive Committees of the Group. Committees covering specific types of risk assist the Board to formulate risk appetite, policies and strategies for that specific risk type, and are responsible for the implementation and maintenance of the risk management framework relating to that risk. The exception to this is the Group Insurance and Investment Risk Committee, which has a remit for wider risk management issues in insurance and investment businesses, as explained below.

The four specific Executive Risk Committees are:

- the Group Credit Risk Committee, which covers all credit risk matters;
- the Group Asset & Liability Committee, which is responsible for balance sheet structure, market risks, trading, funding and liquidity management;
- the Group Insurance and Investment Risk Committee, which is responsible for investment, credit, market, liquidity and insurance risks, and for asset and liability management within the insurance and investment entities within the Group; and
- the Group Operational and Regulatory Risk Committee, responsible for operational and regulatory risks.

In addition, the Group Risk Committee was established on 1st January 2005 to consider and manage the potential for group risks as defined on page 13 below.

The Group has established specialist Group Risk functions in support of these committees. Their accountabilities are:

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

The Group Risk functions consist of Group Financial and Operational Risk and Group Regulatory Risk, which report to the Group Risk Director. Until 4th October 2004 (when a separate post with responsibility for Risk was introduced) this role was fulfilled by the Group Finance Director. For clarity, this role is referred to as Group Risk Director throughout this report. The Group Risk functions provide functional leadership for specialist personnel throughout the Group. They oversee risk management activities across the Group to ensure minimum standards are met; set target standards to promote Group practices that exceed industry minimum standard; and monitor aggregate risk data at Group-wide and cross-divisional regulated entity levels.

Group Financial Risk has three main areas of focus, Group Asset and Liability Management, Group Credit Risk and Group Insurance and Investment Risk, whose function is to support the respective Executive Risk Committees.

The Group Risk areas which support the Group Operational and Regulatory Risk Committee are Group Operational Risk and Group Regulatory Risk. In addition to its support for the Committee, Group Regulatory Risk is also responsible for oversight of the Group's adherence to regulatory requirements and for oversight of communications with regulators on a Group-wide basis, with direct responsibility for relations with the Financial Services Authority (FSA), the Group's principal regulator.

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

Independent Assurance

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. This role provides independent and objective assurance that there is an appropriate control structure throughout the Group. The Group's Audit Committee acts as the audit committee for regulated entities that are not wholly within a single business division and is supported by six divisional Risk Control Committees.

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 Group Financial and Operational Risk, Group Regulatory Risk and Group Internal Audit. The Group Risk Director, the Chief Financial and Operational Risk Officer, the Head(s) of Group Regulatory Risk, and the Head of Group Internal Audit all have right of direct access to the Chairman of the Audit Committee and the Chief Executive.

The Audit Committee also considers external auditors' reports and reviews the minutes and work of divisional Risk Control Committees.

All business divisions have divisional Risk Control Committees which generally comprise at least two independent Non-executive Directors and an Executive Director, independent of that division. They review, on behalf of the Audit Committee, the adequacy of the business divisions' systems of internal control (including financial, regulatory and operational risk management). These committees meet regularly to review the significant risks facing their division's business and the techniques used to identify, assess and manage them.

The divisional Risk Control Committees and, where appropriate, subsidiary companies' Audit Committees operate under delegated authority from the Audit Committee and the planning and co-ordination of their activities is reviewed by the Audit Committee.

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.

Management of Key Risks

The Group is subject to risks, inherent in financial services activity. The Group's principal activities are the provision of retail, business and corporate banking, treasury services, insurance and life assurance. It consequently makes loans to and takes deposits from customers and wholesale counterparties, while the activities of insurance and investment businesses carry insurance underwriting risks.

The banking industry has responded to the growing complexity of the financial markets and a number of regulatory initiatives by developing a suite of sophisticated risk management techniques. The Group is committed to developing its risk management techniques and methodologies, both to maintain high standards of risk management practice, and to fulfil the requirements of UK and international regulators.

The new Basel Capital Accord (BIS II) is intended to encourage improvement in banks' ability to measure risk and to align capital requirements closely with risk management practices. The provisions of BIS II provide the context for much of the Group's current risk development work, including investment in advanced risk models. The Prudential Sourcebook under which the FSA will implement Basel II refers to the following categories of risks:

- credit risk;
- market risk;

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

- liquidity risk
- insurance risk;
- operational risk (including regulatory risk); and
- group risk (sometimes referred to as "group contagion risk").

Credit Risk

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

The Group Credit Risk Committee, one of the Executive Risk Committees described on page 12 above, is chaired by the Group Risk Director and comprises senior executives from across the business divisions and group functions. It meets monthly 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. The Board also approves annually the Group Credit Risk Policy statement.

Day to day management of credit risk is undertaken by specialist credit teams working within each business division in compliance with policies approved by the Board. Typical functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts.

Group Credit Risk, a specialist support function within Group Financial & Operational Risk, provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance of each divisional portfolio to the Group Credit Risk Committee, Group Credit Risk provides a challenge role in terms of adherence to laid down standards, policies and limits.

In Retail 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, current accounts and personal loans, is centralised for the various products, and software systems are used to prioritise action. Mortgage collection is conducted through a number of payment collection departments. Small business customers may be rated using scorecards in a similar manner to retail customers.

Corporate Division typically conducts 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.

For HBOS Treasury Services plc ("HBOSTS"), a subsidiary of Bank of Scotland, credit risk policies are established and reviewed by the Group Wholesale Credit Committee, a subcommittee of the Group Credit Risk Committee.

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

Target and benchmark standards have been established across the Group for the management of credit risk. 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 and price for risk across the portfolio.

Within the insurance and investment businesses, formal policies for credit risk management and an overall credit risk appetite, approved by the Board of the relevant company, are in use together with a regular monitoring process to ensure compliance. Additionally, oversight in this area is undertaken by the Group Insurance and Investment Risk Committee. To meet new regulatory requirements, additional reporting has been developed on how credit risk is managed at the legal entity level.

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),commodity prices and equity prices; 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 which allocates responsibility for oversight and management of market risk to the Group Asset & Liability Committee, one of the Executive Risk Committees described on page 12 above, and chaired by the Group Risk Director. 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 the Group Asset & Liability Committee for approval on at least an annual basis.

Market risk within the insurance and investment businesses arises in a number of ways and depending upon the product, some risks are borne directly by the customer and some by the insurance and investment company. In the case of the risk borne by the customer, this is controlled by adherence to, and regular monitoring of, investment mandates and, if appropriate, unit pricing systems and controls. In the case of the company, overall risk appetites and policies, approved by the company's Board, together with regular monitoring ensure that this is appropriately controlled.

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

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 HBOSTS 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 the Group Asset & Liability Committee to allocate limits to business areas as appropriate within the overall risk appetite, as approved by the Board each year. In turn, the Group Asset & Liability Committee has granted limits which represent the risk tolerance for each division. Interest rate risk arising in the course of business is required to be transferred to HBOSTS from the banking divisions. The residual risk in the banking divisions is

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

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. The Group Asset & Liability Committee undertakes to ensure that the aggregate exposure does not exceed the total Group risk appetite.

Sensitivity to interest rate movements is shown in Note 40 to the Accounts on page 66 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 the Group Asset & Liability Committee to set structural foreign exchange limits. The Group Asset & Liability Committee has established limits for foreign exchange transaction and translation risk.

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

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

Structural foreign exchange exposures are set out in Note 42 to the accounts on page 67.

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 the Group Asset & Liability Committee.

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

The 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 2004 was £5.6m. The calculation is based upon a confidence level 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 exposure, and limited equity exposure.

The current methodology for providing an aggregated VaR for the business uses very conservative assumptions. In order to assess the effectiveness of VaR the 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 profit and loss was £0.9m.

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 2004 is analysed in Note 41 on page 67 of the Accounts. The regulatory capital charge for market risk trading exposures represents only 1.7% of the Group's capital base.

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

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 as a risk management tool for hedging interest rate and foreign exchange rate risk.

The following table "Derivatives Management of Market Risk Exposures" 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.

Derivatives Management of Market Risk Exposures

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.

The Group's activity in derivatives is controlled within risk management limits set by the Board and overseen by the Group Asset & Liability Committee. This framework recognises the principal risks including credit, operational, liquidity and market risk associated with derivatives. Details of derivative contracts outstanding at the year end are included in Note 37 of the Accounts on page 62.

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 is set by the Board. The responsibility to direct the management of liquidity and to report against policy is delegated to the Group Asset & Liability Committee. 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; the Group Asset & Liability Committee 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 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.

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

In addition to the regulatory requirements for holding liquidity, the Board requires that prudential liquidity limits should be set by Group Asset & Liability Committee both at 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. The Group Asset & Liability Committee 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 represent 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. The Group Asset & Liability Committee 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.

Insurance and Investment Risk

Insurance risk is the potential for loss, arising out of adverse claims and persistency experience, from both life and general insurance contracts. Investment risk is the potential for financial loss arising from the risks associated with the asset management activities of the Group. This includes both those assets which correspond to liabilities to policyholders and the free assets corresponding to liabilities to shareholders. It also includes indirect risks associated with the management of assets held on behalf of third parties.

The Group Insurance & Investment Risk Committee, one of the Executive Risk Committees described on page 12 above, considers regular reports on specified aggregate risks across of the Group's insurance and investment businesses. The committee takes a technical and expert perspective on financial risks within these businesses, including insurance and investment risk. It oversees the development, implementation and maintenance of the overall financial risk management framework, covering financial risk in each business individually, as well as in aggregate. As part of the overall Group risk management framework, the Group Insurance & Investment Risk Committee provides regular reporting to the Group Asset and Liability Management Committee and to the Group Credit Risk Committee on market and credit risk (respectively) arising within these businesses.

Day to day management of insurance and investment risk is undertaken both by line management and by specialist teams within the insurance and investment businesses. Use is made of the statutory actuarial roles, both to ensure regulatory compliance in respect of the authorised insurance companies in the Group and to meet Group control standards.

Operational Risk

Operational risk is defined within the Basel Capital Accord as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. (Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions as well as private settlements.) "

The Group Operational and Regulatory Risk Committee is an executive committee chaired by the Group Risk Director, and considers both operational and regulatory risks. It is attended by senior colleagues from Group and the divisions. Inter alia, it receives reports on significant operational risk issues from across the Group.

For operational risk issues, the committee is supported by Group Operational Risk. Group Operational Risk also has responsibility for the design and management of two systems that support the underlying processes; provision of oversight and functional leadership of operational risk management activity across the Group; and production of aggregated reports

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

for several senior committees. An operational risk capital model is also being developed, to help the Group better understand the level of risk it is exposed to.

Within the business, day to day management of operational risk is an intrinsic part of every business manager's role. The line management is supported by specialist operational risk teams in each division. These teams develop divisional specific strategies for managing operational risk, tailor Group policy and ensure that implementation of the framework is embedded.

The main components of the operational risk framework include regular risk and control assessments, loss reporting, key risk indicator tracking and monitoring of external events. Insurance cover and contingency arrangements are also used to mitigate risk where appropriate. During 2004, operational risk systems and controls were reviewed and improved across the Group in preparation for the introduction of revised regulatory standards. In addition, a thorough internal review of the HBOS operational risk framework was undertaken. As a result, enhancements are planned to the approach used for operational risk, which will help to further align the management of operational risk to the day to day running of the Group. These enhancements include clearer definitions of elements of operational risk; more frequent risk self assessments; a greater challenge role for specialist support functions; and a greater focus upon the primary risks to the Group.

These improvements build on the Group's existing operational risk management capabilities, and will be phased-in during 2005.

Regulatory Risk

Regulatory Risk is the risk to the Group’s business strategy, model, plans, reputation and financial condition which results from failure to meet laws, regulations, internal standards and policies. This includes failing to meet expectations of key stakeholders such as customers, employees and society as a whole whose interests are represented by regulators in the UK and elsewhere. Regulatory risk can also arise where the Group fails to anticipate and manage regulatory change adequately or fails to manage its communications and relationships with its regulator adequately.

The Executive Committee responsible for regulatory risk is the Group Operational and Regulatory Risk Committee (described above). In respect of regulatory risk, its aim is to ensure that the requirements of the relevant regulatory authorities are complied with and to this end it considers risk issues and reports from across the Group. In that it is supported by Group Regulatory Risk.

Group Regulatory Risk (a specialist Group Function) provides the “second line of defence” in relation to regulatory risk management within the HBOS Group, recommending the Group-wide regulatory risk management policies, standards and framework. It is also accountable for overseeing the adequacy and effectiveness of regulatory risk management being carried out in each of the operating divisions and for providing reports and assessments in that regard to the operating division Risk Control Committees and to the Group Audit Committee.

Day to day management of regulatory risk is the accountability of line management within the business divisions. Specialist teams of regulatory risk management advisers working within each operating division are accountable for providing line management with advice on requirements and appropriate systems and controls to ensure day to day compliance. These specialist teams are also accountable for designing, carrying out and reporting on appropriate risk-based transactional monitoring programmes to check ongoing compliance with key regulatory requirements.

Group (Contagion) Risk

Group risk in the HBOS Group refers to the aggregation and management of risks arising throughout the Group, and includes the management of group contagion risk, which assesses the extent to which membership of the Group may be a source of both risk and strength to individual entities within the Group.

The potential for these risks to result in adverse financial impacts across the Group is monitored under the direction of the Group Risk Director, who chairs the Group Risk Committee. This committee reviews concentrations of risk across the Group and the results of stress tests applied to aggregate risk positions, to monitor compliance with the overall risk appetite set by the Board.

DIRECTORS' REPORT

The Directors have pleasure in presenting their Report and Accounts for the year ended 31 December 2004.

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 and Financial Review on pages 1 to 19. A list of the main subsidiary undertakings, and the nature of their business, is given in Note 47 to the Accounts on page 69.

Results and Dividends

The profit before tax and exceptional items for the year ended 31 December 2004 amounted to £2,344 million (year ended 31 December 2003 – £1,826 million).

An interim dividend of £127 million was paid on 5 October 2004. The Directors recommend payment of a final dividend of £254 million in respect of the year ended 31 December 2004.

Dividends on the 9 ¼ % and 9 ¾ % Non-Cumulative Irredeemable Preference Stocks for the half year ended 31 August 2004 were paid on 18 November 2004 and for the half year ended 28 February 2005 will be paid on 1 June 2005.

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 2004 by Bank of Scotland was 15 days (year ended 31 December 2003 – 22 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), James Crosby (Director), Phil Hodkinson (Chief Executive, Insurance and Investment), Andy Hornby (Chief Executive, Retail), Colin Matthew (Chief Executive, Strategy and International Operations), Mark Tucker (Director), together with the following Non-Executive Directors: Charles Dunstone, Sir Ronald Garrick, Anthony Hobson, Brian Ivory, John Maclean, Coline McConville, Lord Stevenson, Katherine (Kate) Nealon and David Shearer. Sir Bob Reid and Louis Sherwood retired as Directors on 27 April 2004, Philip Yea retired as a Director on 30 June 2004 and Mike Ellis retired as a Director on 31 December 2004. John Maclean will retire on 27 April 2005. Coline McConville, Phil Hodkinson, Andy Hornby and Dennis Stevenson will retire by rotation at the Annual General Meeting and resolutions for the their re-election will be proposed at the meeting. Mark Tucker has been appointed a Director of the Company with effect from 30 April 2004 and will retire at the forthcoming Annual General Meeting and offer himself for election.

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

DIRECTORS' REPORT (continued)

Charitable and Other Donations

Charitable donations by the Group in the UK during the year amounted to £nil million (year ended 31 December 2003 - £nil million).

Share Capital

Full details of the movements in the authorised and issued share capital during the year are provided in Note 32 to the Accounts on page 60.

Corporate Governance and Directors' Remuneration

No separate report on the 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
1 March 2005

APPENDIX TO DIRECTORS' REPORT

1.1 Directors Share Interests

1.1.1 Shares

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

Table 1	**Number of shares at 31.12.04**	Number of shares at 31.12.03 *
Governor		
George Mitchell	90,562	72,622
Executive Directors		
James Crosby	279,407	184,280
Mike Ellis	275,786	168,833
Phil Hodkinson	112,919	28,806
Andy Hornby	252,640	174,759
Colin Matthew	88,032	72,366
Mark Tucker	Nil	Nil
Non-Executive Directors		
Charles Dunstone	100,000	100,000
Sir Ronald Garrick	19,611	17,306
Anthony Hobson	6,500	5,500
Brian Ivory	7,000	11,000
Coline McConville	2,070	2,070
John Maclean	5,000	5,038
Kate Nealon	8,198	Nil
David Shearer	10,000	Nil
Lord Stevenson	221,726	166,541

* Or date of appointment, if later.

Notes to Table 1

Note 1:
James Crosby, George Mitchell, Brian Ivory and John Maclean all have a non-beneficial interest as at 31 December 2004 over 2,217,507 ordinary shares of the Group (2003 - 4,514,752) as Trustees of the Bank of Scotland Profit Sharing Stock Ownership Scheme. Brian Ivory has a non-beneficial interest over 4,500 ordinary shares (2003 - 4,500).

Note 2:
Certain Directors will receive further interests in the ordinary shares of the Group arising out of the short term incentive plans and, potentially, the long term incentive plans as set out in Tables 2, 3, 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 Group undertaking at the beginning or during or at the end of the financial year. No options to subscribe for shares in other Group companies are granted to Directors of the Group.

Neither James Crosby nor Phil Hodkinson, who are both Non-executive Directors of St James's Place Capital plc, nor their immediate families had any interest in the ordinary shares of that company throughout 2004.

Note 4:
There has been no change in the share interests as set out in the table between the end of the financial year and 1 March 2005, the date of approval of this Annual Report and Accounts.

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 and/or 2003 was taken in shares and these shares are retained in trust for three years, additional shares may also be transferred to the Directors. The basic shares shown below which have already vested are also included in Table 1. The additional shares shown below arise as a result of sharekicker.

APPENDIX TO DIRECTORS' REPORT (continued)

Table 2

	Grant effective from	At 31.12.03		Granted in year		Released in year	At 31.12.04	
		Basic shares	Additional shares	Basic shares	Additional shares		Basic shares	Additional shares
James Crosby	Mar 2001	19,420	9,710			29,130	–	–
	Mar 2002	38,671	19,335				38,671	19,335
	Mar 2003	32,177	16,088				32,177	16,088
	Mar 2004			24,850	12,425		24,850	12,425
		90,268	45,133				95,698	47,848
Mike Ellis	Mar 2001	14,617	7,308			21,925	–	–
	Mar 2002	29,003	14,501				29,003	14,501
	Mar 2003	23,889	11,944				23,889	11,944
	Mar 2004			17,315	8,657		17,315	8,657
		67,509	33,753				70,207	35,102
Phil Hodkinson	Mar 2002	10,327	5,163				10,327	5,163
	Mar 2003	18,282	9,141				18,282	9,141
	Mar 2004			12,826	6,413		12,826	6,413
		28,609	14,304				41,435	20,717
Andy Hornby	Mar 2001	11,067	5,533			16,600	–	–
	Mar 2002	23,525	11,762				23,525	11,762
	Mar 2003	21,939	10,969				21,939	10,969
	Mar 2004			18,437	9,218		18,437	9,218
		56,531	28,264				63,901	31,949
Colin Matthew	Mar 2002	11,384	5,692				11,384	5,692
	Mar 2003	18,282	9,141				18,282	9,141
	Mar 2004			12,505	6,252		12,505	6,252
		29,666	14,833				42,171	21,085
George Mitchell	Mar 2002	14,035	7,017				14,035	7,017
	Mar 2003	23,889	11,944				23,889	11,944
	Mar 2004			17,315	8,657		17,315	8,657
		37,924	18,961				55,239	27,618

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
Mar 2004 – Mar 2007	7.36

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.

Note 3:
Because the basic shares are shown net of each participant's original income tax and National Insurance liability, the additional incentive shares are shown in a like manner. Those released in 2004 represented the basic shares purchased by the Director's own annual cash incentive in March 2001 plus the additional shares arising as a result of sharekicker.

Note 4:
Following his retirement on 31 December 2003, Gordon McQueen retains interests under the short term incentive plan through grants of basic and additional shares of 18,406 and 9,203, respectively (effective from March 2003) and 17,128 and 8,564, respectively (effective from March 2004). These remain subject to the same plan rules as apply to existing Executive Directors.

APPENDIX TO DIRECTORS' 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 31.12.03	Granted (G) or Lapsed (L) in year	Added as a result of performance	Dividend reinvestment shares	Vested in year	At 31.12.04
James Crosby	Jan 2001	70,992		70,992	18,540	160,524	–
	Jan 2002	75,000					75,000
	Jan 2003	103,125					103,125
	Jan 2004		108,089(G)				108,089
		249,117					286,214
Mike Ellis	Jan 2001	53,435		53,435	13,954	120,824	–
	Jan 2002	56,250					56,250
	Jan 2003	76,562					76,562
	Jan 2004		75,313(G)				75,313
		186,247					208,125
Andy Hornby	Jan 2001	40,458		40,458	10,566	91,482	–
	Jan 2002	45,625					45,625
	Jan 2002	260,000					260,000
	Jan 2003	70,312					70,312
	Jan 2004		80,195(G)				80,195
		416,395					456,132
Phil Hodkinson	Jan 2001	53,435		53,435	13,954	120,824	–
	Jan 2002	87,500					87,500
	Jan 2003	58,593					58,593
	Jan 2004		55,788(G)				55,788
		199,528					201,881
Colin Matthew	Jan 2002	45,625					45,625
	Jan 2003	58,593					58,593
	Jan 2004		54,393(G)				54,393
		104,218					158,611
George Mitchell	Jan 2002	56,250					56,250
	Jan 2003	76,562					76,562
	Jan 2004		75,313(G)				75,313
		132,812					208,125
Dennis Stevenson	Jan 2001	38,168		38,168	9,968	86,304	–
	Jan 2002	56,250					56,250
	Jan 2003	77,343					77,343
	Jan 2004		73,221(G)				73,221
		171,761					206,814
Mark Tucker	Jan 2004		156,206(G)				156,206
							156,206

APPENDIX TO DIRECTORS' REPORT (continued)

Notes to Table 3

Note 1:

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

Plan and Performance Period	Share Grant Price £
January 2001 – December 2003	6.55
January 2002 – December 2004/06	8.00
January 2003 – December 2005/07	6.40
January 2004 – December 2006	7.17

Note 2:
The grants effective from January 2001 and January 2002 for Phil Hodkinson, over shares having a value equal to 100% and 200% of salary, respectively, were necessary to facilitate his recruitment in September 2001. Normal grant levels would have been 25% of salary (in respect of three months' service in 2001) and 100% of salary, respectively. These higher grants have no value unless HBOS outperforms the relevant comparator company weighted average, as set out in the HBOS plc Annual Report and Accounts.

The grant effective from January 2004 for Mark Tucker, over shares having a value equal to 200% of salary, was necessary to facilitate his recruitment in April 2004. The normal grant level would have been 67% of salary (in respect of eight months' service in 2004). This higher grant has no value unless HBOS outperforms the relevant comparator company weighted average, as set out in the HBOS plc Annual Report and Accounts.

Following his retirement on 31 December 2003, Gordon McQueen retains interests under the plan through grants of 45,625 and 61,718 shares effective from January 2002 and January 2003, respectively. These remain subject to the same plan rules as apply to existing Executive Directors.

Note 3:
Awards are not pensionable.

Note 4:
The performance period for the January 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% p.a. so a maximum 200% of share grants have been released to grant recipients. Without a maximum payout limit of 200%, the plan would have released 336% of share grants.

The shares granted in January 2001 vested on 1 March 2004. The closing market price of the Group's ordinary shares on that date was £7.34. 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 the Chairman 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 behalves for at least an additional two years and are included in Table 1.

Note 5:
Subject to performance, the shares granted under the long term plan effective from January 2002 will be released to most individuals shortly after the three-year anniversary of the grant date.

As explained in last year's Report, 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 plan for a further two years and take shares at that point based on the better of the three-year and the five-year performance outcomes. This design feature seeks to motivate participants continually to sustain strong performance or to improve lesser performance for their benefit and the benefit of shareholders. This feature does not apply for the 2004 grants and will not apply for any grants in subsequent years, to reflect the preference on "retesting" expressed by most major institutional investors.

APPENDIX TO DIRECTORS' REPORT (continued)

Note 6:
In the case of the Chairman, 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 any notional shares on vesting but has agreed that this value will, subject to any withholdings for income tax or National Insurance, be applied in acquiring shares on his behalf.

Note 7:
The number of shares to be released to participants is dependent on the Group's TSR over a three year period, compared to the annualised weighted average TSR of a basket of comparator companies over an equivalent period. For the grants effective from January 2002 and January 2003, a five year period can also apply. This basket of companies comprises:-

- 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 and Royal Bank of Scotland;

- For the January 2002, 2003 and 2004 grants: Abbey National, Aviva, Barclays, Legal & General, Lloyds TSB, Prudential, Royal & Sun Alliance and Royal Bank of Scotland, but with Abbey National replaced by Alliance & Leicester, Bradford & Bingley and Northern Rock with effect from 1 July 2004.

The Committee decided retrospectively to remove Abbey National from the comparator group, in respect of the January 2002, 2003 and 2004 grants, effective from the end of June 2004 (immediately before bid activity started); and replace it with Alliance & Leicester, Bradford & Bingley and Northern Rock effective from the start of July 2004. This revised group of companies will comprise the comparator group for the January 2005 grant.

* For the period for which it was an independent entity.

Shares will be released as follows:

HBOS Group's relative TSR performance	Amount released as a % of share grant
2001 grants	
0% pa (or below)	0
+4% pa	100*
+8% pa (or above)	200
2002, 2003 and 2004 grants	
0% pa (or below)	0
+3% pa	100*
+6% pa (or above)	200

Intermediate positions are determined by interpolation.

* As shown as granted in the table.

Note 8:
The performance period for the January 2002 grant ended on 31 December 2004. HBOS's TSR over the performance period exceeded the weighted average of the comparator group by 7.44% p.a., so a maximum 200% of share grants will be released to grant recipients, subject to Note 5 above. Without a maximum payout limit of 200%, the plan would have released 248% of share grants.

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

Full details concerning these shares, which will be released to the Chairman and the Executive Directors in March 2005, will be set out in the 2005 Annual Report and Accounts.

APPENDIX TO DIRECTORS' REPORT (continued)

In respect of this January 2002 grant, the Committee decided retrospectively to remove Abbey National from the comparator group of companies with effect from the end of June 2004, (immediately before bid activity started) and to replace them by Alliance & Leicester, Bradford & Bingley and Northern Rock from the start of July 2004. Had Abbey National been replaced at November 2004 (the date when the Company ceased to be independently listed), the plan would still have released a maximum 200% of share grants to grant participants.

The performance periods for the January 2003 and January 2004 grants (where there have been equivalent adjustments in respect of Abbey National) do not end until 31 December 2005 and 31 December 2006, respectively. So far, HBOS's TSR over the two year and one year elapsed periods exceeds the weighted average of the comparator group by 9.55% and 4.91%, respectively.

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 an 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 the Retail division over 2002 to 2004. In broad terms, the maximum release under this special arrangement is delivered in April 2005 subject to at least a 60% increase in the profitability of the Retail division, using a like for like comparison, over the three year period, and provided that Andy Hornby is in the service of the 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 and 2004 have also been satisfied. Full details concerning these shares, which may be released to Andy Hornby in April 2005, will be set out in the 2005 Annual Report & Accounts.

If Andy Hornby were to leave employment as a qualifying leaver or in the event of a change of control before April 2005, the accrued shares would vest. If he were to leave in certain other circumstances, he would 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 in April 2005 it will be eligible for the 50% sharekicker enhancement, which will be released if Andy Hornby retains the shares and remains in the service of the Group until 31 March 2008 (or ranks as a qualifying leaver before that date).

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

1.1.4 Long Term Incentive Plan - Former Bank of Scotland Directors

Approved 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 exceeded the growth in the Retail Prices Index over a period of at least three consecutive financial years by not less than 2% p.a.

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 with Halifax.

The performance target in respect of approved share options was satisfied on 31 December 2002 for all grants and consequently all 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.

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

APPENDIX TO DIRECTORS' REPORT (continued)

Table 4

	Grant effective from	At 31.12.03	Granted (G), exercised (E) or lapsed (L) in year	At 31.12.04	Share Option Price £	Exercisable
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

Note 1:
No Executive Director's share options lapsed in the period 1 January 2005 to 1 March 2005, the date of approval of this Annual Report and Accounts.

Note 2:
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; on 1 March 2004 he exercised options over 48,000, 45,000 and 32,000 shares granted effective from October 1995, October 1996 and October 1997, respectively; and on 2 June 2004, he exercised options over 5,223 shares granted effective from October 1998. He has no remaining options under the plan.

The closing market prices on the dates of exercise were £7.555, £7.34 and £7.12, respectively.

Full details of these options were set out in last year's Report.

Note 3:
Details of the market price of the Group's ordinary shares during 2004 are given in Section 1.1.7.

APPENDIX TO DIRECTORS' REPORT (continued)

1.1.5 Sharesave Plan

The sharesave plan is available to most HBOS Group colleagues.

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

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 31.12.03/ 01.01.04	Granted (G), exercised (E) or lapsed (L) in year	At 31.12.04	Initial exercise date	Expiry date
James Crosby	Sept 2002	2,748		2,748	Jan 2008	Jun 2008
Phil Hodkinson	Sept 2002	2,970		2,970	Jan 2010	Jun 2010
Andy Hornby	Sep 2003	1,607		1,607	Jan 2007	Jun 2007
George Mitchell	Oct 2001	1,723		1,723	Jan 2005	Jun 2005
	Sept 2004		1,740(G)	1,740	Jan 2008	Jun 2008

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 2001	5.62
September 2002	5.975
September 2003	5.74
September 2004	5.443

Note 2:
Gordon McQueen, who retired as an Executive Director on 31 December 2003, exercised options over 2,397 shares on 16 June 2004. He has no remaining options under the plan.

The closing market price on the date of exercise was £7.11.

Full details of these options were set out in last year's Report.

Note 3:
George Mitchell exercised options over 1,723 shares on 2 February 2005.

The closing market price on the date of exercise was £8.57.

George Mitchell retained ownership of these shares as at 1st March 2005, the date of approval of this Annual Report and Accounts.

Note 4:
Details of the market price of the Group's ordinary shares during 2004 are given in Section 1.1.7.

APPENDIX TO DIRECTORS' REPORT (continued)

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:

- the Group's Employee Share Ownership Trusts. As such, they were each treated as at 31 December 2004 as being interested in the 5,298,695 ordinary shares (31 December 2003 - 9,884,870 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 Note 1 of Table 1; and

- the Group's Qualifying Employee Share Ownership Trust. As such, they were each treated as at 31 December 2004 as being interested in the 8,260,555 ordinary shares (31 December 2003 – 10,154,710 ordinary shares) held by the trustee of this Trust. The shares held in the Trust will be used to satisfy entitlements of colleagues arising on the exercise of options under the Sharesave Schemes operated by HBOS plc. The relevant Executive Directors' specific individual interests are shown in Table 5.

All of the Group's share plans empower new issue shares to be allotted to satisfy share requirements. The Group's past practice has generally been to purchase shares in the market in relation to the plans described in Sections 1.1.2 and 1.1.3 and to issue new shares in relation to the plans described in Sections 1.1.4 and 1.1.5 and the Group's share option scheme. This practice is under review, and any changes to the methods of satisfying awards or grants under the Group's various share plans will be confirmed in the Committee's Report for 2005.

1.1.7 General

The closing market price of the Group's ordinary shares at 31 December 2004 was £8.48. The closing market price of the Group's ordinary shares at 31 December 2003 was £7.235. The range during the year was £6.63 to £8.505.

Other than as disclosed in the note to Table, there has been no change in the Directors' interests in shares or options granted by the Group between the end of the financial year and 1 March 2005, the date of approval of this Annual Report and Accounts.

Directors' Accounting Responsibilities

The following statement, which should be read in conjunction with the Independent Auditors' Report on page 32, 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 33 to 70.

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 purposes. 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 31 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 are 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 and the part of the Report of the Board in relation to remuneration policy and practice to be audited. 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 2004 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
1 March 2005

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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 comply with Schedule 4 to the Companies Act 1985 and have been prepared in accordance with applicable accounting standards and pronouncements of the Urgent Issues Task Force and in accordance with the applicable Statements of Recommended Practice, being those issued by the British Bankers' Association, and the Finance and Leasing Association.

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

Changes in Accounting Policy

The Group's accounting policies remain unchanged from last year.

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 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.

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. Where the relevant conditions set out in FRS 5, 'Reporting the Substance of Transactions', are met, 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. 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 consistent 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

ACCOUNTING POLICIES (continued)

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 a 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. If the collection of interest is considered doubtful, it is suspended and excluded from interest income in the profit and loss account.

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 scheme are charged in full in the year in which the expense is incurred.

Retirement Benefits

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

Foreign Currencies

Assets, 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 transfer of title to the Group in relation to the counterparty exposure.

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.

Cash Flow Statement

Under FRS 1 (revised 1996) the Group is exempt from the requirement to prepare a cash flow statement as the parent undertaking, HBOS plc, includes the Group in its own published consolidated accounts.

CONSOLIDATED PROFIT AND LOSS ACCOUNT

For the year ended 31 December 2004

	Notes		31 December 2004 £ million		31 December 2003 £ million
Interest receivable					
Interest receivable and similar income arising from debt securities			756		617
Other interest receivable			14,359		11,004
			15,115		11,621
Interest payable			(12,099)		(8,785)
Net interest income			3,016		2,836
Fees and commissions receivable			1,261		1,149
Fees and commissions payable			(295)		(309)
Dealing profits	1		208		176
Other operating income			781		555
Net operating income (all from continuing operations)	1		4,971		4,407
Administrative expenses	2	(1,500)		(1,566)	
Depreciation and amortisation					
Tangible fixed assets	22	(96)		(94)	
Operating lease assets	23	(377)		(313)	
Goodwill amortisation	21	(29)		(18)	
		(502)		(425)	
Operating expenses			(2,002)		(1,991)
Provisions for bad and doubtful debts	16		(729)		(682)
Amounts written off fixed asset investments	17, 18		(24)		(29)
Operating profit (all from continuing operations)			2,216		1,705
Before exceptional items		2,239		1,762	
Exceptional items	3	(23)		(57)	
Share of operating profits of joint ventures			33		35
Share of operating profits of other associated undertakings			59		29
Profit on disposal of fixed assets			13		
Profit on ordinary activities before taxation			2,321		1,769
Before exceptional items		2,344		1,826	
Exceptional items	3	(23)		(57)	
Tax on profit on ordinary activities	9		(668)		(550)
Profit on ordinary activities after taxation			1,653		1,219
Before exceptional items		1,669		1,259	
Exceptional items	3	(16)		(40)	
Minority interests (equity)			(8)		(28)
(non-equity)			(63)		(42)
Profit attributable to Proprietors			1,582		1,149
Dividends	10				
Ordinary		381		515	
Preference		37		37	
			418		552
Retained profit of the year	11		1,164		597

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 33 to 34 and the notes on pages 41 to 70 form part of these accounts.

CONSOLIDATED BALANCE SHEET

As at 31 December 2004

	Notes		31 December 2004 £ million		31 December 2003 £ million
Assets					
Cash and balance at central banks			1,276		1,081
Items in course of collection			611		442
Treasury bills and other eligible bills	12		4,327		7,926
Loans and advances to banks	13		68,555		45,980
Loans and advances to customers		163,940		131,121	
Less: non-returnable finance	14	(4,170)		(4,963)	
	14		159,770		126,158
Debt securities	17		57,460		49,827
Equity shares	18		208		216
Interests in joint ventures					
Share of gross assets		4,042		3,512	
Share of gross liabilities		(3,898)		(3,358)	
	19		144		154
Interests in other associated undertakings	19		169		191
Intangible fixed assets	21		391		422
Tangible fixed assets	22		539		572
Operating lease assets	23		1,883		1,771
Other assets	25		7,724		6,795
Prepayments and accrued income			2,473		2,440
Total assets			305,530		243,975
Liabilities					
Deposits by banks	26		76,539		50,203
Customer accounts	27		96,017		69,325
Debt securities in issue	28		103,780		97,188
Notes in circulation			721		814
Corporate taxation			303		298
Dividends payable	10		266		329
Other liabilities	29		8,602		8,916
Accruals and deferred income			2,761		2,284
Provisions for liabilities and charges					
Deferred taxation	30	212		253	
Other provisions	30	99		97	
			311		350
Subordinated liabilities	31				
Dated loan capital		3,807		3,663	
Undated loan capital		2,615		1,994	
			6,422		5,657
			295,722		235,364
Capital & Reserves					
Called up share capital	32				
Ordinary stock		410		410	
Preference stock (non-equity)		400		400	
		810		810	
Share premium account	33	2,951		2,951	
Other reserves	33	(11)		(2)	
Profit and loss account	33	5,172		4,008	
Proprietors' funds (including non-equity interests)	34		8,922		7,767
Minority interests (equity)			23		11
Minority and other interests (non-equity)	35		863		833
			9,808		8,611
Total liabilities			305,530		243,975

The statement of accounting policies on pages 33 to 34 and the notes on pages 41 to 70 form part of these accounts.

CONSOLIDATED BALANCE SHEET (continued)

As at 31 December 2004

	31 December 2004 £ million	31 December 2003 £ million
Memorandum items		
Contingent liabilities		
Acceptances and endorsements	**75**	130
Guarantees and assets pledged as collateral security	**3,842**	3,193
	3,917	3,323
Commitments		
Other commitments	**41,257**	36,883

Approved by the Board on 1 March 2005 and signed on its behalf by:

GE Mitchell	AJ Hobson	JR Crosby	ME Tucker
Governor	Chairman of Audit Committee	Director	Director

The statement of accounting policies on pages 33 to 34 and the notes on pages 41 to 70 form part of these accounts.

BANK BALANCE SHEET

As at 31 December 2004

	Notes		31 December2004		31 December2003
			£ million		£ million
Assets					
Cash and balance at central banks			1,004		881
Items in course of collection			611		442
Loans and advances to banks	13		30,946		22,038
Loans and advances to customers		100,922		89,628	
Less: non-returnable finance	14	(4,091)		(4,843)	
	14		96,831		84,785
Debt securities	17		301		596
Equity shares	18		36		55
Interest in joint ventures	19		2		
Interests in associated undertakings	19		80		81
Interests in group undertakings	20		1,942		1,945
Intangible fixed assets	21		66		70
Tangible fixed assets	22		361		389
Deferred tax asset	30		138		145
Other assets			213		268
Prepayments and accrued income			787		693
Total assets			133,318		112,388
Liabilities					
Deposits by banks	26		62,889		52,162
Customer accounts	27		52,980		42,672
Debt securities in issue	28		1,161		2,960
Notes in circulation			721		814
Corporate taxation			165		186
Dividends payable	10		266		329
Other liabilities			1,197		846
Accruals and deferred income			462		612
Provisions for liabilities and charges					
Other provisions	30		77		81
Subordinated liabilities	31				
Dated loan capital		3,105		2,998	
Undated loan capital		2,970		2,347	
			6,075		5,345
			125,993		106,007
Capital & Reserves					
Called up share capital	32				
Ordinary stock		410		410	
Preference stock (non-equity)		400		400	
		810		810	
Share premium account	33	2,951		2,951	
Other reserves	33	69		53	
Profit and loss account	33	3,495		2,567	
Proprietors' funds (including non-equity interests)	34		7,325		6,381
Total liabilities			133,318		112,388

The statement of accounting policies on pages 33 to 34 and the notes on pages 41 to 70 form part of these accounts.

BANK BALANCE SHEET (continued)

As at 31 December 2004

	Notes	31 December 2004 £ million	31 December 2003 £ million
Memorandum Items			
Contingent liabilities			
Acceptances and endorsements		**55**	55
Guarantees and assets pledged as collateral security		**20,442**	10,958
		20,497	11,013
Commitments			
Other commitments		**31,054**	29,247

Approved by the Board on 1 March 2005 and signed on its behalf by:

GE Mitchell	AJ Hobson	JR Crosby	ME Tucker
Governor	Chairman of Audit Committee	Director	Director

CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

For the year ended 31 December 2004

	Notes	**Year ended 31 December 2004 £ million**	Year ended 31 December 2003 £ million
Profit attributable to Proprietors	34	**1,582**	1,149
Exchange translation	34	**(9)**	17
Total recognised gains and losses in the year		**1,573**	1,166

The statement of accounting policies on pages 33 to 34 and the notes on pages 41 to 70 form part of these accounts.

NOTES ON THE ACCOUNTS

1. Net Operating Income

		2004 £ million		2003 £ million
Net operating income is after taking account of:				
Dividend income from equity shares		13		8
Amounts receivable under finance leases (including capital repayments)		878		728
Operating lease rental income		526		452
Profit on sale of investment securities		105		34
Mortgage incentives		(226)		(163)
Interest payable on subordinated liabilities		(357)		(310)
Dealing profits				
Foreign exchange	72		64	
Interest related	104		103	
Securities trading	32		9	
		208		176

Dealing profits arise from the Group's trading book. The types of instrument in which the Group trades are set out in Note 37.

2. Administrative Expenses

	2004 £ million	2003 £ million
Administrative expenses includes:		
Staff costs (Note 4)	838	791
Property rentals	58	48
Hire of equipment	2	

3. Exceptional Items

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

	2004 £ million	2003 £ million
HBOS merger integration costs	(23)	(57)
Tax effect	7	17
	(16)	(40)

The HBOS merger integration costs relate to the costs of integration and reorganising Bank of Scotland Group following the merger with Halifax Group plc.

NOTES ON THE ACCOUNTS (continued)

4. Staff

	2004 Number	2003 Number
The average number of persons employed by the Group during the year was:		
Full time	17,883	19,026
Part time	3,471	4,879
	21,354	23,905

	2004 £ million	2003 £ million
The aggregate remuneration payable to those employees comprises:		
Wages and salaries	707	672
Social security costs	64	56
Other pension costs (Note 8)	67	63
Staff costs charged to administrative expenses	838	791

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 2004 or the comparative period. Full details of the directors' remuneration are disclosed in the 2004 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.

	2004			2003		
	Within UK £ million	**Outwith UK £ million**	**Total £ million**	Within UK £ million	Outwith UK £ million	Total £ million
Group						
Audit services						
Statutory audits	1.9	0.7	2.6	1.4	0.4	1.8
Audit-related regulatory reporting	1.1	0.2	1.3	0.3	0.1	0.4
Total audit services	3.0	0.9	3.9	1.7	0.5	2.2
Further assurance services	0.7	0.1	0.8	0.8	0.2	1.0
Tax services						
Compliance services		0.2	0.2			
Advisory services		0.2	0.2	0.2	0.2	0.4
Total tax services		0.4	0.4	0.2	0.2	0.4
Other services	0.2	0.1	0.3	0.2	0.3	0.5
Total non-audit services	0.9	0.6	1.5	1.2	0.7	1.9
	3.9	1.5	5.4	2.9	1.2	4.1

In respect of the Bank, statutory audit fees were £0.2million (2003 - £0.2 million) and other fees were £1.9 million (2003 - £0.3 million). All of the Bank fees are within the UK in 2004. In 2003 £0.3 million was within the UK and £0.2 million was outwith the UK.

Both the Board and the external auditors have safeguards in place to prevent the auditors' independence and objectivity from being compromised. The Audit Committee maintains a comprehensive policy to regulate the use of auditors for non-audit services. This policy sets out the nature of the work the external auditors may not undertake. For those services that are deemed appropriate for the auditors to carry out, the policy sets out the approval process that must be followed for each type of assignment.

7. Operating Leases

	Group				Bank			
	2004		2003		**2004**		2003	
	Property £ million	**Equipment £ million**	Property £ million	Equipment £ million	**Property £ million**	**Equipment £ million**	Property £ million	Equipment £ million
There are commitments to make payments in the following year in respect of non-cancellable operating leases which expire:								
within 1 year	1	1		2				
between 1 and 5 years	15	10	8	22	3	9	2	20
after 5 years	34		38		25		26	
	50	11	46	24	28	9	28	20

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 97 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 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 December 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 represents the ratio of the Scheme's assets to the value of the benefits that had accrued to members and pensioners at the valuation date after allowing for expected future increases in earnings and pensions.

The charge has been increased by spreading the shortfall in assets in the Scheme over the average future working lifetime of the membership (16 years) by fixed capital instalments plus interest on the reducing balance. These elements, together with interest on the opening balance sheet position result in a charge of £51 million (2003 – £54 million).

Contributions to the Scheme of £52 million were paid over the year. As contributions differ from the amount charged in the Profit and Loss Account a provision of £74 million (2003 – £75 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 £16 million (2003 – £9 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 FRS 17 and to assess the assets and liabilities of the scheme as at 31 December 2004 have been used in assessing the FRS 17 disclosures. Scheme assets are stated at their market value at 31 December 2004.

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

	Rates per annum At 31 December 2004	Rates per annum At 31 December 2003	Rates per annum At 31 December 2002
Future price inflation	**2.8 per cent**	2.8 per cent	2.4 per cent
Discount rate	**5.45 per cent**	5.6 per cent	5.8 per cent
Increases in earnings*	**3.8 per cent**	3.8 per cent	3.4 per cent
Increases in pensions**	**2.8 per cent**	2.8 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 Dec 2004	**Value at 31 Dec 2004 £ million**	Expected rate of return per annum at 31 Dec 2003	Value at 31 Dec 2003 £ million	Expected rate of return per annum at 31 Dec 2002	Value at 31 Dec 2002 £ million
Equities	**8.2 per cent**	**1,145**	8.5 per cent	962	8.5 per cent	864
Bonds	**5.0 per cent**	**294**	5.2 per cent	246	5.0 per cent	254
Property	**6.6 per cent**	**43**				
Cash	**3.8 per cent**	**12**	3.8 per cent	165	3.8 per cent	55
Total market value of assets		**1,494**		1,373		1,173
Present value of liabilities of the Scheme		**2,125**		1,903		1,567
Deficit in the Scheme		**631**		530		394
Potential deferred tax asset		**(189)**		(159)		(118)
Net pension liability		**442**		371		276

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

	Year ended 31 December 2004 £ million	Year ended 31 December 2003 £ million
Deficit in the Scheme at beginning of year	**(530)**	(394)
Contributions paid	**52**	61
Current service cost	**(77)**	(68)
Past service cost	**(6)**	
Other finance charge	**(4)**	
Actuarial loss	**(66)**	(129)
Deficit in the Scheme at end of year	**(631)**	(530)

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 2004 £ million	Year ended 31 December 2003 £ million
Current service cost	77	68
Past service cost	6	
Total charged to operating profit	83	68

Analysis of amount that would be charged to other finance income		
Interest on pension scheme liabilities	105	89
Expected return on assets in pension scheme	(101)	(89)
Net amount that would be charged to other finance income	4	
Total potential profit and loss charge before deduction for tax	87	68

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

	Year ended 31 December 2004 £ million	Year ended 31 December 2003 £ million
Gain on Scheme assets	(16)	(103)
Experience loss on liabilities	18	9
Loss on change of assumptions (financial and demographic)	64	223
Total potential loss recognised in STRGL before tax	66	129

History of experience gains and losses

	Year ended 31 December 2004	Year ended 31 December 2003	Year ended 31 December 2002
(Gain)/Loss on Scheme assets	(16)	(103)	329
Amount/(£ million)			
% of Scheme assets at end of year	1%	8%	28%
Experience loss on Scheme liabilities			
Amount (£ million)	18	9	19
% of Scheme assets at end of year	1%	Nil	1%
Total actuarial loss recognised in Statement of Total Recognised Gains and Losses			
Amount (£ million)	66	129	378
% of Scheme liabilities at end of year	3%	7%	24%

9. Taxation

	2004 £ million	2003 £ million
UK Corporation Tax at 30 per cent (2003 – 30 per cent)	530	420
Relief for overseas taxation	(23)	(21)
	507	399
Overseas taxation	127	104
Share of joint ventures' taxation	10	23
Share of other associated undertakings' taxation	11	6
Total current corporation tax	655	532
Deferred taxation (Note 30(i))	13	18
Tax on profit on ordinary activities	668	550

NOTES ON THE ACCOUNTS (continued)

9. Taxation (continued)

The total current corporation tax for the year is lower (2003 – higher) than the standard rate of corporation tax in the UK (30 per cent). The differences are explained below:

	2004 £ million	2003 £ million
Profit on ordinary activities before taxation	2,321	1,769
Profit on ordinary activities multiplied by the standard rate of corporation tax in the UK of 30 per cent (2003 – 30 per cent)	696	531
Effects of:		
Expenses not deductible for tax purposes	10	26
Capital allowances in excess of depreciation	(11)	(20)
Net effect of differing tax rates overseas	(9)	(11)
Book gains covered by capital losses/indexation	(2)	(1)
Deductible interest on innovative tier 1 capital	(10)	(10)
Amounts written off fixed asset investments	14	2
Other timing differences	(7)	35
Adjustments in respect of previous periods	(32)	(22)
Others	6	2
Current corporation tax charge for year	655	532

10. Dividends

		2004 £ million	2003 £ million
Preference dividends	paid	25	25
	payable	12	12
		37	37
Ordinary dividend			
Interim dividend		127	198
Proposed final dividend		254	317
		381	515
		418	552

11. Retained Profit

	2004 £ million	2003 £ million
The profit of the Group has been retained by		
Bank of Scotland	928	184
Subsidiary undertakings	228	422
	1,156	606
Joint ventures and other associated undertakings	8	(9)
	1,164	597

Of the profit attributable to Proprietors, £1,346 million (2003 – £736 million) is dealt with within the accounts of the Company.

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

NOTES ON THE ACCOUNTS (continued)

12. Treasury Bills and Other Eligible Bills

	2004		2003	
Group	**Book Value £ million**	**Market Value £ million**	Book Value £ million	Market Value £ million
Investment securities				
Treasury bills and similar securities	2,850	2,849	6,088	6,087
Other eligible bills	855	855	387	390
	3,705	3,704	6,475	6,477
Other securities				
Treasury bills and similar securities	499	499	1,315	1,315
Other eligible bills	123	123	136	136
	622	622	1,451	1,451
	4,327	4,326	7,926	7,928

	Group £ million
The movement on treasury bills and other Eligible bills held for investment purposes was as follows:	
At 1 January 2004	6,475
Exchange translation	8
Additions and transfers	10,907
Disposals	(13,766)
Amortisation	81
At 31 December 2004	**3,705**
Aggregate unamortised discounts net of premiums at 31 December 2004	**18**

NOTES ON THE ACCOUNTS (continued)

13. Loans and Advances to Banks

	Group		Bank	
	2004	2003	2004	2003
	£ million	£ million	£ million	£ million
Repayable on demand or at short notice	5,905	16,137	11,223	10,131
Other loans and advances repayable				
In 3 months or less excluding on demand or at short notice	22,467	23,821	16,403	5,312
1 year or less but over 3 months	12,408	5,158	318	530
5 years or less but over 1 year	23,250	494	1,138	309
over 5 years	4,525	370	1,864	5,756
Loans and advances to banks	68,555	45,980	30,946	22,038
Included above are loans to subsidiary undertakings				
Subordinated			1,591	1,442
Unsubordinated			29,045	19,517
Fellow subsidiary undertakings - unsubordinated	52,698	31,757	18	14

14. Loans and Advances to Customers

	Group		Bank	
	2004	2003	2004	2003
	£ million	£ million	£ million	£ million
Repayable on demand or at short notice	24,897	18,246	19,139	15,864
Other loans and advances repayable				
in 3 months or less excluding on demand or at short notice	35,025	29,088	29,720	24,675
1 year or less but over 3 months	9,855	9,602	4,568	5,136
5 years or less but over 1 year	27,635	19,681	12,556	10,067
over 5 years	63,907	51,097	31,963	30,137
	161,319	127,714	97,946	85,879
Provisions for bad and doubtful debts (Note 16)	(1,411)	(1,408)	(1,016)	(1,002)
Interest in suspense	(138)	(148)	(99)	(92)
Loans and advances to customers	159,770	126,158	96,831	84,785
Included above are loans to:				
Subsidiary undertakings			2,831	2,433
Fellow subsidiary undertakings	3,013	245	3,013	245
Ultimate parent undertaking	7	10	7	10
Joint ventures and associated undertakings	6,940	6,008	4,564	3,949

Group loans and advances to customers include finance lease receivables of £2,778 million (2003 – £3,078 million). Assets acquired in the year for letting under finance leases amounted to £777 million (2003 – £882 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.

	2004	2003
	£ million	£ million
Agriculture, forestry and fishing	1,326	1,194
Energy	1,244	1,511
Manufacturing industry	6,182	6,010
Construction and property	29,380	23,914
Hotels, restaurants and wholesale and retail trade	10,258	8,889
Transport, storage and communication	2,928	2,764
Financial	31,963	11,867
Other services	16,785	14,321
Individuals		
Home mortgages	40,949	38,625
Other personal lending	10,742	9,244
Overseas residents	9,562	9,375
	161,319	127,714

NOTES ON THE ACCOUNTS (continued)

14. 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 Tansactions", for a linked presentation format, are shown below.

		At 31 December 2004				At 31 December 2003			
		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	79		79		120		120	
Mound Financing (No. 1) PLC	Mortgages	617	617	616	616	617	617	616	616
Mound Financing (No. 2) PLC	Mortgages	525	525	524	524	525	525	524	524
Melrose Financing No. 1 plc	Corporate Loans	900	900	693	693	1,500	1,500	1,445	1,445
Mound Financing (No. 3) PLC	Mortgages	2,261	2,261	2,258	2,258	2,261	2,261	2,258	2,258
		4,382	4,303	4,170	4,091	5,023	4,903	4,963	4,843

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. The noteholders have agreed in writing that 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 aggregate the securitisation undertakings had net interest income of £18.0 million (2003 – £15.1 million), operating expenses of £7.2 million (2003 – £5.4 million), provisions for bad and doubtful debts of £11.1 million (2003 – £9.8 million), resulting in a loss for the year of £0.3 million (2003 – £0.1 million).

Loans and advances include advances of £258 million (2003 £nil million) which have been sold by a subsidiary of the Company to bankruptcy remote special purpose vehicles, funded by the issue of Covered Bonds on terms whereby the rewards and some of the risks of the portfolio have been retained by the subsidiary. Accordingly, these advances have been retained on the Group's balance sheet with the Covered Bonds being included within debt securities in issue (Note 28). The Group acquired £1,350 million of loans at book value from Halifax plc, a fellow subsidiary undertaking of HBOS plc, as part of arrangements to launch a Social Housing Covered Bond by the HBOS Group.

Loans and advances also include certain portfolios of advances of £1,824 million (2003 - £290 million) which have been securitised and which did not qualify for linked presentation (Note 28).

15. Non-Performing Assets

Non-performing loans and advances amount to £3,246 million (2003 – £2,965 million) including £1,110 million (2003 – £1,077 million) of advances on which interest is being held in suspense. Net of provisions and interest in suspense, non-performing loans amount to £1,704 million (2003 – £1,409 million).

16. Provisions for Bad and Doubtful Debts

	Group			Bank		
	Specific £ million	General £ million	Total £ million	Specific £ million	General £ million	Total £ million
At 1 January 2004	884	524	1,408	661	341	1,002
Exchange movements	(4)	(3)	(7)	(3)		(3)
Acquisition of subsidiary undertakings and transfers	50		50	6		6
New provisions less releases	760	(4)	756	666	(1)	665
Amounts written off	(796)		(796)	(654)		(654)
Cumulative provisions as at 31 December 2004	**894**	**517**	**1,411**	**676**	**340**	**1,016**
New provisions less releases	**760**	**(4)**	**756**	**666**	**(1)**	**665**
Recoveries of amounts previously written off	**(27)**		**(27)**	**(14)**		**(14)**
Net charge to profit and loss account	**733**	**(4)**	**729**	**652**	**(1)**	**651**

NOTES ON THE ACCOUNTS (continued)

17. Debt Securities

Group	2004 Issued by public bodies £ million	2004 Issued by others £ million	2004 Total Book Value £ million	2004 Market Value £ million	2003 Issued by public bodies £ million	2003 Issued by Others £ million	2003 Total Book Value £ million	2003 Market Value £ million
Investment securities								
Listed								
British Government Securities	59		59	59	211		211	210
Others	2,486	19,730	22,216	22,361	1,426	16,552	17,978	17,990
Unlisted								
Certificates of deposit issued by banks and building societies		5,470	5,470	5,471		3,040	3,040	3,040
Others		8,495	8,495	8,553		6,847	6,847	6,847
Total investment securities	2,545	33,695	36,240	36,444	1,637	26,439	28,076	28,087
Other securities								
Listed	392	6,876	7,268	7,268	540	2,749	3,289	3,289
Unlisted		13,952	13,952	13,952		18,462	18,462	18,462
	2,937	54,523	57,460	57,664	2,177	47,650	49,827	49,838
of which:								
maturing within 1 year			21,401				23,706	
maturing in 1 year and over			36,059				26,121	
			57,460				49,827	
Bank								
Investment securities								
Listed								
Others		19	19	21		200	200	200
Unlisted								
Certificates of deposit issued by banks and building societies		26	26	26		112	112	112
Others		256	256	257		284	284	284
Total investment securities		301	301	304		596	596	596
of which:								
maturing within 1 year			26				112	
maturing in 1 year and over			275				484	
			301				596	

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

	Group Amortised Cost £ million	Group Aggregate amount written off £ million	Group Value £ million	Bank Amortised Cost £ million	Bank Aggregate amount written off £ million	Bank Book Value £ million
At 1 January 2004	28,107	(31)	28,076	617	(21)	596
Exchange translation	(1,437)		(1,437)	(37)		(37)
Additions	26,662		26,662	223		223
Amortisation	11		11			
Disposals	(17,062)		(17,062)	(478)		(478)
Amounts written off		(10)	(10)		(3)	(3)
At 31 December 2004	**36,281**	**(41)**	**36,240**	**325**	**(24)**	**301**
Aggregate unamortised discount						
At 31 December 2004	**(46)**		**(46)**			

Debt securities include securities pledged as collateral amounting to £10,666 million (2003 – £11,030 million). Debt securities include securities with a market value of £1,702 million (2003 – £6,467 million) for the Group, sold subject to repurchase. Debt securities include asset backed securities of £14,507 million (2003 – £12,824 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 28).

NOTES ON THE ACCOUNTS (continued)

18. 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 2004	56	(13)	43	213	(40)	173	216
Exchange translation				(2)		(2)	(2)
Additions	5		5	38		38	43
Disposals	(4)		(4)	(33)	2	(31)	(35)
Amounts written off		(5)	(5)		(9)	(9)	(14)
At 31 December 2004	**57**	**(18)**	**39**	**216**	**(47)**	**169**	**208**

	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 2004	12	(2)	10	66	(21)	45	55
Exchange translation							
Additions							
Disposals	(2)		(2)	(11)		(11)	(13)
Amounts written off					(6)	(6)	(6)
At 31 December 2004	**10**	**(2)**	**8**	**55**	**(27)**	**28**	**36**

The total fair market value of equity shares as at 31 December 2004 for the Group was £326 million (2003 – £393 million) and for the Bank £51 million (2003 – £128 million) including for the Group £53 million (2003 – £105 million) and for the Bank £22 million (2003 – £79 million) in respect of the market value of listed equity shares.

19. 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	Bank Cost £ million
At 1 January 2004	200	(48)	152	2	154	
Acquisitions and subscriptions of capital	21		21		21	2
Disposals	(6)	(4)	(10)		(10)	
Equity accounting adjustments		(21)	(21)		(21)	
At 31 December 2004	**215**	**(73)**	**142**	**2**	**144**	**2**

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 2004	145	46	191		191	81
Acquisitions and subscriptions of capital	5		5		5	
Transfer to subsidiary undertaking	(10)	(32)	(42)		(42)	
Disposals	(10)	(4)	(14)		(14)	(1)
Equity accounting adjustments		29	29		29	
At 31 December 2004	**130**	**39**	**169**		**169**	**80**

All the interests in other associated undertakings are unlisted.

The main joint venture and other associated undertakings are listed in Note 46 on page 68.

NOTES ON THE ACCOUNTS (continued)

20. Interests in Group Undertakings

	Banks £ million	Others £ million	Total £ million
At cost at 1 January 2004	863	1,082	1,945
Exchange translation		(3)	(3)
At cost at 31 December 2004	**863**	**1,079**	**1,942**

21. Intangible Fixed Assets

Goodwill	Group £ million	Bank £ million
Cost		
At 1 January 2004	469	73
Additions (Note 44)	6	
Exchange translation	(8)	
At 31 December 2004	**467**	**73**
Amortisation		
At 1 January 2004	47	3
Amortisation charged in year	29	4
At 31 December 2004	**76**	**7**
Net Book Value		
At 31 December 2004	**391**	**66**
At 31 December 2003	422	70

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

NOTES ON THE ACCOUNTS (continued)

22. Tangible Fixed Assets

	Group			Bank		
	Cost £ million	Depreciation £ million	Book Value £ million	Cost £ million	Depreciation £ million	Book Value £ million
Property						
At 1 January 2004	351	(55)	296	220	(33)	187
Exchange translation	(1)		(1)			
Additions	24		24	18		18
Disposals	(11)	5	(6)	(5)		(5)
Depreciation for year		(20)	(20)		(13)	(13)
At 31 December 2004	**363**	**(70)**	**293**	**233**	**(46)**	**187**
Equipment						
At 1 January 2004	742	(466)	276	484	(282)	202
Exchange translation	(5)	4	(1)			
Additions	92		92	61		61
Disposals	(65)	20	(45)	(45)	8	(37)
Depreciation for year		(76)	(76)		(52)	(52)
At 31 December 2004	**764**	**(518)**	**246**	**500**	**(326)**	**174**
Total tangible fixed assets at 31 December 2004	**1,127**	**(588)**	**539**	**733**	**(372)**	**361**
Total tangible fixed assets at 31December 2003	1,093	(521)	572	704	(315)	389
Included above:						
Assets in the course of construction	**53**			**48**		

	Group		Bank	
Property comprises:	**2004 £ million**	2003 £ million	**2004 £ million**	2003 £ million
Freehold	**257**	230	**161**	132
Long leasehold	**5**	4	**3**	4
Short leasehold	**31**	62	**23**	51
	293	296	**187**	187
Occupied for own activities	**290**	283	**178**	174

23. Operating Lease Assets

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

	Group		
	Cost £ million	Depreciation £ million	Total £ million
At 1 January 2004	2,428	(657)	1,771
Exchange translation	(1)		(1)
Additions	1,112		1,112
Disposals	(884)	262	(622)
Depreciation for year		(377)	(377)
At 31 December 2004	**2,655**	**(772)**	**1,883**

NOTES ON THE ACCOUNTS (continued)

23. 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	
	2004	2003
	£ million	£ million
On operating leased assets where the residual value is expected to be recovered in:		
1 year or less	**529**	449
2 years or less but over 1 year	**203**	173
5 years or less but over 2 years	**193**	160
Over 5 years	**45**	40
Total exposure	**970**	822

24. Capital and Other Commitments

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ 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	**13**	6		5
Commitments for which contracts have been place in relation to operating leased assets	**3**	9		
Other financial commitments	**1**			
Included in other liabilities are net obligations under finance leases payable as follows:				
1 year or less	**28**	5		
5 years or less but over 1 year	**2**	3		

25. Other Assets

	Group	
	2004	2003
	£ million	£ million
Positive market values of trading derivative contracts	**6,176**	5,480
Other assets	**1,548**	1,315
	7,724	6,795

Other assets includes £517 million (2003 £560 million) due by HBOS plc.

NOTES ON THE ACCOUNTS (continued)

26. Deposits by Banks

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ million
Repayable on demand	**19,741**	6,781	**2,304**	2,654
Repayable				
3 months or less but not repayable on demand	**28,150**	32,190	**38,721**	35,089
1 year or less but over 3 months	**11,322**	5,613	**5,745**	7,086
5 years or less but over 1 year	**8,656**	1,681	**9,201**	3,922
over 5 years	**8,670**	3,938	**6,918**	3,411
	76,539	50,203	**62,889**	52,162
Amounts above include:				
Subsidiary undertakings			**57,187**	47,908
Fellow subsidiary undertakings	**39,871**	9,967	**3,131**	2,025
Other associated undertakings	**135**	155	**14**	13

27. Customer Accounts

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ million
Repayable on demand	**57,210**	43,983	**50,463**	39,122
Repayable:				
3 months or less but not repayable on demand	**20,455**	17,916	**1,893**	1,976
1 year or less but over 3 months	**3,920**	4,236	**427**	736
5 years or less but over 1 year	**2,421**	1,306	**21**	303
over 5 years	**12,011**	1,884	**176**	535
	96,017	69,325	**52,980**	42,672
Amounts above include:				
Subsidiary undertakings			**592**	1,046
Fellow subsidiary undertakings	**20,380**	3,667	**3,131**	1,298
Ultimate parent undertaking	**97**	121	**97**	121
Other associated undertakings	**41**	64	**41**	64
Joint ventures	**139**	57	**139**	57

28. Debt Securities in Issue

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ million
Bonds and Medium Term Notes				
Repayable:				
1 year or less or on demand	**8,445**	8,203	**19**	
2 years or less but over 1 year	**10,010**	9,550	**19**	
5 years or less but over 2 years	**15,015**	9,840	**1,045**	273
over 5 years	**8,043**	5,576		535
	41,513	33,169	**1,083**	808
Other Debt Securities				
3 months or less	**50,318**	53,600	**52**	1,026
1 year or less but over 3 months	**10,156**	10,299	**26**	1,042
2 years or less but over 1 year	**881**	115		84
5 years or less but over 2 years	**251**	5		
over 5 years	**661**			
	62,267	64,019	**78**	2,152
Total debt securities in issue	**103,780**	97,188	**1,161**	2,960

Bonds and Medium Term Notes at Group include £1,824 million (2003 – £290 million) in respect of the funding arising from the securitisation of certain portfolios of advances which are not available for linked presentation. The portfolios of advances continue to be reported in Loans and Advances to Customers (Note 14). Bonds and Medium Term Notes also include £275 million (2003 – £288 million) secured on advances to customers and certain other assets of the Group. Other Debt Securities at Group include £15,092 million (2003 – £12,895 million) in respect of commercial paper issued to fund the purchase of asset backed securities by special purpose vehicles (Note 17).

NOTES ON THE ACCOUNTS (continued)

29. Other Liabilities

	Group 2004 £ million	Group 2003 £ million
Negative market values of trading derivative contracts	6,564	7,675
Other liabilities	2,038	1,241
	8,602	8,916

30. Provisions for Liabilities and Charges

(i) Deferred Taxation	Group £ million	Bank £ million
At 1 January 2004	253	(145)
Charge in year (Note 9)	13	7
Other movements	(54)	
At 31 December 2004	212	(138)

Deferred taxation comprises:	2004 £ million	2003 £ million
Group		
Capital allowances:		
on assets leased to customers	493	452
on other assets	(1)	33
General provisions	(163)	(157)
Other timing differences	(117)	(75)
At 31 December 2004	212	253
Bank		
Capital allowances on fixed assets	3	5
General provisions	(102)	(102)
Other timing differences	(39)	(48)
	(138)	(145)

(ii) Other Provisions

Group	Pensions and other similar obligations £ million	Merger integration provision £ million	Other provisions £ million	Total provisions £ million
At 1 January 2004	75	7	15	97
Charge for year	51	23	8	82
Utilised in year	(52)	(26)	(2)	(80)
At 31 December 2004	74	4	21	99

Bank	Pensions and other similar obligations £ million	Merger Integration provision £ million	Other provisions £ million	Total provisions £ million
At 1 January 2004	72	7	2	81
Charge for year	38	19	1	58
Utilised in year	(39)	(22)	(1)	(62)
At 31 December 2004	71	4	2	77

Other provisions include property related costs on surplus leased space.

NOTES ON THE ACCOUNTS (continued)

31. Subordinated Liabilities

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ million
Dated Loan Capital				
US$300 million 8.80% Notes 2004		168		168
US$150 million 8.85% Notes 2006	**78**	84	**78**	84
£60 million 9.00% Instruments 2006	**60**	60		
€500 million 5.50% Instruments 2009	**353**	353	**353**	353
US$500 million Notes 2010	**258**	280	**258**	280
£75 million Floating Rate Notes 2010	**75**	75	**75**	75
US$150 million Notes 2011	**78**	84	**78**	84
€7 million Floating Rate Notes 2011	**5**	5		
€12.8 million 6.25% Instruments 2012	**9**	9		
€325 million 6.125% Notes 2013	**229**	229	**229**	229
€1,000 million Subordinated Callable Fixed/Floating rate instruments 2013	**705**	706	**705**	706
£250 million 6.375% Instruments 2019	**250**	250	**250**	250
€750 million 5.50% Notes 2012	**529**	530	**529**	530
US$450 million Subordinated Floating Rate Notes 2012	**232**	252	**232**	252
A$75 million Callable Notes 2012	**30**	31		
US$1,000 million 4.25% Subordinated Guaranteed Notes 2013	**517**	560		
£330 million Floating Rate Subordinated Notes 2009 (1)	**330**		**330**	
A$200 million 6.375% Instruments 2014 (2)	**81**			
Unamortised Premiums, Discounts and Issue Costs	**(12)**	(13)	**(12)**	(13)
	3,807	3,663	**3,105**	2,998
Repayable:				
in 1 year or less		168		168
in more than 1 year but not more than 5 years	**491**	144	**431**	84
after 5 years	**3,316**	3,351	**2,674**	2,746
	3,807	3,663	**3,105**	2,998

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 the company other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the dated loan capital.

(1) On 30 January 2004, £330 million Floating Rate Subordinated Notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 100 bps

(2) On 23 December 2004, a subsidiary of the Bank issued A$200 million 6.375% Instruments 2019, at par, to its ultimate parent undertaking HBOS plc. These instruments bear interest at the three month Australian Bank rate plus 85 bps.

NOTES ON THE ACCOUNTS (continued)

31. Subordinated Liabilities (continued)

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ million
Undated Loan Capital				
US$300 million Reset Notes	**155**	168	**155**	168
£200 million Perpetual Notes	**200**	200	**200**	200
£300 million Perpetual Regulatory tier One Securities	**300**	300	**300**	300
€500 million Instruments	**353**	353	**353**	353
US$250 million Floating Rate Primary Capital Notes	**129**	140	**129**	140
£150 million Instruments	**150**	150	**150**	150
£150 million Instruments	**150**	150	**150**	150
JPY 17 billion Instruments	**86**	90	**86**	90
£100 million Instruments	**100**	100	**100**	100
JPY 9 billion Instruments	**45**	47		
£300 million Instruments	**300**	300	**300**	300
£250 million Perpetual Preferred Notes			**250**	250
£150 million Perpetual Preferred Notes			**150**	150
£150 million Floating Rate Subordinated Notes (1)	**150**		**150**	
£500 million Floating Rate Subordinated Notes (2)	**500**		**500**	
Unamortised Premiums, Discounts and Issue Costs	**(3)**	(4)	**(3)**	(4)
	2,615	1,994	**2,970**	2,347

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 January 2004, £150 million Floating Rate Subordinated Notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 1.9%.

(2) On 30 April 2004, £500 million Floating Rate Subordinated Notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month LIBOR rate plus 1.9%.

NOTES ON THE ACCOUNTS (continued)

32. Share Capital

Authorised	Ordinary Stock 25p each £ million	9¼% Non-Cumulative Irredeemable Preference Stock £1 each £ million	9¾% Non-Cumulative Irredeemable Preference Stock £1 each £ million	8.117% Non-Cumulative Preference Stock Class A £ million	7.754% Non-Cumulative Preference Stock Class B £ million
At 1 January 2004	446	375	125	2.5	1.5
Authorised during the year					
At 31 December 2004	446	375	125	2.5	1.5
Allotted, called up and fully paid					
At 1 January 2004	410	300	100		
Issued					
At 31 December 2004	410	300	100		

33. Reserves

Group	Share Premium £ million	Other Reserves £ million	Profit and Loss Account £ million
At 1 January 2004	2,951	(2)	4,008
Exchange translation		(9)	
Retained profit			1,164
At 31 December 2004	2,951	(11)	5,172
Bank			
At 1 January 2004	2,951	53	2,567
Exchange translation		16	
Retained profit			928
At 31 December 2004	2,951	69	3,495*

*Of which £3,300 million is distributable

Exchange gains of £36 million (2003 – losses of £91 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 (2003 – £228 million).

34. Reconciliation of Proprietors' Funds

	Group		Bank	
	2004 £ million	2003 £ million	**2004 £ million**	2003 £ million
Profit attributable to Proprietors	**1,582**	1,149	**1,346**	736
Dividends	**(418)**	(552)	**(418)**	(552)
Other recognised gains and losses	**(9)**	17	**16**	(15)
Ordinary capital subscribed		1,200		1,200
	1,155	1,814	**944**	1,369
Proprietors' Funds at 1 January 2004	**7,767**	5,953	**6,381**	5,012
Proprietors' Funds at 31 December 2004	**8,922**	7,767	**7,325**	6,381
Of which:				
Attributable to non-equity interests	**400**	400	**400**	400
Attributable to equity interests	**8,522**	7,367	**6,925**	5,981
	8,922	7,767	**7,325**	6,381

NOTES ON THE ACCOUNTS (continued)

35. Minority and Other Interests (non equity)

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

	Group	
	2004	2003
	£ million	£ million
£250 million preferred securities	**250**	250
£150 million preferred securities	**150**	150
A$1,025 million Redeemable Preference Shares	**415**	433
A$115 million Redeemable Preference Shares	**48**	
Total	**863**	833

A subsidiary of the company issued A$115 million Redeemable Preference Shares which are held by HBOS plc, the Group's parent undertaking.

36. 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.

	2004 Contract Amount £ million	2003 Contract Amount £ million
Group		
Contingent Liabilities		
Acceptances and endorsements	**75**	130
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	**3,842**	3,193
	3,917	3,323
Commitments		
Other commitments		
Short-term trade related transactions	**129**	146
Undrawn formal standby facilities, credit lines and commitments to lend		
Up to and including 1 year	**25,939**	25,421
over 1 year	**15,189**	11,316
	41,257	36,883
Bank		
Contingent Liabilities		
Acceptances and endorsements	**55**	55
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	**20,442**	10,958
	20,497	11,013
Amounts included above in respect of guarantees to subsidiary undertakings	**16,881**	8,002
Commitments		
Other commitments		
Short-term trade related transactions	**114**	127
Undrawn formal standby facilities, credit lines and commitments to lend		
Up to and including 1 year	**17,322**	19,332
over 1 year	**13,618**	9,788
	31,054	29,247
Amounts included above in respect of commitments to subsidiary undertakings	**104**	103

NOTES ON THE ACCOUNTS (continued)

37. 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 predominantly customer driven and are generally matched whilst proprietary activity is restricted within modest amounts.

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 arm's length transaction.

	2004			2003		
	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	703	36	159	186	8	3
Cross currency swaps	56,447	854	1,992	51,669	1,127	2,209
	57,150	890	2,151	51,855	1,135	2,212
Interest Rate Related Contracts						
Interest rate swaps	39,178	744	348	44,526	774	1,060
Options	197			342	2	1
Forward rate agreements	141					
	39,516	744	348	44,868	776	1,061
Equity and Commodity Related Contracts						
Options and swaps	41			803	50	36
	96,707	1,634	2,499	97,526	1,961	3,309
Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	66,127	1,089	1,853	64,943	1,348	3,376
Cross currency swaps	1,495	41	133	546	23	87
Options	936	9	9	558	15	16
	68,558	1,139	1,995	66,047	1,386	3,479
Interest Rate Related Contracts						
Interest rate swaps	399,979	4,604	4,135	387,041	3,789	3,673
Forward rate agreements	76,773	18	18	19,976	5	5
Options	62,538	132	119	71,893	165	238
Futures	20,765	5	34	100,421	18	28
	560,055	4,759	4,306	579,331	3,977	3,944
Equity and Commodity Related Contracts						
Options and swaps	1,827	222	146	831	89	78
Total Trading Derivatives	630,440	6,120	6,447	646,209	5,452	7,501
Total Group Derivatives	727,147	7,754	8,946	743,735	7,413	10,810

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

	2004		2003	
	Notional Principal Amount £ million	Replacement Cost £ million	Notional Principal Amount £ million	Replacement Cost £ million
Group				
Contracts maturing:				
In 1 year or less	301,947	1,902	244,206	2,098
In more than 1 year but not more than 5 years	242,836	2,208	265,218	2,363
In more than 5 years	161,598	3,639	133,890	2,934
	706,381	7,749	643,314	7,395

NOTES ON THE ACCOUNTS (continued)

37. Derivatives (continued)

	2004 Notional Principal Amount £ million	2004 Year End Fair Value Asset £ million	2004 Year End Fair Value Liability £ million	2003 Notional Principal Amount £ million	2003 Year End Fair Value Asset £ million	2003 Year End Fair Value Liability £ million
Bank						
Non Trading						
Exchange Rate Related Contracts						
Cross currency swaps				89	18	
				89	18	
Interest Rate Related Contracts						
Interest rate swaps	4,851	1	5	21,609	185	502
	4,851	1	5	21,609	185	502
Equity and Commodity Related Contracts						
Options and swaps	16			148	3	4
Total Non Trading Derivatives	4,867	1	5	21,846	206	506
Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	961	20	20	1,097	26	26
Total Trading Derivatives	961	20	20	1,097	26	26
Total Bank Derivatives	5,828	21	25	22,943	232	532

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

	2004 Notional Principal Amount £ million	2004 Replacement Cost £ million	2003 Notional Principal Amount £ million	2003 Replacement Cost £ million
Group				
Contracts maturing:				
In 1 year or less	907	19	4,703	40
In more than 1 year but not more than 5 years	103	2	6,856	39
In more than 5 years	4,818		11,384	153
	5,828	21	22,943	232

NOTES ON THE ACCOUNTS (continued)

37. Derivatives (continued)

Credit Risk Analyses

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

	Group		Bank	
	2004	2003	**2004**	2003
	£ million	£ million	**£ million**	£ million
Institutional				
Financial institutions	**6,428**	6,420	**10**	217
Non-financial institutions	**1,321**	975	**11**	15
	7,749	7,395	**21**	232
Geographical				
UK	**7,606**	7,098	**21**	232
Rest of World	**143**	297		
	7,749	7,395	**21**	232

The Group's objectives and policies in managing the risks that arise in connection with the use of financial instruments are set out on page 17 of the Financial Review and Risk Management section of the Business and Financial Review.

38. 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 37 are carried at fair values. Derivatives held for non-trading purposes are accounted for in the same way as the underlying transaction being hedged. Fair values are based on market prices where available, or are estimated using other valuation techniques.

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

	2004				2003			
	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	Value £ million
Group								
Non Trading								
Treasury bills and other eligible bills	**3,705**	**3,704**			6,475	6,477		
Debt securities	**36,240**	**36,444**			28,076	28,087		
Equity shares	**208**	**326**			216	393		
Debt securities in issue			**103,051**	**104,039**			96,020	96,478
Dated loan capital			**3,807**	**4,091**			3,663	3,891
Undated loan capital			**2,615**	**2,816**			1,994	2,254
Minority and other interests (non equity)			**863**	**932**			833	903
Derivatives	**464**	**1,634**	**396**	**2,499**	337	1,961	684	3,309
Total Non Trading	**40,617**	**42,108**	**110,732**	**114,377**	35,104	36,918	103,194	106,835
Trading								
Treasury bills and other eligible bills	**622**	**622**			1,451	1,451		
Loans and advances to banks	**2,513**	**2,513**			1,151	1,151		
Loans and advances to customers	**1,776**	**1,776**			289	289		
Debt securities	**21,220**	**21,220**			21,751	21,751		
Other assets	**62**	**62**			43	43		
Debt securities in issue			**729**	**729**			1,168	1,168
Deposits by banks			**5,206**	**5,206**			8,785	8,785
Customer accounts			**9,481**	**9,481**			5,479	5,479
Other liabilities			**107**	**107**			156	156
Derivatives	**6,120**	**6,120**	**6,447**	**6,447**	5,452	5,452	7,501	7,501
Total Trading	**32,313**	**32,313**	**21,970**	**21,970**	30,137	30,137	23,089	23,089

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 2004.

NOTES ON THE ACCOUNTS (continued)

39. 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:

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

	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)

NOTES ON THE ACCOUNTS (continued)

40. Interest Rate Sensitivity Gap

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

	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 & 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			

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)

41. 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 16 of the Financial Review and Risk Management Review Section. The Group's trading market risk exposure for the year ended 31 December 2004 is analysed below.

	Exposure							
	As at 31 December 2004 £ million	As at 31 December 2003 £ million	Average **2004 £ million**	Average 2003 £ million	Highest **2004 £ million**	Highest 2003 £ million	Lowest **2004 £ million**	Lowest 2003 £ million
Total Value at Risk	**5.1**	6.1	**5.6**	11.9	**9.4**	23.0	**3.6**	6.1

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

42. 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.

Functional currency of the operation	2004 Net investments In overseas operations £ million	2004 Borrowing taken out to hedge the net investments £ million	2004 Remaining structural currency exposure £ million	2003 Net investments in overseas operations £ million	2003 Borrowing taken out to hedge the net investments £ million	2003 Remaining structural currency exposure £ million
US Dollar	**90**	**49**	**41**	72	53	19
Euro	**522**	**522**		442	393	49
Australian Dollar	**1,119**	**1,099**	**20**	1,000	847	153
Other	**11**		**11**	7		7
Total	**1,742**	**1,670**	**72**	1,521	1,293	228

As at 31 December 2004 and 31 December 2003 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 16 of the Financial Review and Risk Management Review Section.

43. Assets and Liabilities in Foreign Currencies

	Group **2004 £ million**	Group 2003 £ million	Bank **2004 £ million**	Bank 2003 £ million
The aggregate amounts of assets and liabilities denominated in currencies other than sterling were:				
Assets	**97,791**	76,926	**21,251**	22,888
Liabilities	**104,708**	107,676	**21,499**	22,800

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)

44. Acquisitions

On 1 November 2004, the Group increased its shareholding in Drive Financial Services LP from 49.0% to 64.5%.

The acquisition method of accounting has been applied to this acquisition.

The following table summarises the effects of this acquisition.

	Acquired book value and fair value to the Group Drive £ million
Loans and advances to banks and customers	512
Interests in other associates	(42)
Other assets	9
Total assets	479
Deposits by banks and debt securities in issue	445
Other liabilities	9
Minority interests	23
Total liabilities	477
Net assets	2
Goodwill (Note 21)	6
Consideration	8
Satisfied by:	
Cash	8

The effect on the Group's profit and loss account from the respective dates of acquisition to 31 December 2004 is not material.

45. Related Party Transactions

In the year ended 31 December 2004, 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 £34 million (2003 – £20 million), of which £21 million was outstanding at the year end (2003 – £7 million).

Bank of Scotland Group, as a subsidiary undertaking of HBOS plc, has followed the exemption contained in FRS 8 'Related Party Disclosures' not to disclose details of transactions with other group companies or investees of the group qualifying as related parties, other than as required under Companies Act 1985, as the consolidated accounts in which Bank of Scotland Group is included are publicly available.

46. 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 2004	UK
NFU Mutual Finance Limited	Finance	ordinary	£500,002	50.0%*	December 2004	UK
RFS Limited	Finance	ordinary	£6,000,006	50.0%*	December 2004	UK
Other Associated Undertaking:						
Sainsbury's Bank plc	Banking	ordinary	£140,000,000	45.0%	March 2004**	UK
		loan	£80,000,000	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 2004.

NOTES ON THE ACCOUNTS (continued)

47. Main Subsidiary Undertakings

	Company's Interest in Ordinary Share Capital and Voting Rights	Principal Business	Incorporated
HBOS Treasury Services PLC	100%	Banking	UK
HBOS Australia Pty Ltd and subsidiaries including Bank of Western Australia Ltd	100%	Retail and commercial banking	Australia
Bank of Scotland (Ireland) Ltd	100%	Banking	Ireland
CAPITAL BANK plc	* 100%	Banking and personal finance	UK

* Bank of Scotland holds 100% of the issued preference share capital.

48. Transactions with Directors, Officers and Connected Persons

The aggregate amounts outstanding at 31 December 2004 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	3	3,295
Credit card accounts	8	52

49. Segmental Analysis

Business Sector

Following an internal reorganisation, from 1 January 2004, the Group reported throughout the year through five divisions (Retail, Corporate, Treasury, Insurance & Investment and International), plus Group Items. 2003 figures have been restated to reflect the new structure.

	Year ended 31 December 2004			Year ended 31 December 2003		
	Profit before tax and exceptional Items £ million	**Exceptional Items £ million**	**Profit before tax £ million**	Restated Profit before tax and exceptional Items £ million	Restated Exceptional Items £ million	Restated Profit before tax £ million
Retail	**688**	**(5)**	**683**	481	(5)	476
Corporate	**1,208**	**(12)**	**1,196**	901	(4)	897
Treasury	**249**		**249**	232	(3)	229
Insurance & Investment	**32**		**32**	54		54
International	**311**	**(4)**	**307**	257		257
Group Items	**(144)**	**(2)**	**(146**	(99)	(45)	(144)
Profit on ordinary activities before tax	**2,344**	**(23)**	**2,321**	1,826	(57)	1,769

	Net Assets		Total Assets	
	2004 £ million	2003 £ million	**2004 £ million**	2003 £ million
Retail	**1,625**	1,199	**44,901**	42,494
Corporate	**4,666**	3,693	**78,977**	68,675
Treasury	**837**	882	**154,464**	110,010
Insurance & Investment			**13**	19
International	**1,794**	1,993	**27,175**	22,762
Group Items				15
	8,922	7,767	**305,530**	243,975

NOTES ON THE ACCOUNTS (continued)

49. 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.

	2004			2003		
	UK £ million	Rest of World £ million	Group Total £ million	UK £ million	Rest of World £ million	Group Total £ million
Interest receivable	13,196	1,919	15,115	9,950	1,671	11,621
Fees and commissions receivable	1,039	222	1,261	922	227	1,149
Dealing profits	197	11	208	165	11	176
Other operating income	722	59	781	496	59	555
Gross income	15,154	2,211	17,365	11,533	1,968	13,501
Operating profit before exceptional items	1,836	403	2,239	1,379	383	1,762
Share of operating profits of joint ventures	36	(3)	33	39	(4)	35
Share of operating profits of other associated undertakings	45	14	59	17	12	29
Profit on sale of fixed assets	13		13			
Exceptional items	(18)	(5)	(23)	(57)		(57)
Group profit before taxation	1,912	409	2,321	1,378	391	1,769
Total assets	265,673	39,544	305,217	209,754	33,876	243,630
Joint ventures			144			154
Associated undertakings			169			191
Group total assets			305,530			243,975
Net assets (excluding minority interests)	7,413	1,509	8,922	6,489	1,278	7,767

50. Ultimate Parent Undertaking

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