# THE GOVERNOR & COMPANY OF THE BANK OF SCOTLAND
# ANNUAL REPORT AND ACCOUNTS

FOR THE YEAR ENDED 31 DECEMBER 2006

CONTENTS



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# Business and Financial Review

## Introduction

The Directors are pleased to present the consolidated results of the Bank of Scotland and its subsidiaries (the 'Group') for the year ended 31 December 2006. The Bank of Scotland (the 'Bank') is a directly held subsidiary of HBOS plc.

Group profit before tax amounts to £3,021m (2005 £2,546 m).

## Basis of Preparation

The Group and Divisional financial information included in the following Financial Review and the Divisional Reviews has been prepared on the basis fully explained on page 38.

## Business Sector Analysis of Results

The business sector results of the Bank of Scotland Group presented below exclude goodwill impairment and the profit on the sale of Drive.

Following an internal reorganisation, from 1 July 2005 HBOS Group reports its results through five divisions (Retail, Corporate, Insurance & Investment, International and Treasury & Asset Management), plus Group Items. The business sectors within the Bank of Scotland Group mirror the business sectors of the HBOS Group and have been similarly organised.

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

Retail

Corporate

Insurance & Investment

International

Treasury & Asset Management

## Business And Financial Review (continued)

### Retail

Retail provides financial services to its customers through a broad distribution base ranging from branches to direct mail, telephone and internet services. Retail's range of multi-branded products includes personal and business banking services providing mortgages, savings, bank accounts, personal loans and credit cards.

The Retail strategy remains focused on creating shareholder value by delivering superior customer value across a broad spectrum of products and distribution channels.

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Net interest income | **837** | 911 |
| Non-interest income | **296** | 229 |
| Net operating income | **1,133** | 1,140 |
| Operating expenses | **(378)** | (363) |
| Operating profit before provisions | **755** | 777 |
| Impairment losses on loans and advances | **(303)** | (245) |
| Share of profits of associates and jointly controlled entities | | 7 |
| Non operating income | **9** | |
| Pre-tax profit | **461** | 539 |

Retail profits decreased by 14% to £461m, primarily due to higher impairment losses.

### Risks and uncertainties

Risks and uncertainties faced by Retail revolve predominantly around uncertain economic conditions which, if adverse, could lead to a potential contraction of the housing market and bring further pressure to bear in the unsecured lending markets, both resulting in a downturn in business volumes and an increase in credit related impairment losses.

To mitigate, Retail are continuing to manage the business in a very proactive way in respect of credit, developing enhancements in our credit decisioning and management tools. Affordability measures, responsible lending practices and effective debt collection and recovery processes will help in this respect. Additionally, the investment in fraud detection and prevention processes and systems will help to mitigate potential increases in losses in this area.

Business And Financial Review (continued)

## Corporate

Corporate provides innovative and tailored products and services to UK businesses, typically those with turnover in excess of £1m, in their chosen markets. The division comprises a number of relationship banking and specialist lending teams with considerable experience and expertise. They are committed to understanding our customers' needs and are empowered to make decisions quickly.

The markets in which Corporate operate are large, diverse and have the potential to deliver sustainable profitable growth for many years to come. We continue to provide a comprehensive and ever growing range of products as we seek out quality opportunities with the right partners to deliver significant and sustainable shareholder returns.

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Net interest income | **1,857** | 1,689 |
| Non-interest income | **1,268** | 1,276 |
| Net operating income | **3,125** | 2,965 |
| Operating expenses | **(1,205)** | (1,156) |
| Operating profit before provisions* | **1,920** | 1,809 |
| Impairment losses on loans and advances | **(424)** | (429) |
| Impairment on investment securities | **(69)** | (45) |
| Share of profits of associates and jointly controlled entities | **148** | 46 |
| Pre-tax profit | **1,575** | 1,381 |

* Excluding goodwill impairment

Underlying profit before tax in Corporate increased by 14% to £1,575m as a result of improved margins on lending growth and from increased profits from our portfolio of associates and jointly controlled entities.

## Risks and uncertainties

Risks and uncertainties faced by Corporate in the execution of the divisional strategy are primarily based around our ability to manage the balance between risk and return at each stage of the economic cycle. In the current highly competitive corporate market there is pressure on margins in many segments. Whilst credit conditions are currently favourable, in an adverse credit or competitive cycle our ability to maintain current levels of returns to shareholders may be adversely affected.

To mitigate this, Corporate retain an appropriate risk appetite focusing on protecting returns rather than chasing market share. Corporate are currently pursuing a strategy of selective lending choosing the appropriate balance between sell downs and retention activity. Their market understanding, asset quality, sound customer and partner base, proven track record and enhanced sector intelligence (which is being enhanced through their asset class management strategy) are all designated to manage the balance between risk and return.

# Business And Financial Review (continued)

## Insurance & Investment

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Net interest income | | 2 |
| Non-interest income | **11** | 15 |
| Net operating income | **11** | 17 |
| Pre-tax profit | **11** | 17 |

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

Business And Financial Review (continued)

## International

International comprises 3 distinct geographical businesses. HBOS Australia provides retail, commercial, corporate, asset finance and insurance & investment products. In Ireland, Bank of Scotland ('Ireland') focuses on providing banking solutions to business banking customers and is committed to becoming a full service retail bank in 2007. Europe & North America includes the Group's retail, corporate and insurance & investment businesses in those areas.

Internationally, Bank of Scotland Group is seeking to grow its businesses by taking the strategy that has served it so well in the UK, to economies the Group understand well.

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Net interest income | **1,228** | 1,016 |
| Non-interest income | **279** | 223 |
| Net operating income* | **1,507** | 1,239 |
| Operating expenses | **(586)** | (505) |
| Operating profit before provisions | **921** | 734 |
| Impairment losses on loans and advances | **(217)** | (177) |
| Impairment on investment securities | **(2)** | (6) |
| Share of profits/(losses) in associates and jointly controlled entities | **4** | (2) |
| Pre-tax profit* | **706** | 549 |

* Excluding profit on the sale of Drive.

Underlying profits in International increased by 29% to £706m with all three businesses contributing to this growth. On 7 December 2006, we sold our 64.5% financial investment in Drive Financial Services ('Drive'), the sub-prime auto finance receivables business based in Texas. The sale of the investment in Drive realised a gain on disposal of £180m which has been excluded from the Group's underlying results and consequently does not feature in the International divisional numbers.

## Risks and uncertainties

The primary risk faced by International is the economic uncertainty of trading in foreign markets. Furthermore, the success of International's strategy will also depend on the competitor reaction of incumbent banks and new entrants. These risks are mitigated through robust divisional governance procedures where credit, operational, market, liquidity and insurance and investment risks are actively managed.

## Business And Financial Review (continued)

### Treasury & Asset Management

Within Bank of Scotland this division only contains treasury operations. All asset management sits within other legal entities of HBOS plc.

The Treasury division focuses on performing three core functions; funding and managing the liquidity position of the Group, providing financial services to the Group and its customers, and delivering profits. Of these, funding and liquidity is the most important function and will take priority over the other functions.

Treasury's strategy is to provide treasury services to support the growth of the Group's business and deliver treasury products to the Group's customers.

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Net interest income | **201** | 181 |
| Non-interest income | **243** | 188 |
| Net operating income | **444** | 369 |
| Operating expenses | **(156)** | (133) |
| Pre-tax profit | **288** | 236 |

Underlying profit before tax in Treasury increased by 22% to £288m. Asset quality remains high and no credit provisions were required in the period.

### Risks and uncertainties

Risks and uncertainties faced by Treasury include the risk that the Group does not have sufficient financial resources to meet its obligations when they become due, or will have to do so at excessive cost. To mitigate this, Treasury has diversified its funding channels and increased securitisation capacity.

### Overview of Results

Group underlying profit before tax amounts to £2,882m (2005 £2,546m) and is derived as follows:-

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Group profit before tax | **3,021** | 2,546 |
| Add back: | | |
| Goodwill impairment | **41** | |
| Profit on sale of Drive | **(180)** | |
| Group underlying profit before tax | **2,882** | 2,546 |

## Business And Financial Review (continued)

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

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Retail | **461** | 539 |
| Corporate | **1,575** | 1,381 |
| Insurance & Investment | **11** | 17 |
| International | **706** | 549 |
| Treasury & Asset Management | **288** | 236 |
| Group Items* | **(159)** | (176) |
| | **2,882** | 2,546 |

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

Group net interest income in the year of £4,123m is up £324m, reflecting strong asset led growth.

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Interest receivable | **22,645** | 18,054 |
| Interest payable | **(18,522)** | (14,255) |
| Net interest income | **4,123** | 3,799 |

Non-interest income amounted to £2,097m for the year compared with £1,931m for the year to 31 December 2005.

| | **Year ended 31 December 2006 £m** | Year ended 31 December 2005 £m |
|---|---|---|
| Net fees and commission income | **737** | 595 |
| Operating lease rental income | **601** | 610 |
| Net trading income | **277** | 214 |
| Profit on sale of investment securities | **300** | 182 |
| Other operating income | **182** | 330 |
| Non-interest income | **2,097** | 1,931 |

Business And Financial Review (continued)

Operating expenses increased 8% to £2,525m as a result of the planned investment in people and infrastructure in International and Treasury & Asset Management.

| | Year ended 31 December 2006 £m | Year ended 31 December 2005 £m |
|---|---|---|
| Staff costs | **1,162** | 1,051 |
| Accommodation, repairs and maintenance | **135** | 135 |
| Technology | **44** | 32 |
| Marketing and communication | **136** | 133 |
| Depreciation: | | |
| Property and equipment and intangible assets other than goodwill | **95** | 100 |
| Operating lease assets | **501** | 505 |
| Goodwill impairment | **41** | |
| Other | **411** | 377 |
| | **2,525** | 2,333 |

## Taxation

The tax charge for the year of £801m (2005 £678m), represents 27% (2005 27%) 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 more detail in Note 8 on page 61.

## Balance Sheet

Advances to customers increased by 21% to £215bn. The mix of the group's lending portfolio at the year end and gross lending exposure is shown in more detail in Note 12 on page 66.

## Impairment Provisions and Impaired Loans

The total charge for loan impairment losses against group profits was £944m (2005 £851m).

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

| | 2006 £m | 2006 As % of customer advances | 2005 £m | 2005 As % of customer advances |
|---|---|---|---|---|
| Impairment provisions | **1,561** | 0.73 | 1,637 | 0.92 |

# Business And Financial Review (continued)

## Capital Structure

| Risk Weighted Assets | 31 December 2006 £m | 31 December 2005 £m |
|---|---|---|
| On balance sheet – Banking book | **162,503** | 144,239 |
| On balance sheet – Trading book | **7,702** | 5,967 |
| Off balance sheet | **13,552** | 11,527 |
| **Total Risk Weighted Assets** | **183,757** | 161,733 |
| **Tier 1** | | |
| Ordinary share capital | **436** | 410 |
| Preference share capital | **400** | 400 |
| Perpetual securities | **298** | 298 |
| Eligible reserves | **10,905** | 8,931 |
| Minority interests (equity) | **1,169** | 734 |
| Preference instruments (non-equity): | | |
| Preferred securities | **400** | 400 |
| Less: goodwill & other intangible assets | **(1,565)** | (952) |
| **Total Tier 1 Capital** | **12,043** | 10,221 |
| **Tier 2** | | |
| Available for sale reserve | **168** | 107 |
| Undated subordinated debt | **2,126** | 2,339 |
| Dated subordinated debt | **4,815** | 3,983 |
| Other minority interest (non-equity) | **56** | 492 |
| Collectively assessed impairment provisions | **1,184** | 1,172 |
| **Total Tier 2 Capital** | **8,349** | 8,093 |
| Supervisory deductions: | | |
| Unconsolidated investments – other | **(28)** | (6) |
| Investments in other banks | **(18)** | (10) |
| Other deductions | **(775)** | (805) |
| Total supervisory deductions | **(821)** | (821) |
| **Total regulatory capital** | **19,571** | 17,493 |
| **Tier 1 capital ratio (%)** | **6.6** | 6.3 |
| **Total capital ratio (%)** | **10.7** | 10.8 |

## Business And Financial Review (continued)

### Key Performance Indicators

| | **31 December 2006** | 31 December 2005 |
|---|---|---|
| Cost:income ratio* | **34.9%** | 35.1% |
| Loans and Advances to customers | **£215.3bn** | £177.8bn |
| Impaired loans as a % of closing advances | 1.83% | 2.46% |
| Total Capital Ratio | **10.7%** | 10.8% |

***** The cost:income ratio is calculated excluding the profit on sale of Drive, mortgage endowment compensation, goodwill impairment and Retail rationalisation costs and after netting operating lease depreciation, impairment on investment securities, changes in insurance and investment liabilities and net claims incurred on insurance contracts against operating income.

Our credentials in respect of tight cost control are now well established. Our aim is to continue to control costs whilst at the same time increasing income and further reduce our cost:income ratio.

### Future Developments

Corporate will continue to sharpen their focus on core markets to enhance their depth of knowledge and experience. By concentrating on these markets, Corporate will continue to develop long term relationships with their chosen customers. Retail will continue to look for growth opportunities across all principal business activities. International are looking to expand into new markets and increase their depth of presence and relationships in current markets. Treasury and Asset Management's primary focus is to deliver a top quality service and performance to the Group and its clients and will continue to invest in its capabilities to do so.

It is expected that, during the financial year ending 31 December 2007, the businesses now carried on by Capital Bank plc, Halifax plc and HBOS Treasury Services plc, including all their property and liabilities, will be transferred to the Governor and Company of the Bank of Scotland. The Governor and Company of the Bank of Scotland will become registered under the Companies Act 1985 and will change its corporate name to Bank of Scotland plc. These changes will be effected pursuant to the HBOS Group Reorganisation Act 2006 which received Royal Assent on 22 June 2006.

## Risk Management

### Introduction

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

Identification, measurement and management of risk is a strategic priority for HBOS. The provision of financial services carries a number of diverse risks which may have a material impact on financial performance. Consequently, the board has established a comprehensive framework covering accountability, oversight, measurement and reporting to maintain high standards of risk management throughout the Group.

The principal risks managed by HBOS are:

– Credit Risk - the risk of financial loss from a customer's failure to meet obligations as they fall due.

– Liquidity or Funding Risk - the risk that the Group does not have sufficient financial resources to meet its obligations when they are due, or will have to do so at excessive cost.

– Market Risk - defined as the potential loss in value or earnings arising from changes in external market factors such as interest rates, foreign currency rates, commodities and equities, and the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions.

– Operational Risk - arising from internal processes, people and systems or from external events.

– Regulatory Change - the risk to HBOS strategy, reputation and financial position arising from failure to respond to changes in laws, regulations or business standards in the jurisdictions and businesses in which we operate.

– Insurance and Investment Risk - the potential for loss through adverse claims, expense and persistency experience, from both life and general insurance contracts.

This report has been audited by KPMG Audit Plc from the section entitled 'Credit Risk' on page 15 to the end of the section 'Liquidity Risk (Funding)' on page 19.

### Management and Controls

### Principles

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

– Key risks are identified, measured where appropriate, and managed to achieve a balance between risk and reward, which is acceptable to the Board. Each year the Board carries out a formal strategic review of risk management, and also reassesses its appetite for risk in light of the 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. The Board also reviews risk management performance through regular management information reporting.

– Responsibility for risk is a key element of managers' competencies at all levels. For each major risk type, specialist teams have been established where appropriate, both in the Divisions and at Group level, to ensure that guidance is available for managers within the Group. Specialist risk managers are tasked with researching industry best practice, and with ensuring that standards and policies within the Group are progressively developed to improve risk management practice.

– Staff and systems resources are dedicated to ensuring that risk management information is accurate, timely and relevant to the business, reflecting the true position at any given time.

– The Board has overall responsibility for the Group's system of control and approval of principal risk policies and standards, which are continually evolving. The Board is also responsible for reviewing the effectiveness of the systems and controls. The system of controls described in this section has been in place throughout the period to the date of approval of the Annual Report & 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.

### The Risk Management Framework

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

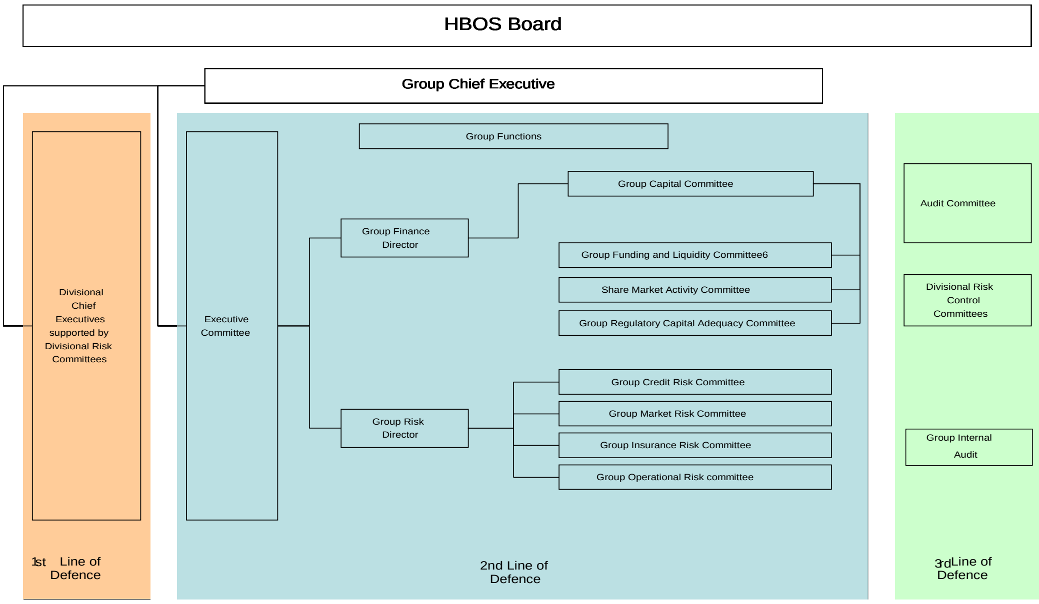
– Within Operating Divisions, primary management responsibility for strategy, performance management and risk control lies with the Divisional Chief Executives (first line of defence). They have responsibility for managing

Risk Management (continued)

– strategic, market, credit, liquidity, regulatory and operational issues and risks affecting their own operations within the parameters of Group policies. Each Operating Division also has its own risk management committee or committees.

– Centralised policies and standards are developed and objective oversight of risk management is exercised by specialist risk functions, supporting the Group's Executive Committees and Executive Risk Committees (second line of defence);

– Independent and objective assurance on the effectiveness of control systems is provided by Group Internal Audit with oversight by the Audit Committee (third line of defence).




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

**The Committee Framework**

The Group Executive Risk Committees develop the policies and parameters within which Operating Divisions are required to manage risk. The Committees provide central oversight by reviewing and challenging the work of the Operating Divisions' own risk committees and considering the application of appropriate risk management techniques.

The four specific Executive Risk Committees are:

– Group Credit Risk Committee, which covers all credit risk matters;

– Group Market Risk Committee, which is responsible for all trading and market risk matters;

– Group Insurance Risk Committee, which is responsible for insurance risks, within the insurance and investment businesses; and

– Group Operational Risk Committee, responsible for operational and regulatory risks.

The Group has an established specialist Group Risk Function, reporting to the Group Risk Director, in support of these committees. Its accountabilities are:

– to recommend Group policies, standards and limits;

– to monitor compliance with those policies, standards and limits;

– to provide leadership in the development and implementation or risk management techniques; and

– to aggregate risks arising in the business divisions and to monitor the overall Group position independently from the Divisions' own analysis.

## Risk Management (continued)

Consideration of capital, liquidity and balance sheet management is undertaken on an integrated basis. All capital and funding related activities are the responsibility of the Group Capital Committee, supported by three sub-committees, which focuses on the core aspects of overall Group requirements. The Group Capital Committee is chaired by the Group Finance Director and operates under delegated authority from the Board, to:

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

**Strategy, Risk Control and Oversight**

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

Divisional management has primary responsibility for identifying and evaluating significant risks to the business and for designing and operating suitable controls. Internal and external risks are assessed, including economic factors, 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.

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

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

**The Basel II Accord**

HBOS continues to make good progress with Basel II preparations. The primary goal of our programme has always been to optimise the way we do business through an improved risk management capability. The overarching objective of all HBOS activity is to deliver sustainable income streams and generate added shareholder value and the Basel II programme is integral to our strategy of targeted growth. During 2006 the UK legislative process gathered significant momentum with the publication of several consultative papers and feedback statements that culminated on 25 October 2006 with the Financial Services Authority ('FSA') Board approving final GENPRU and BIPRU rules for adoption into the Prudential Sourcebook for Banks, Building Societies and Investment Firms. This legislative process enacts

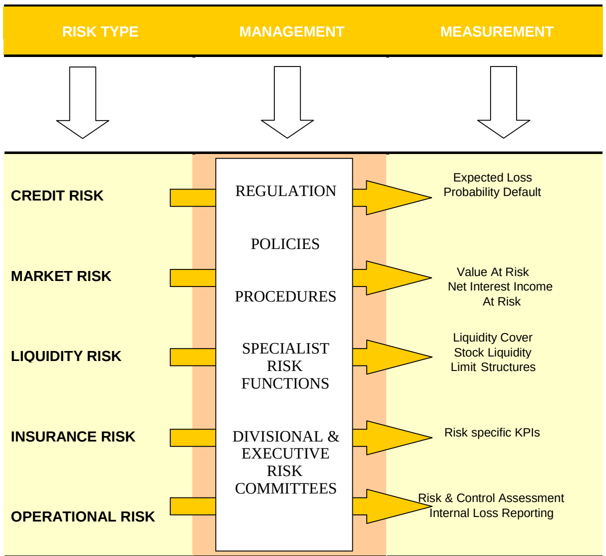
Risk Management (continued)

the European Capital Requirements Directive and, therefore, the Basel II Capital Accord, in the UK with effect from 1 January 2007.

HBOS continues to promote a prudent and responsible approach to the management of capital. Management and the Board's view of future requirements will continue to be the main determinant of total capital holdings. HBOS has elected to adopt transitional arrangements in 2007 and remain on the current Basel I rules to determine minimum regulatory capital requirements. HBOS has submitted Advanced Internal Ratings Based Approach and Advanced Measurement Approach waiver applications to the FSA and is seeking approval to adopt the more sophisticated approaches to capital determination from 1st January 2008. We continue to maintain a close dialogue with the FSA to work through the accreditation process.

**Management of Key Risks**

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.




**Credit Risk**

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

The Group Credit Risk Committee, one of the Executive Risk Committees, is chaired by the Group Risk Director and comprises senior executives from across the Operating Divisions and Group Functions. It meets monthly and reviews the Group's lending portfolio. It also assists the Board in formulating the Group's credit risk appetite. The Group Credit Risk Policy Statement, to be applied across all businesses subject to credit risk, is approved by the Board on an annual basis.

Group Credit, a specialist support function within Group Risk, provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance of each divisional portfolio to the Group Credit Risk Committee, Group Credit exercises independent oversight over the effectiveness of credit risk management arrangements and adherence to agreed policies, standards and limits.

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

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

- For Retail portfolios use is made 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. Affordability is an increasingly important measure and is reviewed in combination with either application and/or behavioural scores. 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.

## Risk Management (continued)

- For Corporate portfolios, a full independent credit assessment of the financial strength of each potential transaction and/or customer is undertaken, awarding an internal credit risk rating. Internal ratings are reviewed regularly. The same approach is also used for larger SME (small to medium enterprise) customers.
- Within HBOS Treasury Services ('Treasury'), largely incorporating the Group’s wholesale, sovereign and banking related exposures, focused credit risk policies are established and reviewed by the Group Wholesale Credit Committee (‘GWCC’), a subcommittee of the Group Credit Risk Committee.

An additional measure within the credit risk framework is the establishment of product, industrial sector and country limits to avoid excessive concentrations of risk particularly within volatile economic sectors or individual countries. Material portfolio areas, such as the mortgages portfolios, have approved sub-sector limits to ensure that they remain within our plans and tolerance for risk. 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.

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

Within the insurance and investment businesses, formal policies and an overall risk appetite, approved by the Board of the relevant insurance subsidiary, are in use together with a regular monitoring process to help ensure compliance.

**Market Risk**

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

- changes in external market factors such as interest rates (interest rate risk), foreign currency rates (foreign currency risk), commodities and equities; and
- 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
- those making decisions have appropriate information on market risk, 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 Market Risk Committee, one of the Executive Risk Committees, chaired by the Group Risk Director.The Group devotes considerable resources to ensuring that market risk is comprehensively captured, accurately modelled and reported, and effectively managed. Trading and non-trading portfolios are managed at various organisational levels, from the HBOS Group overall, down to specific business areas.

Market risk measurement and management methods are designed to meet or exceed industry standard, and the tools used facilitate internal market risk management and reporting, as well as external disclosure requirements.

Market risk is controlled across the Group by setting limits using a range of measurement methodologies. The principal methodologies are Value-at-Risk ('VaR'), Net Interest Income ('NII') at Risk and scenario analysis. NII at risk is a technique that provides estimates of the potential negative change in the forecast NII of a portfolio over a specified time horizon for a specific interest rate environment. VaR is a technique that produces estimates of the potential negative change in the market value of a portfolio over a specified time horizon at given confidence levels. Scenario analysis is performed in order to estimate the potential economic loss that could arise from extreme, but plausible stress events. In 2006 the Group introduced market value methodology for its banking businesses to expand on the Groups capabilities in capturing market risk.

## Risk Management (continued)

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 requires appropriate divisional sanction, and is then forwarded to the Group Market Risk 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, the overall risk appetites and policies are approved by the company's Board and monitored thereafter.

Market risk – principally interest rate and equity – also arises from the Group's defined benefit pensions obligations. These sensitivities are regularly measured and are reported to the Group Market Risk Committee every month.

Group items (centrally managed net free reserves, subordinated debt and structural foreign currency) are managed within separate policies and limits/mandates, as set by the Group Capital 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 which 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. Risk exposures will be monitored using one or a combination of the following measures:

– Net Interest Income at Risk – This methodology combines an analysis of the Group's Interest Rate Risk position overlaid with behavioural assessment and re-pricing assumptions of planned future activity. The change to forecast NII is calculated with reference to different interest rates scenarios. These scenarios range from next most likely rate move, to a significant parallel shock.

– Present Value of a Basis Point ('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.

– Market Value Measures (Banking Book) – A dynamic balance sheet mark to market is a risk measurement that considers future business and customer behaviour implications to capture the optionality embedded within the banking books.

– Duration provides a single measure of a portfolio's 'average maturity' as calculated when considering all future cash flows of that portfolio, discounted at current market rates.

The Board has delegated authority to the Group Market Risk 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 Market Risk 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 Treasury from the banking Divisions. The residual risk in the banking Divisions is primarily that related either to behavioural characteristics or to basis risk arising from imperfect correlations in the adjustment of rates earned and paid on different instruments with otherwise similar characteristics.

Sensitivity to interest rate movements is shown in Note 33 to the Accounts on pages 91 to 92 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. The methodology used in analysing the year end repricing profile does not take into consideration the effects of behavioural and basis risk issues, hence for internal management of risk the Group relies on a number of methodologies, as described above.

**Foreign Currency Risk**

The Group Funding & Liquidity Committee is responsible for oversight and management of structural foreign currency risk. The Group Funding & Liquidity Committee manages foreign currency exposures based on forecast currency information provided by the Operating Divisions, and mandates Treasury to execute transactions and undertake currency programmes to manage structural currency risk. The risk position is monitored monthly by the Group Market Risk Committee.

## Risk Management (continued)

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 currency exposures are set out in Note 35 to the Accounts on page 93.

**Trading**

The Group's market risk trading activities are principally conducted by Treasury. This Group activity is subject to a Trading Book Policy Statement, which is approved by the Board, and limits set by the Group Market Risk 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 currency rate exposure. The framework for managing the market risk in these activities requires detailed and tailored modelling techniques, which are the responsibility of the Treasury Market Risk team.

The Group employs several complementary techniques to measure and control trading activities including: 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 2006 was £4.2m. 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, credit spread and volatility risk), and foreign currency risk. The current methodology for providing an aggregated VaR for the business uses conservative assumptions. In order to assess the effectiveness of VaR the Group uses a technique known as 'back-testing', which compares the daily profit and loss from trading activities to the VaR estimate for that day. Daily standard deviation of trading profit and loss was £0.6m.

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 2006 is analysed in Note 34 on page 93 to the Accounts. The regulatory capital charge for market risk trading exposures represents only 28.2% of the Group's capital base.

**Derivatives**

In the normal course of banking business, the Group uses a limited range of derivative instruments for both trading and non-trading purposes. The principal derivative instruments used are interest rate swaps, interest rate options, cross currency swaps, forward rate agreements, forward foreign currency contracts and futures. The Group uses derivatives as a risk management tool for hedging interest rate and foreign currency rate risk.

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

– Fixed interest rate swaps are used to manage the interest rate risk of fixed rate mortgages; and

– Basis swaps are used to manage exposure between 1 month LIBOR and base rates.

The Group's activity in derivatives is controlled within risk management limits set by the Board and overseen by the relevant Group Risk Committees. 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 11 on pages 63, 64 and 65.

**Liquidity Risk (Funding)**

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

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

Risk Management (continued)

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 Treasury; the Group Funding & Liquidity Committee (a sub-Committee of the Group Capital Committee) oversees the controls exercised by Treasury.

The Board requires that prudential liquidity limits should be set by the Group Funding & Liquidity 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 – from sight to eight days and from sight to one month.

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

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

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

The Group also adheres to the requirements of other regulatory authorities including the Australian Prudential Regulatory Authority and the Irish Financial Regulator in whose jurisdictions the Group has branches or subsidiaries.

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 Funding & Liquidity 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 Treasury represents a significant component of its overall funding, and the Group Funding & Liquidity Committee directs and co-ordinates the activities of the Operating Divisions in raising liabilities from a range of sources. Within Treasury, 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 Funding & Liquidity Committee approves the appropriate balance of short to medium term funding.

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

**Operational Risk**

Operational Risk exists in the normal conduct of business. Examples of potential sources of operational risk include fraud, system reliability, human error, failure of key suppliers, IT security, business continuity, change management, operational outsourcing and failure to comply with legislation or regulation.

The Board has approved an Operational Risk Policy that establishes the framework for managing operational risk. The main components of the Operational Risk Framework include risk and control assessment, internal loss reporting, capture of risk event information, key risk indicator monitoring and evaluation of external events.

The Group Operational Risk Committee is one of the four Executive Risk Committees chaired by the Group Risk Director. It is attended by senior executives from the Divisions and Group specialist areas. The committee considers the management of issues and exposures, recommends the appropriate capital requirement, approves policies and standards and provides oversight of the operational risk communities.

A key enhancement to our infrastructure has been to focus on the explicit risk management of specialist areas that underpin the HBOS Operational Risk Framework. All specialist functions have clear roles defined to help lead the identification, management and measurement of risks relevant to their areas across the Group. The Group Operational Risk function co-ordinates the specialist areas, designs and maintains Group-wide risk systems and undertakes the detailed modelling required to assess risk exposure.

# Risk Management (continued)

**Regulatory Change**

The Financial Services Authority is the main regulator for UK financial institutions, including HBOS although the Group's main international businesses in the USA, Australia and Ireland are subject to direct scrutiny from the US Federal Reserve, APRA and The Financial Regulator respectively.

HBOS understands that consumers have an ever-increasing choice of supplier and product and are more demanding of financial services providers. Consumer lobby groups have also become more vociferous on their behalf. The Group's Customer Contract, which was approved by the Board in November 2005, sets out principles for doing business and is HBOS's response to the FSA's Treating Customers Fairly initiative. The objective is to meet the requirements of our shareholders through meeting the needs of our customers.

HBOS is alert to the wider, cumulative picture of regulatory change and enforcement requirements, using centralised expertise in the area of regulatory and legal compliance, specifically to:

- Identify and assess the impact of, respond to and potentially influence the direction of regulatory developments on behalf of HBOS;
- Lead the development and monitoring of the application of specific Group-wide policies and standards; and,
- Oversee the management, support and coordination of the liaison and interaction with HBOS regulatory stakeholders across all its international businesses.

The impact of regulatory change is reported across all Executive Risk Committees with specific reference to the discipline affected and at Group level to Audit Committee and Board.

## Directors' Report

The Directors have pleasure in presenting their Annual Report and Accounts for the year ended 31 December 2006.

**Principal Activities**

The principal activity of the group is the provision of financial services. A list of the main subsidiary undertakings, and the nature of their business, is given in Note 16 to the accounts on page 71.

**Business Review**

The Companies Act 1985 requires the Directors' Report to include a Business Review of the Bank of Scotland Group giving a fair review of the business of the group and a description of the principal risks and uncertainties facing the Group.

The Group's development and performance during the year, position at the year end and likely future prospects are reviewed in the Business and Financial Review on pages 2 to 11 and the Risk Management report on pages 12 to 20. The information in both of these sections, which fulfils the requirements of the Business Review, is incorporated into this Directors' Report by reference.

**Results and Dividends**

The profit before tax for the year ended 31 December 2006 amounted to £3,021m (year ended 31 December 2005 - £2,546m).

An interim dividend of £308m was paid in October 2006 and a further dividend of £650m was paid in December 2006. The final dividend of £467m in respect of the year ended 31 December 2005 was paid in March 2006. The Directors recommend payment of a final dividend of £525m in respect of the year ended 31 December 2006.

**Payment Policy**

The Bank's suppliers are paid through HBOS plc's centralised Accounts Payable department. For the forthcoming period the group's policy for the payment of suppliers will be as follows:

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

Trade creditors outstanding at 31 December 2006 represented 18 days of purchases.

**Employees**

The principal employer for UK based employees is HBOS plc. The Group is a 'two-tick' employer actively seeking applications for employment from disabled people and guaranteeing an interview where disabled applicants meet the essential criteria for the role being applied for. In the event of an existing colleague becoming disabled, HBOS works with external specialists to ensure that all possible reasonable adjustments are made to allow the colleague to continue in their existing role. If, after making all possible adjustments, a colleague is not able to continue in their current role, HBOS will look at suitable alternative roles within the Group. Training and career development opportunities are open to all colleagues, including disabled colleagues, and Group policies are designed with inclusion of disabled colleagues in mind.

**Directors**

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

Sir James Crosby retired as a Director on 31 July 2006. Sir Brian Ivory and David Shearer will step down from the Board on 25 April 2007 and will not seek re-election.

Colin Matthew will retire by rotation at the 2007 AGM and a resolution for his re-election will be proposed at the meeting. Lord Stevenson and Sir Ron Garrick retire annually and resolutions for their re-election will be proposed at the 2007 AGM.

## Directors' report (continued)

Jo Dawson and Benny Higgins were appointed Directors on 1 May 2006 and Richard Cousins will become a Non-executive Director on 1 March 2007. All three will retire at the forthcoming 2007 AGM and offer themselves for election.

Details of Directors' interests in the shares of the group are disclosed on page 23.

**Charitable and Other Donations**

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

**Share Capital**

Full details of the movements in the issued share capital during the year are provided in Note 25 to the Accounts on page 82.

**Corporate Governance and Directors' Remuneration**

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

**Going Concern**

The Directors are satisfied that the group has adequate resources to continue in business for the foreseeable future and consequently the going concern basis continues to be appropriate in preparing the accounts.

**Properties**

The Directors are of the opinion that the current market value of the group's properties is not significantly different from the amount at which they are included in the balance sheet.

**Auditors**

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

**Auditors information**

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

On behalf of the Board

H F Baines

Company Secretary

27 February 2007

Directors' Report (continued)

## Directors Share Interests

### 1. Shares

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

| Table 1 | Number of shares at 31 December 2006 Or date of appointment if later | Number of shares at 31 December 2005 Or date of appointment if later |
|---|---|---|
| **Governor** | | |
| Dennis Stevenson | **267,794** | 301,006 |
| **Executive Directors** | | |
| Peter Cummings | **88,791** | 71,097 |
| Jo Dawson | **52,485** | 51,655 |
| Benny Higgins | **311** | |
| Phil Hodkinson | **263,094** | 207,648 |
| Andy Hornby | **535,379** | 496,780 |
| Colin Matthew | **356,930** | 213,445 |
| **Non-Executive Directors** | | |
| Charles Dunstone | **100,000** | 100,000 |
| Sir Ron Garrick | **23,980** | 23,268 |
| Anthony Hobson | **7,500** | 6,500 |
| Sir Brian Ivory | **7,000** | 7,000 |
| Karen Jones | **10,000** | |
| Coline McConville | **5,320** | 5,320 |
| Kathleen (Kate) Nealon | **12,879** | 12,879 |
| David Shearer | **10,000** | 10,000 |

### Notes to Table 1

**Note 1:**

Sir Brian Ivory has a non-beneficial interest over 4,500 ordinary shares (2005 4,500).

**Note 2:**

Certain Executive Directors and former Executive Directors will or may receive further interests in the ordinary shares of the Group arising out of the short term incentive plans and long term incentive plans as set out in tables 2, 3, 4, 5 and 6.

**Note 3:**

Karen Jones had an interest over 200,000 4.875% HBOS Treasury Services Guaranteed Notes. Otherwise, no Director had any interest in the preference shares of the Group or in the loan 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.

Directors' Report (continued)

## 2. Short-Term Incentive Plans – HBOS Directors

All Executive Directors, excluding Benny Higgins, who did not join the Group until 2006, have conditional entitlements to shares arising from sharekicker. Where the annual incentive for 2002 and/or 2003 and/or 2004 and/or 2005 was taken in shares and these shares are retained in trust for three years, additional shares may also be transferred to the Directors. Details of these shares are set out below.

The basic and additional shares shown below which vested in 2006 are also included in table 1.

| **Table 2** | Grant | At 31 December 2005 | | Added in year | | | At 31 December 2006 | |
|---|---|---|---|---|---|---|---|---|
| | effective from | Basic Shares | Additional shares | Basic shares | Additional shares | Released in year | Basic shares | Additional Shares |
| Peter Cummings | March 2003 | 1,997 | 998 | | | 2,995 | | |
| | March 2004 | 3,807 | 1,903 | | | | 3,807 | 1,903 |
| | March 2005 | 10,808 | 5,404 | | | | 10,808 | 5,404 |
| | March 2006 | | | 15,153 | 7,576 | | 15,153 | 7,576 |
| | | 16,612 | 8,305 | | | | **29,768** | **14,883** |
| Jo Dawson | March 2003 | 6,864 | 3,432 | | | 10,296 | | |
| | March 2004 | 11,280 | 5,640 | | | | 11,280 | 5,640 |
| | March 2005 | 14,648 | 7,324 | | | | 14,648 | 7,324 |
| | March 2006 | | | 14,232 | 7,116 | | 14,232 | 7,116 |
| | | 32,792 | 16,396 | | | | **40,160** | **20,080** |
| Phil Hodkinson | March 2003 | 18,282 | 9,141 | | | 27,423 | | |
| | March 2004 | 12,826 | 6,413 | | | | 12,826 | 6,413 |
| | March 2005 | 20,511 | 10,255 | | | | 20,511 | 10,255 |
| | March 2006 | | | 23,052 | 11,526 | | 23,052 | 11,526 |
| | | 51,619 | 25,809 | | | | **56,389** | **28,194** |
| Andy Hornby | March 2003 | 21,939 | 10,969 | | | 32,908 | | |
| | March 2004 | 18,437 | 9,218 | | | | 18,437 | 9,218 |
| | March 2005 | 28,436 | 14,218 | | | | 28,436 | 14,218 |
| | April 2005 | 141,826 | 70,913 | | | | 141,826 | 70,913 |
| | March 2006 | | | 27,462 | 13,731 | | 27,462 | 13,731 |
| | | 210,638 | 105,318 | | | | **216,161** | **108,080** |
| Colin Matthew | March 2003 | 18,282 | 9,141 | | | 27,423 | | |
| | March 2004 | 12,505 | 6,252 | | | | 12,505 | 6,252 |
| | March 2005 | 20,511 | 10,255 | | | | 20,511 | 10,255 |
| | March 2006 | | | 22,050 | 11,025 | | 22,050 | 11,025 |
| | | 51,298 | 25,648 | | | | **55,066** | **27,532** |

## Directors' Report (continued)

**Notes to Table 2**

**Note 1:**

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

| Plan | Share Grant Price £ |
|---|---|
| March 2003 – March 2006 | 6.76 |
| March 2004 – March 2007 | 7.36 |
| March 2005 – March 2008 | 8.19 |
| April 2005 – April 2008 | 8.32 |
| March 2006 – March 2009 | 9.86 |

**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 2006 represented the basic shares purchased by the Director's own annual cash incentive in March 2003 plus the additional shares arising as a result of sharekicker. The closing market price of the Group's ordinary shares on the date of release was £9.85.

**Note 4:**

Following his retirement on 31 December 2005, George Mitchell retains interests under the short term incentive plan through grants of basic and additional shares of 23,889 and 11,944, respectively, (effective from March 2003), 17,315 and 8,657, respectively, (effective from March 2004) and 26,338 and 13,169, respectively, (effective from March 2005). These remain subject to the same plan rules as apply to existing Executive Directors.

Following his retirement on 31 July 2006, Sir James Crosby retains interests under the short term incentive plan through grants of basic and additional shares of 32,117 and 16,088, respectively, (effective from March 2003), 24,850 and 12,425, respectively, (effective from March 2004) and 38,458 and 19,229, respectively, (effective from March 2005). These remain subject to the same plan rules as apply to existing Executive Directors.

Directors' Report (continued)

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

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

| **Table 3** | Grant effective from | At 31 Dec 2005 | Granted (G) or lapsed (L) in year | Added as a result of superior performance | Dividend reinvestment shares | Vested in year | At 31 Dec 2006 |
|---|---|---|---|---|---|---|---|
| Peter Cummings | January 2003 | 18,750 | | | | | 18,750 |
| | January 2004 | 27,894 | | | | | 27,894 |
| | January 2005 | 23,809 | | | | | 23,809 |
| | January 2006 | | 51,203 (G) | | | | 51,203 |
| | | **70,453** | | | | | **121,656** |
| Jo Dawson | January 2003 | 18,229 | | 15,130 | 5,177 | 38,536 | |
| | January 2004 | 25,569 | | | | | 25,569 |
| | January 2005 | 27,380 | | | | | 27,380 |
| | January 2006 | | 39,285 (G) | | | | 39,285 |
| | | **71,178** | | | | | **92,234** |
| Benny Higgins | January 2006 | | 128,008 (G) | | | | 128,008 |
| | May 2006 | | 30,425 (G) | | | | 30,425 |
| | | | | | | | **158,433** |
| Andy Hornby | January 2003 | 70,312 | | 58,358 | 19,971 | 148,641 | |
| | January 2004 | 80,195 | | | | | 80,195 |
| | January 2005 | 72,619 | | | | | 72,619 |
| | January 2006 | | 70,148 (G) | | | | 70,148 |
| | | **223,126** | | | | | **222,962** |
| Phil Hodkinson | January 2003 | 58,593 | | 48,632 | 16,642 | 123,867 | |
| | January 2004 | 55,788 | | | | | 55,788 |
| | January 2005 | 52,380 | | | | | 52,380 |
| | January 2006 | | 58,883 (G) | | | | 58,883 |
| | | **166,761** | | | | | **167,051** |
| Colin Matthew | January 2003 | 58,593 | | 48,632 | 16,642 | 123,867 | |
| | January 2004 | 54,393 | | | | | 54,393 |
| | January 2005 | 52,380 | | | | | 52,380 |
| | January 2006 | | 56,323 (G) | | | | 56,323 |
| | | **165,366** | | | | | **163,096** |
| Dennis Stevenson | January 2003 | 77,343 | | 64,194 | 21,968 | 163,505 | |
| | January 2004 | 73,221 | | | | | 73,221 |
| | January 2005 | 65,476 | | | | | 65,476 |
| | January 2006 | | 58,883 (G) | | | | 58,883 |
| | | **216,040** | | | | | **197,580** |

# Directors' Report (continued)

**Notes to Table 3**

**Note 1:**

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

| Plan and Performance Period | Share Grant Price £ |
|---|---|
| January 2003 – December 2005/2007 | 6.40 |
| January 2004 – December 2006 | 7.17 |
| January 2005 – December 2007 | 8.40 |
| January 2006 – December 2008 | 9.765 |

**Note 2:**

The first grant effective from January 2006 for Benny Higgins over 128,008 shares, was necessary to facilitate his recruitment in May 2006 and partially reflects value foregone from his previous employment. This special grant level was at 200% of his salary. The normal grant level would have been 100% of his salary. The grant is otherwise subject to the same performance conditions as apply to the other Executive Directors.

The second grant effective from May 2006 for Benny Higgins over 30,425 shares having a value of £300,000 was necessary to facilitate his recruitment in May 2006 and partially reflects value foregone from his previous employment. This award will vest in May 2009, subject to his continued employment, and is not subject to any performance conditions.

**Note 3:**

Following his retirement on 31 December 2005, George Mitchell retains interests under the plan through grants of 75,313 and 67,261 shares effective from January 2004 and January 2005, respectively. These remain subject to the same plan rules as apply to existing Executive Directors.

Following his retirement on 31 July 2006, Sir James Crosby retains interests under the plan through grants of 108,089 and 98,214 shares effective from January 2004 and January 2005, respectively. These remain subject to the same plan rules as apply to existing Executive Directors.

**Note 4:**

Awards are not pensionable.

**Note 5:**

The performance period for the January 2003 grant ended on 31 December 2005. HBOS's TSR over the performance period exceeded the weighted average of the comparator group by 5.49% p.a. so 183% of share grants have been released to grant recipients. The shares granted in January 2003 vested on 3 March 2006. The closing market price of the Group's ordinary shares on that date was £9.895. In addition, dividend reinvestment shares have been released to grant recipients as set out in the table and as provided for under the rules of the plans. The dividend reinvestment shares are the additional shares which would have accrued on the overall share grants actually released had dividends due during the performance period been reinvested in shares.

**Note 6:**

As explained in last year's report, for the 2003 grants, all participants could choose to take any shares released after three years based on the three-year performance outcome or could 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 seeked to motivate participants continually to sustain strong performance or to improve lesser performance for their benefit and the benefit of shareholders. This feature does not apply for the 2004 grants and does not apply for any grants in subsequent years, to reflect the preference on 'retesting' expressed by most major institutional investors. With the exception of Peter Cummings, all Executive Directors chose to take their 2003 grants in 2006 based on the three year performance outcome.

## Directors' Report (continued)

**Note 7:**

Subject to performance, the shares granted under the long term plan effective from January 2004 will be released to most individuals shortly after the three-year anniversary of the grant date, in March 2007.

**Note 8:**

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

**Note 9:**

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 grant effective from January 2003, a five year period can also apply. This basket of companies comprises:

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

- for the January 2005 and subsequent grants: Alliance & Leicester, Aviva, Barclays, Bradford & Bingley, Legal & General, Lloyds TSB, Northern Rock, Prudential, Royal & Sun Alliance and Royal Bank of Scotland.

Shares have been or will be released as follows:

| Group's relative TSR performance | Amount released as a % of share grant |
|---|---|
| 2003, 2004, 2005 and 2006 grants | |
| 0% pa (or below) | 0 |
| +3% p.a. | 100* |
| +6% p.a. (or above) | 200 |

Intermediate positions are determined by interpolation.

* Shown as granted in the table.

**Note 10:**

The performance period for the January 2004 grant ended on 31 December 2006. HBOS's TSR over the performance period exceeded the weighted average of the comparator group by 3.40% p.a., as illustrated in Chart 1, so 113.33% of share grants will be released to grant recipients in March 2007.

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

Full details concerning these shares, which will be released to the Governor and the Executive Directors in March 2007, will be set out in the 2007 Annual Report and Accounts.

The performance period for the January 2005 grants does not end until 31 December 2007. So far, HBOS's TSR over the two year elapsed period exceeds the weighted average of the comparator group by 6.26%.

The performance period for the January 2006 grants does not end until 31 December 2008. So far, HBOS's TSR over the one year elapsed period falls short of the weighted average of the comparator group by 3.17%.

Directors' Report (continued)

## 4. Long Term Incentive Plan – Share Options

HBOS Executive Directors are not awarded executive share options.

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

No further share options have been or can be granted under these plans.

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

| Table 4 | Option effective from | At 31 Dec 2005/ 1 Jan 2006 | Granted (G), exercised (E) or lapsed (L) in year | At 31 Dec 2006 | Share Option Price £ | Exercisable |
|---|---|---|---|---|---|---|
| Colin Matthew | October 1996 | 50,000 | 50,000 (E) | | 2.7367 | |
| | October 1997 | 28,000 | | 28,000 | 5.3533 | January 2007– October 2007 |
| | October 1998 | 5,223 | | 5,223 | 5.7433 | January 2007– October 2008 |
| | October 1998 | 29,777 | | 29,777 | 5.8350 | January 2007– October 2008 |
| | May 2000 | 40,000 | | 40,000 | 5.5150 | January 2007– May 2010 |
| | October 2000 | 40,000 | | 40,000 | 6.1000 | January 2007– October 2010 |
| | | **193,000** | | **143,000** | | |

### Notes to Table 4

**Note 1:**

On 27 September 2006, Colin Matthew exercised options over 50,000 shares granted effective from October 1996. The closing market price for the Group's ordinary shares on the date of exercise was £10.58.

**Note 2:**

On 23 March 2006, George Mitchell, who retired as an Executive Director on 31 December 2005, exercised options over 50,000, 35,000, 40,000, 45,000 and 50,000 shares granted effective from October 1996, October 1997, October 1998, May 2000 and October 2000, respectively. The closing market price of the Group's ordinary shares on the date of the exercise was £9.86. He has no remaining options under the plan.

**Note 3:**

Details of the market price of the HBOS Group's ordinary shares during 2006 are given in Section 8.

**Note 4:**

Jo Dawson has share options under the HBOS all-colleague plan which were granted before she was appointed an Executive Director or to Level 9 or Level 8. She has options over 3,727 shares granted effective from April 2002 at an option price of £7.512. These are exercisable between 15 April 2005 and 14 April 2008. There are no performance conditions.

Directors' Report (continued)

## 5. Sharesave Plan

The sharesave plan is available to all UK based 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** | Option effective from | At 31 Dec 2005/ 1 Jan 2006 | Granted (G), exercised (E) or lapsed (L) in year | At 31 Dec 2006 | Exercisable |
|---|---|---|---|---|---|
| Peter Cummings | September 2001 | 600 | | 600 | January 2007 – June 2007 |
| | September 2002 | 549 | | 549 | January 2008 – June 2008 |
| | September 2004 | 452 | | 452 | January 2008 – June 2008 |
| | September 2005 | 791 | | 791 | January 2011 – June 2011 |
| | September 2006 | | 238 (G) | 238 | January 2010- June 2010 |
| | | **2,392** | | **2,630** | |
| Jo Dawson | September 2003 | 1,607 | | 1,607 | January 2007 – June 2007 |
| | September 2006 | | 2,065(G) | 2,065 | January 2012 – June 2012 |
| | | **1,607** | | **3,672** | |
| Benny Higgins | September 2006 | | 2,065 (G) | 2,065 | January 2012 – June 2012 |
| | | | | **2,065** | |
| Phil Hodkinson | September 2002 | 2,970 | | 2,970 | January 2010 – June 2010 |
| | | **2,970** | | **2,970** | |
| Andy Hornby | September 2003 | 1,607 | | 1,607 | January 2007 – June 2007 |
| | September 2006 | | 2,216 (G) | 2,216 | January 2014 – June 2014 |
| | | **1,607** | | **3,823** | |

**Notes to Table 5**

**Note 1:**

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

Directors' Report (continued)

| Effective date of grant | Share Option Price £ |
|---|---|
| October 2001 | 5.62 |
| September 2002 | 5.975 |
| September 2003 | 5.74 |
| September 2004 | 5.443 |
| September 2005 | 6.912 |
| September 2006 | 7.928 |

**Note 2:**

On 28 March 2006, George Mitchell exercised options over 603 shares granted effective from September 2004. The closing market price of the Group's ordinary shares on the date of exercise was £9.665. He has no remaining options under the plan.

**Note 3:**

On 28 December 2006, Sir James Crosby, who retired as an Executive Director on 31 July 2006, exercised options over 1,911 shares granted effective from September 2002. The closing market price of the Group's ordinary shares on the date of exercise was £11.37. He has no remaining options under the plan.

**Note 4:**

Details of the market price of the Group's ordinary shares during 2006 are given in Section 8.

### 6. Free Share Plan

The free share plan is available to most Group colleagues.

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

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

## Directors' Report (continued)

**Table 6**

| | Grant effective From | At 31 Dec 2005 / 1 Jan 2006 | Awarded (A), Released (R), Forfeit (F), in year | Dividend reinvestment shares acquired in year | At 31 Dec 2006 | Releasable |
|---|---|---|---|---|---|---|
| Peter Cummings | August 2005 | 333 | | 14 | 347 | August 2008 |
| | August 2006 | | 308 (A) | 3 | 311 | August 2009 |
| | | **333** | | | **658** | |
| Jo Dawson | August 2005 | 333 | | 14 | 347 | August 2008 |
| | August 2006 | | 308 (A) | 3 | 311 | August 2009 |
| | | **333** | | | **658** | |
| Benny Higgins | August 2006 | | 308 (A) | 3 | 311 | August 2009 |
| | | | | | **311** | |
| Andy Hornby | August 2005 | 333 | | 14 | 347 | August 2008 |
| | August 2006 | | 308 (A) | 3 | 311 | August 2009 |
| | | **333** | | | **658** | |
| Phil Hodkinson | August 2005 | 333 | | 14 | 347 | August 2008 |
| | August 2006 | | 308 (A) | 3 | 311 | August 2009 |
| | | **333** | | | **658** | |
| Colin Matthew | August 2005 | 333 | | 14 | 347 | August 2008 |
| | August 2006 | | 308 (A) | 3 | 311 | August 2009 |
| | | **333** | | | **658** | |

**Notes to Table 6**

**Note 1:**

Shares were awarded at £9.10 and £9.74 in August 2005 and August 2006, respectively, the middle market price of the Group's ordinary shares on the days immediately preceding the dates of the awards.

**Note 2:**

Participants in this plan have an interest in dividends on the free shares (in the form of dividend shares) as and when they become due. Dividends were paid on 15 May 2006 and 9 October 2006 and were reinvested in shares. The closing market price of the Group's ordinary shares on these dates was £9.45 and £10.83, respectively. Dividend reinvestment shares are required to be held for three years from the dates of payment.

**Note 3:**

On 21 February 2006, 333 shares were released from the trust on behalf of George Mitchell, who retired as an Executive Director on 31 December 2005. The closing market price of the Group's ordinary shares on the date of release was £10.36. He has no remaining shares under the plan.

**Note 4:**

On 29 December 2006, 342 shares were released from the trust on behalf of Sir James Crosby, who retired as an Executive Director on 31 July 2006. The closing market price of the Group's ordinary shares on the date of release was £11.32. He has no remaining shares under the plan.

**Note 5:**

Details of the market price of the Group's ordinary shares during 2006 are given in Section 8.

Directors' Report (continued)

### 7. Interest in Shares under Trusts

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

- the Group's Employee Share Ownership Trusts. As such, they were each treated as at 31 December 2006 as being interested in the 5,405,010 ordinary shares (31 December 2005 – 276,879 ordinary shares) held by the trustees of these Trusts. The shares held in the Trusts will be used to satisfy share awards under Short Term and Long Term Incentive Plans. The relevant Executive Directors' specific individual interests are shown in tables 2 and 3;
- the Group's Qualifying Employee Share Ownership Trust. As such, they were each treated as at 31 December 2006 as being interested in the 1,697,350 ordinary shares (31 December 2005 – 3,167,458 ordinary shares) held by the trustee of this Trust. The shares held in the Trust will be used to satisfy entitlements of colleagues arising on the exercise of options under the Sharesave Plan. The relevant Executive Directors' specific individual interests are shown in table 5; and
- the Group's Share Incentive Plan Trust. As such, they were each treated as at 31 December 2006 as being interested in the 12,964,303 ordinary shares (31 December 2005 – 7,129,501 ordinary shares) held by the trustees of this Trust. The shares held in the Trust will be used to satisfy share awards under the Free Share Plan. The relevant Executive Directors' specific individual interests are shown in table 6.

All of the 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 2, 3 and 6 and to issue new shares in relation to the plans described in Sections 4 and 5 and the Group's all-employee share option scheme. This practice was reviewed in 2006, and as a consequence, purchased shares were also used to a large extent to satisfy awards in relation to the plan described in Section 5 and the Group's all-employee share option scheme. New issue shares were used to satisfy awards made under the plan described in Section 6. The method by which share plan requirements are satisfied will again be reviewed in 2007 and any changes to the 2006 practice will be set out in the Annual Report & Accounts 2007.

### 8. General

The closing market price of the Group's ordinary shares at 31 December 2006 was £11.32. The closing market price of the Group's ordinary shares at 31 December 2005 was £9.93. The range during the year was £8.95 to £11.37.

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

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

Company law requires the Directors to prepare Group and parent company financial statements for each financial year. They are required to prepare the Group financial statements in accordance with International Financial Reporting Standards ('IFRS') as adopted by the EU and have elected to prepare the parent company financial statements on the same basis.

The Group and parent company financial statements are required by law and IFRS as adopted by the EU to fairly present the financial position of the Group and the parent company and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRS as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the Directors are also responsible for preparing a Directors' Report and Business Review.

## Independent Auditors’ Report To The Shareholders of Bank of Scotland

We have audited the Group and Bank financial statements (the 'financial statements') of the Bank of Scotland Group for the year ended 31 December 2006 which comprise Group Income Statement, the Group and Bank Balance Sheets, the Group and Bank Cash Flow Statements, the Group and Bank Statements of Recognised Income and Expense and the related notes. The financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Bank's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Bank's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's members as a body, for our audit work, for this report, or for the opinions we have formed.

### Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, Directors' Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 34.

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

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Annual Report that is cross referred from the Business Review section of the Directors' Report.

In addition we report to you if, in our opinion, 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 other transactions is not disclosed.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### Basis of audit opinion

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

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

**Opinion**

In our opinion:

- the group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the group's affairs as at 31 December 2006 and of its profit for the year then ended;
- the Bank financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent Bank's affairs as at 31 December 2006;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

**KPMG Audit Plc**
*Chartered Accountants*
*Registered Auditor*

*Edinburgh*
27 February 2007

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# Accounting Policies

## Statement of Compliance

The 2006 statutory consolidated statements set out on pages 47 to 57 have been prepared in accordance with IFRS as adopted by the European Union.

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

The accounts also comply with the relevant provisions of Part VII of the Companies Act 1985, as amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004. Additionally the Group has applied Financial Reporting Standard 27 'Life Assurance' issued by the UK Accounting Standards Board as appropriate.

## Basis of Preparation

The financial statements have been prepared under the historical cost basis, except that the following assets and liabilities are stated at their fair values; derivatives, financial instruments held for trading, financial instruments designated at fair value through the income statement, financial instruments classified as available for sale and investment properties.

## Critical Accounting Estimates and Judgements

The preparation of the financial statements necessarily requires the exercise of judgement both in the application of accounting policies which set out in the sections below and in the selection of estimates. These estimates and judgements are reviewed on an ongoing basis and are continually evaluated based on historical experience and other factors. However, actual results may differ from these estimates. The most significantly affected components of the financial statements are as follows:

### Impairment Losses on Loans and Advances

Impairment loss calculations involve the estimation of future cash flows of loans and advances based on observable data at the balance sheet date and historical loss experience for assets with similar credit risk characteristics. These calculations are undertaken on a portfolio basis other than in respect of significant balances, relating principally to larger corporate customers, which are assessed individually. In applying the portfolio basis the Group makes use of various statistical modelling techniques which are specific to different portfolio types. Significant judgement is applied in selecting and updating these models. In calculating individual impairment provisions the Group takes account of a number of relevant considerations including historical experience, future prospects of the customer, value of collateral held and reliability of information. Significant judgement is supplied in estimating the impact of these considerations on the expected future cash flows.

### Effective Interest Rate

In calculating the effective interest rate of financial instruments and in particular loans and advances the Group takes into account interest received or paid, fees and commissions paid or received, expected early redemptions and related penalties and premiums and discounts on acquisition or issue that are integral to the yield as well as incremental transaction costs. These calculations are undertaken on a portfolio basis other than in respect of significant balances, relating principally to larger corporate customers, which are assessed individually. In applying the portfolio basis the Group makes use of various statistical modelling techniques which are specific to different portfolios in estimating the expected cash flows from early redemptions and related fees to the extent that these are applicable. Significant judgement is applied in selecting and updating these models. In calculating the effective interest rates of individually significant balances the group takes into account a number of relevant considerations to estimate the cash flows from early redemptions including previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions at the date of acquisition. Significant judgement is applied in estimating the impact of these considerations on the expected future cash flows.

Accounting policies (continued)

**IFRS Not Yet Applied**

The following standards and interpretations have been adopted by the European Union but are not effective for the year ended 31 December 2006 and have not been applied in preparing the consolidated financial statements:

IFRS 7 'Financial Instruments: Disclosure' and the 'Capital disclosure amendment' to IAS 1 'Presentation of financial statements' which are applicable for periods commencing on or after 1 January 2007. The application of these standards in 2006 would not have affected the balance sheets, income statement or cash flow statements as they are only concerned with disclosure.

IFRIC 7 'Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies which is effective for periods commencing on or after 1 March 2006. The application of this Interpretation in 2006 would not have affected the balance sheets, income statement or cash flow statements as the Group goes not operate in hyperinflationary economies.

IFRIC 8 'Scope of IFRS 2 Share-based Payment' which is effective for periods commencing on or after 1 May 2006. The application of this Interpretation in 2006 would not have affected the balance sheets, income statement or cash flow statements as share based payment transactions in the Group are made for the receipt of identifiable services.

IFRIC 9 ‘Reassessment of Embedded Derivatives’ which is effective for periods commencing on or after 1 June 2006. The application of this Interpretation in 2006 would not have affected the financial statements because the Group’s approach to reassessing embedded derivatives already reflects the requirements of the Interpretation.

The following standards and interpretations have not yet been adopted by the European Union, are not effective for the year ended 31 December 2006 and have not been applied in preparing the financial statements:

IFRS 8 ‘Operating Segments’ which is applicable for periods commencing on or after 1 January 2009. The application of this standard in 2006 would not have affected the financial statements as it is only concerned with disclosure.

IFRIC 10 ‘Interim Financial Reporting and Impairment’ which is effective for periods commencing on or after 1 November 2006. The application of this Interpretation in 2006 would not have affected the financial statements as no reversals to impairment losses within the scope of this Interpretation have been made.

IFRIC 11 ‘Group and Treasury Share Transactions’ which is effective for periods commencing on or after 1 March 2007. The application of this Interpretation in 2006 would not have affected the financial statements.

IFRIC 12 ‘Service Concession Arrangements’ which is effective for periods commencing on or after 1 January 2008. The application of this Interpretation in 2006 would not have affected the financial statements.

**Basis of Consolidation**

The consolidated financial statements include the results of the Bank and its subsidiary undertakings, together with the Group’s interests in associated undertakings and jointly controlled entities.

**Subsidiaries**

The financial statements of subsidiaries and special purpose entities controlled by the Group are consolidated within the Group financial statements commencing on the date control is obtained until the date control ceases. Control is defined as being where the Group has power, directly or indirectly, to govern the financial and operating policies of such entities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. The effects of intra-group transactions are eliminated on consolidation.

**Associated Undertakings and Jointly Controlled Entities**

Associated undertakings are entities over which the Group has significant influence, but not control over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity but is not control over those policies.

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

The attributable share of results of associated undertakings and jointly controlled entities, generally based on audited accounts, are included in the consolidated financial statements using the equity method of accounting. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

## Accounting policies (continued)

### Designation of Financial Instruments

The Group has designated its financial instruments in accordance with IAS 39 ‘Financial Instruments: Recognition and Measurement’ as follows:

- Non-derivative financial assets where there is no active market and which have fixed or determinable payments are designated as 'loans and receivables'.
- The Group’s ‘trading’ portfolio is designated as ‘held for trading’.
- Derivative instruments are automatically designated as ‘at fair value through the income statement’ unless they form part of a hedging relationship.
- Instruments that are designated on initial recognition to eliminate a measurement mismatch or where they contain an embedded derivative which is not separated from the host contract are designated at 'at fair value through the income statement'.
- Assets in support of the general insurance and long term assurance business are designated ‘at fair value through the income statement’.
- Investment contracts within the long term assurance business are designated at fair value through the income statement.
- No financial assets are designated as 'held to maturity'.
- All other financial assets are classified as 'available for sale’.
- All other financial liabilities are classified as 'at amortised cost'.

The resulting treatment of these financial instruments is set out in the accounting policies below.

### Derivatives

Derivatives are initially recognised at fair value on the date the contract is entered into. Where the fair value of a derivative is positive, it is carried as a derivative asset and where negative as a derivative liability. The gain or loss on re-measurement to fair value at the balance sheet date is taken to net trading income except for the interest accrual element relating to derivatives used for economic hedging purposes that do not qualify for hedge accounting treatment which are taken to net interest income, insurance and investment related derivatives which are taken to net investment income related to insurance and investment business or when cash flow hedge accounting is employed.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of the same. At inception of the hedge relationship formal documentation must be drawn up specifying the hedging strategy, the component transactions and the methodology that will be used to measure effectiveness.

Monitoring of hedge effectiveness is undertaken on an ongoing basis. A hedge is regarded as effective if the change in fair value or cash flows of the hedge instrument and the hedged item are negatively correlated within a range of 80% to 125% either for the period since effectiveness was last tested or cumulatively since inception.

The Group uses three hedge accounting methods.

Firstly, fair value hedge accounting offsets the change in the fair value of the hedging instrument against the change in the fair value of the hedged item in respect of the risk being hedged. The hedged item is adjusted for the fair value of the risk being hedged irrespective of its financial instrument classification. These changes in fair value are recognised in the income statement through net trading income. Adjustments made to the carrying amount of the hedged item for fair value hedges will be amortised on an effective interest rate basis over the remaining expected life in line with the presentation of the underlying hedged item. If the hedge is highly effective the net impact on the income statement is minimised.

Secondly, cash flow hedge accounting matches the cash flows of hedged items against the corresponding cash flow of the hedging derivative. The effective part of any gain or loss on a hedging instrument is recognised directly in equity in the cash flow hedge reserve and the hedged item is accounted for in accordance with the policy for that financial instrument. Any ineffective portion of the hedging instrument’s fair value is recognised immediately in the income statement through net trading income. Additionally, in circumstances where the hedge relationship subsequently proves ineffective, is early settled or is terminated the associated gains and losses that were recognised directly in reserves are reclassified to the income statement through net trading income. The amount deferred in reserves will either remain in reserves until the designated transaction occurs at which time it is released and accounted for through the income statement in line with the treatment of the hedged item.

Accounting policies (continued)

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

A derivative may be embedded in another financial instrument, known as the host contract. Where the economic characteristics and risks of an embedded derivative are not closely related to those of the host contract the embedded derivative is separated from the host and held on balance sheet at fair value except for those instruments that have been designated at fair value through the income statement where the derivative is not separated from the host instrument. Movements in fair value are posted to the income statement through net trading income, whilst the host contract is accounted for in accordance with the policy for that class of financial instrument.

Derivative fair values are determined using valuation techniques that are consistent with techniques commonly used by market participants to price these instruments. These techniques include discounted cash flow analysis and other pricing models. The fair values calculated from these models are regularly compared with prices obtained in actual market transactions to ensure reliability. In all material instances these techniques use only observable market data.

**Loans and Advances**

Loans and advances held for trading are carried at fair value. Gains, losses and related income are taken to net trading income as they arise.

Loans and advances designated at fair value through the income statement are carried at fair value. Gains, losses and related income are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business.

All other loans and advances are classified as loans and receivables. They are initially recognised at fair value plus directly related transaction costs and are subsequently carried at amortised cost using the effective interest method less provision for impairment.

The Group assesses impairment individually for financial assets that are significant and individually or collectively for assets that are not significant.

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

The written down value of the impaired loan is compounded back to the net realisable balance over time using the original effective interest rate. This is reported through interest receivable within the income statement and represents the unwinding of the discount.

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

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

Collective impairment is identified for groups of assets that share similar risk characteristics. Collective impairment is assessed using a methodology based on existing risk conditions or events that have a strong correlation with a tendency to default.

Loans and advances to customers include advances that are subject to non-returnable finance arrangements following securitisation of portfolios of mortgages and other advances. The principal benefits of these advances were acquired by special purpose securitisation companies that fund their purchase primarily through the issue of floating rate notes. These floating rate notes are accounted for as debt securities in issue on the balance sheet.

The fair value of loans and advances to customers is estimated by discounting anticipated cash flows, including interest, at a current market rate of interest. The fair value of floating rate placements and overnight deposits is equal to carrying value. The fair value of fixed interest bearing deposits is based on cash flows discounted using current money market interest rates for debts with similar maturity and credit risk characteristics.

**Finance Leases, Instalment Credit and Operating Leases**

Assets leased to customers that transfer substantially all the risks and rewards incidental to ownership to the customer are classified as finance leases.

## Accounting policies (continued)

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

**Investment Securities**

Investment securities held for trading are carried at fair value. Gains, losses and related income are taken to net trading income as they arise.

Investment securities designated at fair value through the income statement are carried at fair value. Gains, losses and related income are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business.

Debt securities for which there is no active market are classified as loans and receivables, other than those that are held for trading or designated at fair value through the income statement. They are initially recognised at fair value plus directly related transaction costs and are subsequently carried on the balance sheet at amortised cost using the effective interest method less provision for impairment.

All other investment securities are classified as available for sale. They are initially recognised at fair value plus directly related transaction costs and are subsequently carried on the balance sheet at fair value. Unrealised gains or losses are recognised directly in equity in the available for sale reserve, except for impairment losses or foreign currency gains or losses related to debt securities, which are recognised immediately in the income statement in impairment on investment securities or other operating income respectively. Income on debt securities is recognised on an effective interest rate basis and taken to interest receivable through the income statement. Income from equity shares is credited to other operating income, with income on listed equity shares being credited on the ex-dividend date and income on unlisted equity shares being credited on an equivalent basis. On sale or maturity, previously unrealised gains and losses are recognised in other operating income.

Impairment losses on available for sale equity instruments are not reversed through the income statement. Any increase in the fair value of an available for sale equity instrument after an impairment loss has been recognised is treated as a revaluation and recognised directly in equity. An impairment loss on an available for sale debt instrument is reversed through the income statement, if there is evidence that the increase in fair value is due to an event that occurred after the impairment loss was recognised.

The fair value of investment securities is based on market prices or broker/dealer valuations. Where this information is not available, the fair value is estimated using quoted market prices for securities with similar credit, maturity and yield characteristics or similar valuation models.

The Group uses settlement date accounting when recording the purchase and sale of investment securities, with the exception of those held for trading for which trade date accounting is used.

**Repurchase Agreements**

Debt securities sold subject to repurchase agreements are retained within the balance sheet where the Group retains substantially all of the risks and rewards of ownership. Funds received under these arrangements are included within deposits by banks or customer accounts. Conversely, debt securities acquired under commitments to resell are not recognised in the balance sheet as debt securities where substantially all the risks and rewards do not pass to the Group. In this case, the purchase price is included within loans and advances to banks or loans and advances to customers. The difference between sale and repurchase prices for such transactions is reflected in the income statement over the lives of the transactions, within interest payable or interest receivable as appropriate.

**Goodwill**

The excess of the cost of a business combination over the interest in the net fair value of the identifiable assets, liabilities and contingent liabilities at the date of acquisition, of subsidiary undertakings, associated undertakings (including jointly controlled entities) and other businesses, is capitalised as goodwill.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill carried in the consolidated balance sheet is subject to a six monthly impairment review by comparing the value in use with the carrying value. When this indicates that the carrying value is not recoverable, it is irrevocably written down through the income statement by the amount of any impaired loss identified. IFRS 3, ‘Business Combinations’ has not been applied retrospectively to business combinations that occurred before 1 January 2004.

## Accounting policies (continued)

### Software

Costs associated with the development of software for internal use, subject to de minimis limits, are capitalised if the software is technically feasible and the Group has both the intent and sufficient resources to complete the development. Costs are only capitalised if the asset can be reliably measured, will generate future economic benefits and there is an ability to use or sell the asset.

Only costs that are directly attributable to bringing the asset into working condition for its intended use are capitalised. These costs include all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in a manner intended by management. Other development expenditure is recognised in the income statement as an expense as incurred.

Capitalised development expenditure and purchased software is stated at cost less accumulated amortisation and impairment losses. Once the software is ready for use, the capitalised costs are amortised over their expected lives, generally four years. Capitalised software is assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The amortisation charge for the asset is then adjusted to reflect the asset's revised carrying amount.

Subsequent expenditure is only capitalised when it increases the future economic benefits embodied in the specific asset to which it relates.

### Property and Equipment

Property and equipment is stated at cost less accumulated depreciation and impairment losses.

Freehold land is not depreciated. Freehold and leasehold property, other than freehold investment properties, is stated at cost and depreciated over fifty years or the length of the lease term if shorter. Improvements to leasehold properties are stated at cost and are depreciated in equal instalments over the lesser of the remaining life of the lease or eight years. Premiums are amortised over the period of the lease.

The cost of equipment, which includes fixtures and fittings, vehicles and computer hardware, less estimated residual value, is written off in equal instalments over the expected lives of the assets, generally between three and eight years.

Subsequent costs are included in the asset's carrying amount, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably.

Property and equipment is assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The depreciation charge for the asset is then adjusted to reflect the asset's revised carrying amount.

### Investment Properties

Investment properties which are defined as properties held either to earn rental income or for capital appreciation or both, are initially recognised at cost and are fair valued annually. Any gains or losses arising from a change in the fair value are recognised in the income statement in the period that they occur through other operating income except for those relating to insurance and investment business which are taken through net investment income related to insurance and investment income. Investment properties are not depreciated.

### Taxation

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity. The tax charge is analysed between tax that is payable in respect of policyholder returns and tax that is payable on shareholders' equity returns. This allocation is based on an assessment of the effective rate of tax that is applicable to shareholders' equity for the year.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided: goodwill not deductible for tax purposes, the initial recognition of assets and liabilities that affects neither accounting nor taxable profit and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates at the balance sheet date.

## Accounting policies (continued)

**Disposal Group**

Assets and liabilities of a disposal group are classified as held for sale where the carrying amount will be recovered principally through a sale transaction as opposed to continuing use and they are available for sale in the present condition subject only to the terms that are usual and customary for the sale of such assets and liabilities and the sale being highly probable at the balance sheet date. The disposal group is measured at the lower of carrying amount and fair value less costs to sell.

**Defined Contribution Schemes**

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

**Share Based Payments**

The group operates various equity-settled, share-based compensation schemes in exchange for employee services received. The fair value of options or shares granted is determined at the date of grant and expensed over the vesting period. The fair value of the options or shares granted are measured using various models, taking into account the terms and conditions upon which the options and shares were granted. At each balance sheet date the group revises its estimate of the number of options or shares that it expects to vest and spreads any adjustments required to the income statement over the remaining vesting period except for those which relate to a market condition or for which no adjustment is permitted.

**Deposits by Banks and Customer Accounts**

Deposits by banks and customer accounts held for trading are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. Deposits by banks and customer accounts designated at fair value through the income statement relate to insurance and investment business only and are carried at fair value. Gains, losses and related income are taken to net investment income related to insurance and investment business. All other customer accounts and deposits by banks are held at amortised cost using the effective interest method.

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

**Other Borrowed Funds**

Other borrowed funds comprises preference shares that are classified as debt, preferred securities and subordinated liabilities, all of which are held at amortised cost.

Preference shares are classified as debt where they are redeemable on a specific date or at the option of the shareholders or if dividend payments are not discretionary. Dividends on preference shares classified as debt are recognised in the income statement through interest payable.

Preferred securities are classified as debt where they are redeemable on a specific date or at the option of the holders or if interest payments are not discretionary. The interest payable on such securities is recognised in the income statement through interest payable.

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

**Debt Securities in Issue**

Debt securities in issue held for trading are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. Debt securities in issue designated at fair value through the income statement are carried at fair value. Gains, losses and related income are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business. All other debt securities in issue are held at amortised cost. They are initially recognised at fair value plus directly related transaction costs and are subsequently carried on the balance sheet at amortised cost using the effective interest method.

Fair values are calculated based on quoted market prices. Where quoted market prices are not available, a cash flow model is used, discounted using an appropriate current yield curve for the remaining term to maturity.

## Accounting policies (continued)

### Other Provisions

The Group recognises a provision if there is a present obligation either as a consequence of a legal or constructive obligation resulting from a past event for which it is probable that an outflow of economic resources that can be reliably measured will be required to settle the obligation. Provisions are measured as the discounted expected future cash flows taking account of the risks and uncertainties associated with the specific liability where appropriate. A constructive obligation is only deemed to exist in respect of restructuring provisions once a detailed restructuring plan has been formally approved and the plan has been announced publicly or work on the restructure has commenced.

### Netting

Assets and liabilities are shown net where there is a legal right of offset and there is an intention and ability to settle on a net basis. The Group nets loans, deposits and derivative transactions covered by master agreements where current net settlement is permitted under the terms of the relevant agreements.

### Foreign Currencies

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

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

Currency gains and losses arising from the translation at balance sheet date currency rates of monetary assets and liabilities are recognised in the income statement except for differences arising from net investment hedges and derivatives related to cash flow hedges which are recognised directly in equity.

The results and financial position of all Group entities that have a functional currency different from sterling are translated into sterling as follows:

– assets and liabilities for each balance sheet presented are translated at the closing rate at the date of the balance sheet;

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

– income and expenses are translated at the average currency rates for the period (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions).

All resulting currency differences are recognised as a separate component of other reserves within equity.

On consolidation, currency differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to equity where the hedge is deemed to be effective. When a foreign operation is sold, such currency differences are recognised in the income statement as part of the gain or loss on sale. The ineffective portion of any net investment hedge is recognised in the income statement immediately.

Cumulative translation differences for all foreign operations are deemed to be zero at 1 January 2004. Any gain or loss on the subsequent disposal of a foreign operation shall exclude translation differences that arose before 1 January 2004, but include later translation differences.

### Cash and Cash Equivalents

Cash and cash equivalents are held for the purpose of meeting short term cash commitments rather than investing or other purposes. Cash and cash equivalents consist of cash and balances at central banks that are freely available, loans and advances to banks with a maturity of three months or less excluding financial assets that are held for trading purposes.

### Guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument. Intra group financial guarantee contracts are accounted for as insurance contracts. This practice will also be applied to any such contract written in the future.

Accounting policies (continued)

**Effective Interest Rate**

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

**Fees and commissions**

Fee and commission income and expense is recognised in the income statement as the related service is provided except those that are integral to the effective interest rate calculations or to investment contract deferred origination costs.

# Consolidated Income Statement

## For the year ended 31 December 2006

| | Notes | 2006 £m | 2005 £m |
|---|---|---|---|
| Interest receivable | | **22,645** | 18,054 |
| Interest payable | | **(18,522)** | (14,255) |
| **Net interest income** | | **4,123** | 3,799 |
| Fees and commission income | | **894** | 727 |
| Fees and commission expense | | **(157)** | (132) |
| Net earned premiums on insurance contracts | | **21** | 16 |
| Net trading income | 1 | **277** | 214 |
| Other operating income | 1 | **1,062** | 1,106 |
| **Net operating income (continuing operations)** | 1 | **6,220** | 5,730 |
| Change in investment contract liabilities | | **(11)** | (11) |
| Net claims incurred on insurance contracts | | **(2)** | (1) |
| Net change in insurance contract liabilities | | **(6)** | (6) |
| Administrative expenses | 2 | **(1,869)** | (1,710) |
| Depreciation and amortisation | | | |
| Intangible assets other than goodwill | 17 | **(36)** | (43) |
| Property and equipment | 18 | **(59)** | (57) |
| Operating lease assets | 20 | **(501)** | (505) |
| | | **(596)** | (605) |
| Goodwill impairment | 17 | **(41)** | |
| **Operating expenses** | | **(2,525)** | (2,333) |
| Impairment losses on loans and advances | 13 | **(944)** | (851) |
| Impairment on investment securities | | **(71)** | (51) |
| **Operating profit (continuing operations)** | | **2,680** | 2,495 |
| Share of operating profits of jointly controlled entities | 15 | **139** | 41 |
| Share of profits of other associated undertakings | 15 | **13** | 10 |
| Non-operating income | 1 | **189** | |
| **Profit before taxation** | | **3,021** | 2,546 |
| Tax on profit | 8 | **(801)** | (678) |
| **Profit after taxation** | | **2,220** | 1,868 |
| Profit of disposal group held for sale | 10, 38 | **5** | |
| **Profit for the year** | | **2,225** | 1,868 |
| | | | |
| **Attributable to:** | | | |
| Shareholders | | **2,189** | 1,845 |
| Minority interests | | **36** | 23 |
| | | **2,225** | 1,868 |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

# Consolidated Balance Sheet

## As at 31 December 2006

| | Notes | 2006 £m | 2005 £m |
|---|---|---|---|
| **Assets** | | | |
| Cash and balance at central banks | | **1,641** | 1,384 |
| Items in course of collection | | **733** | 603 |
| Financial assets held for trading | 9 | **49,139** | 41,766 |
| Disposal group assets held for sale | 10, 38 | **1,388** | |
| Derivative assets | 11 | **8,383** | 9,711 |
| Loans and advances to banks | | **126,068** | 90,247 |
| Loans and advances to customers | 12 | **215,255** | 177,766 |
| Investment securities | 14 | **45,508** | 42,782 |
| Interests in jointly controlled entities | 15 | **454** | 205 |
| Interests in associated undertakings | 15 | **179** | 169 |
| Goodwill and other intangible assets | 17 | **506** | 521 |
| Property and equipment | 18 | **455** | 487 |
| Investment properties | 19 | **39** | 37 |
| Operating lease assets | 20 | **2,084** | 1,884 |
| Current tax asset | | **73** | |
| Deferred tax asset | 21 | | 119 |
| Other assets | | **2,579** | 3,131 |
| Prepayments and accrued income | | **695** | 498 |
| **Total Assets** | | **455,179** | 371,310 |
| **Liabilities** | | | |
| Deposits by banks | | **140,185** | 87,379 |
| Customer accounts | | **106,829** | 100,299 |
| Financial liabilities held for trading | 9 | **22,334** | 25,007 |
| Disposal group liabilities held for sale | 10, 38 | **909** | |
| Derivative liabilities | 11 | **9,338** | 8,562 |
| Notes in circulation | | **857** | 830 |
| Insurance contract liabilities | | **19** | 17 |
| Investment contract liabilities | | **96** | 98 |
| Current tax liabilities | | | 169 |
| Deferred tax liabilities | 21 | **371** | |
| Other liabilities | | **3,775** | 2,191 |
| Accruals and deferred income | | **1,524** | 1,587 |
| Net post retirement benefit liabilities | 6 | **13** | 827 |
| Other provisions | 22 | **39** | 40 |
| Debt securities in issue | 23 | **147,777** | 126,487 |
| Other borrowed funds | 24 | **8,708** | 8,341 |
| **Total Liabilities** | | **442,774** | 361,834 |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

## Consolidated Balance Sheet (continued)

| | Notes | 2006 £m | 2005 £m |
|---|---|---|---|
| **Shareholders' Equity** | | | |
| Issued share capital | 25 | **436** | 410 |
| Share premium | 26 | **3,926** | 2,951 |
| Other reserves | 26 | **1,106** | 328 |
| Retained earnings | 26 | **6,568** | 5,708 |
| Shareholders' Equity (excluding minority interests) | 26 | **12,036** | 9,397 |
| Minority interests | 26 | **369** | 79 |
| **Total Shareholders' Equity** | | **12,405** | 9,476 |
| **Total Liabilities and Shareholders' Equity** | | **455,179** | 371,310 |

By virtue of the exemption contained within Section 230 of the Companies Act 1985, the income statement of the Bank is not presented. Of the profit attributable to shareholders, £1,818m (2005 £1,137m) is dealt with in the accounts of the Bank.

Approved by the Board on 27 February 2007 and signed on its behalf by:

| | | | |
|---|---|---|---|
| Lord Stevenson | A J Hobson | A H Hornby | P A Hodkinson |
| Governor | Chairman of Audit Committee | Director | Director |

## Bank Balance Sheet

## As at 31 December 2006

| | Notes | 2006 | 2005 |
|---|---|---|---|
| | | **£m** | £m |
| **Assets** | | | |
| Cash and balance at central banks | | **1,059** | 1,007 |
| Items in course of collection | | **667** | 546 |
| Derivative assets | 11 | **47** | 30 |
| Loans and advances to banks | | **53,154** | 44,921 |
| Loans and advances to customers | 12 | **120,693** | 104,736 |
| Investment securities | 14 | **397** | 365 |
| Interests in jointly controlled entities | 15 | **2** | 2 |
| Interests in associated undertakings | 15 | **67** | 67 |
| Interests in group undertakings | 16 | **2,493** | 1,921 |
| Goodwill and other intangible fixed assets | 17 | **174** | 147 |
| Property and equipment | 18 | **270** | 277 |
| Current tax asset | | **146** | |
| Deferred tax asset | 21 | **205** | 464 |
| Other assets | | **328** | 432 |
| Prepayments and accrued income | | **507** | 243 |
| **Total Assets** | | **180,209** | 155,158 |
| **Liabilities** | | | |
| Deposits by banks | | **92,194** | 70,957 |
| Customer accounts | | **68,674** | 66,383 |
| Derivative liabilities | 11 | **55** | 36 |
| Debt securities in issue | 23 | **1,046** | 1,065 |
| Notes in circulation | | **857** | 830 |
| Current tax liabilities | | | 97 |
| Other liabilities | | **392** | 692 |
| Accruals and deferred income | | **756** | 633 |
| Net post retirement benefit liabilities | 6 | | 814 |
| Other provisions | 22 | **3** | 2 |
| Other borrowed funds | 24 | **7,427** | 6,843 |
| **Total Liabilities** | | **171,404** | 148,352 |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

## Bank Balance Sheet (continued)

| | Notes | **2006** | 2005 |
|---|---|---|---|
| | | **£m** | £m |
| **Shareholders' Equity** | | | |
| Issued share capital | 25 | **436** | 410 |
| Share premium account | 26 | **3,926** | 2,951 |
| Other reserves | 26 | **571** | 59 |
| Retained earnings | 26 | **3,872** | 3,386 |
| **Shareholders' Equity** | 26 | **8,805** | 6,806 |
| **Total Liabilities and Shareholders' Equity** | | **180,209** | 155,158 |

Approved by the Board on 27 February 2007 and signed on its behalf by:

| | | | |
|---|---|---|---|
| Lord Stevenson | A J Hobson | A H Hornby | P A Hodkinson |
| Governor | Chairman of Audit Committee | Director | Director |

## Consolidated Statement of Recognised Income and Expense

## For the year ended 31 December 2006

| | **2006** | 2005 |
|---|---|---|
| | **£m** | £m |
| Net actuarial gains/(losses) from defined benefit plans and other movements (net of tax) | **71** | (167) |
| Capital contribution | **515** | |
| Tax relief on share plans | **25** | |
| Foreign currency translation | **(33)** | (4) |
| Available for sale investments | | |
| Net change in fair value (net of tax) | **186** | 132 |
| Net gains transferred to the income statement (net of tax) | **(163)** | (119) |
| Cash flow hedges | | |
| Effective portion of changes in fair value taken to equity (net of tax) | **187** | 16 |
| Net losses transferred to the income statement (net of tax) | **86** | 34 |
| **Net income/(expense) recognised directly in equity** | **874** | (108) |
| Profit for the year | **2,225** | 1,868 |
| **Total recognised income and expense** | **3,099** | 1,760 |
| Attributable to: | | |
| Shareholders | **3,063** | 1,737 |
| Minority interests | **36** | 23 |
| | **3,099** | 1,760 |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

## Bank Statement of Recognised Income and Expense

## For the year ended 31 December 2006

| | 2006 £m | 2005 £m |
|---|---|---|
| Net actuarial gains/(losses) from defined benefit plans and other movements (net of tax) | **71** | (168) |
| Capital contribution | **515** | |
| Tax relief on share plan | **23** | |
| Foreign currency translation | **(14)** | (7) |
| Available for sale investments | | |
| Net change in fair value (net of tax) | **3** | (7) |
| Cash flow hedges | | |
| Effective portion of changes in fair value taken to equity (net of tax) | **7** | (7) |
| **Net income/(expense) recognised directly in equity** | **605** | (189) |
| Profit for the year | **1,818** | 1,137 |
| **Total recognised income and expense** | **2,423** | 948 |
| Attributable to: | | |
| Shareholders | **2,423** | 948 |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

## Consolidated Cash Flow Statement

## For the year ended 31 December 2006

| | 2006 £m | 2005 £m |
|---|---|---|
| Profit before tax | **3,021** | 2,546 |
| Adjustments for: | | |
| Impairment losses on loans and advances | **944** | 851 |
| Depreciation and amortisation | **596** | 605 |
| Goodwill impairment | **41** | |
| Amortisation of discounts on debt securities | **5** | (10) |
| Movement in derivatives held for trading | **2,159** | (2,466) |
| Interest on other borrowed funds | **499** | 498 |
| Pension charge for defined benefit schemes | | 96 |
| Profit on sale of investment securities | **(234)** | (172) |
| Equity accounts for jointly controlled entities and associated undertakings | **(152)** | 10 |
| Revaluation surplus on investment properties | **(4)** | |
| Other provisions charged | **11** | 18 |
| Provision utilised | **(10)** | (5) |
| Impairment on investment securities | **71** | 66 |
| Currency differences | **3,625** | (2,658) |
| Other non-cash items | **342** | (47) |
| Net change in operating assets | **(76,504)** | (25,312) |
| Net change in operating liabilities | **80,438** | 49,608 |
| **Net cash flows from operating activities before tax** | **14,848** | 23,628 |
| Income taxes paid | **(889)** | (813) |
| **Cash flows from operating activities** | **13,959** | 22,815 |
| Cash flows from investing activities | **(7,493)** | (3,823) |
| Cash flows from financing activities | **130** | (703) |
| **Net increase in cash and cash equivalents** | **6,596** | 18,289 |
| Opening cash and cash equivalents | **27,230** | 8,941 |
| **Closing cash and cash equivalents** | **33,826** | 27,230 |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

Consolidated Cash Flow Statement (continued)

## Analysis of Cash and Cash Equivalents

| | 2006 £m | 2005 £m |
|---|---|---|
| Cash and balances at central banks | **1,631** | 283 |
| Loans and advances to other banks – repayable in less than 3 months | **32,195** | 26,947 |
| **Closing cash and cash equivalents** | **33,826** | 27,230 |

**Investing activities**

| | 2006 £m | 2005 £m |
|---|---|---|
| Sale and maturity of investment securities | **24,429** | 25,160 |
| Purchase of investment securities | **(30,772)** | (28,024) |
| Sale of operating lease assets | **695** | 584 |
| Purchase of operating lease assets | **(1,400)** | (1,138) |
| Sale of other intangible assets | **5** | 13 |
| Purchase of other intangible assets | **(92)** | (77) |
| Sale of property and equipment | **32** | 42 |
| Purchase of property and equipment | **(67)** | (129) |
| Cash contribution to defined benefit pension schemes | **(228)** | (166) |
| Sale of investment properties | **2** | 14 |
| Purchase of investment properties | | (17) |
| Investment in subsidiary undertakings | **(77)** | |
| Disposal of subsidiary undertakings | **87** | |
| Investment in jointly controlled entities and associated undertakings | **(198)** | (137) |
| Disposal of jointly controlled entities and associated undertakings | **22** | 14 |
| Dividends received from jointly controlled entities | **57** | 30 |
| Dividends received from associated undertakings | **12** | 8 |
| **Cash flows from investing activities** | **(7,493)** | (3,823) |

**Financing activities**

| | 2006 £m | 2005 £m |
|---|---|---|
| Issue of ordinary stock | **1,001** | |
| Issue of other borrowed funds | **1,478** | 353 |
| Minority interest acquired | **365** | 4 |
| Minority interest disposed | **(32)** | |
| Repayments of other borrowed funds | **(726)** | (75) |
| Equity dividends paid | **(1,425)** | (487) |
| Dividends paid to minority shareholders in subsidiary undertakings | **(29)** | (3) |
| Interest on other borrowed funds relating to servicing of finance | **(502)** | (495) |
| **Cash flows from financing activities** | **130** | (703) |

The statement of accounting policies on pages 38 to 46 and the notes on pages 58 to 101 form part of these accounts.

## Bank Cash Flow Statement

## For the year ended 31 December 2006

| | 2006 £m | 2005 £m |
|---|---|---|
| Profit before tax | **2,303** | 1,560 |
| Adjustments for: | | |
| Impairment losses on loans and advances | **621** | 598 |
| Depreciation and amortisation | **58** | 68 |
| Movement in derivatives held for trading | | (22) |
| Interest on other borrowed funds | **391** | 394 |
| Pension charge for defined benefit schemes | | 94 |
| Profit on sale of investment securities | | (6) |
| Other provisions charged | **1** | |
| Provision utilised | | (4) |
| Impairment on investment securities | **99** | 12 |
| Currency differences | **(161)** | 46 |
| Other non-cash items | **259** | (14) |
| Net change in operating assets | **(17,498)** | (4,570) |
| Net change in operating liabilities | **23,367** | 20,293 |
| **Net cash flows from operating activities before tax** | **9,440** | 18,449 |
| Income taxes paid | **(696)** | (470) |
| **Cash flows from operating activities** | **8,744** | 17,979 |
| Cash flows from investing activities | **(352)** | (211) |
| Cash flows from financing activities | **(56)** | (651) |
| **Net increase in cash and cash equivalents** | **8,336** | 17,117 |
| Opening cash and cash equivalents | **44,995** | 27,878 |
| **Closing cash and cash equivalents** | **53,331** | 44,995 |

# Bank Cash Flow Statement (continued)

## Analysis of Cash and Cash Equivalents

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| Cash and balances at central banks | **292** | 186 |
| Loans and advances to other banks – repayable in less than 3 months | **53,039** | 44,809 |
| **Closing cash and cash equivalents** | **53,331** | 44,995 |

**Investing activities**

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| Sale and maturity of investment securities | **57** | 152 |
| Purchase of investment securities | **(103)** | (174) |
| Sale of other intangible assets | | 10 |
| Purchase of other intangible assets | **(53)** | (57) |
| Sale of property and equipment | **12** | 20 |
| Purchase of property and equipment | **(37)** | (37) |
| Cash contribution to defined benefit pension schemes | **(228)** | (151) |
| Disposal of subsidiary undertakings | | 21 |
| Disposal of jointly controlled entities and associated undertakings | | 5 |
| **Cash flows from investing activities** | **(352)** | (211) |

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| Issue of ordinary stock | **1,001** | |
| Issue of other borrowed funds | **1,000** | 300 |
| Repayments of other borrowed funds | **(237)** | (75) |
| Equity dividends paid | **(1,425)** | (484) |
| Interest on other borrowed funds relating to servicing of finance | **(395)** | (392) |
| **Cash flows from financing activities** | **(56)** | (651) |

## Notes to the Accounts

### 1. Income

| | 2006 £m | 2005 £m |
|---|---|---|
| Included within net interest income are the following: | | |
| Interest receivable on financial instruments not designated as at fair value through the income statement | **22,645** | 18,054 |
| Interest payable on financial instruments not designated as at fair value through the income statement | **(18,450)** | (14,211) |
| Net gains less losses on financial instruments designated as at fair value through income statement are included in: | | |
| Interest payable | **72** | 44 |
| Net trading income | **(23)** | (7) |
| Net investment income related to insurance and investment business | **6** | 6 |
| Other operating income | **15** | (6) |
| Net trading income comprises: | | |
| Equity and commodity instruments and related derivatives | **20** | 22 |
| Interest bearing securities and related derivatives | **166** | 114 |
| Foreign currency and related derivatives | **91** | 78 |
| | **277** | 214 |
| Included within net operating income are the following: | | |
| Dividend income on financial investments designated as available for sale | **25** | 125 |
| Net realised gains on sale of financial instruments designated as available for sale | **233** | 168 |
| Net realised gains on sale of financial instruments designated as loans and receivables | **1** | 4 |
| Non-operating income comprises: | | |
| Profit on the sale of RFS Ltd | **9** | |
| Profit on the sale of Drive Financial Service LP | **180** | |
| | **189** | |

### 2. Administrative Expenses

| | 2006 £m | 2005 £m |
|---|---|---|
| Administrative expenses also include: | | |
| Staff costs (Note 3) | **1,162** | 1,051 |
| Accommodation, repairs and maintenance | **135** | 135 |
| Technology | **44** | 32 |
| Marketing and communication | **136** | 133 |

Notes to the Accounts (continued)

## 3. Staff

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

| | **2006 Number** | 2005 Number |
|---|---|---|
| The average number of persons recharged to the Group during the year was: | | |
| Full time | **20,486** | 19,704 |
| Part time | **3,797** | 3,662 |
| | **24,283** | 23,366 |

| | **2006 £m** | 2005 £m |
|---|---|---|
| The aggregate remuneration payable included within administrative expenses to those employees comprises: | | |
| Wages and salaries | **893** | 850 |
| Social security costs | **98** | 63 |
| Other pension costs (Note 6) | **134** | 106 |
| Expense arising from share-based payments (Note 7) | **37** | 32 |
| Staff costs charged to administrative expenses | **1,162** | 1,051 |

## 4. Directors' Remuneration

The Directors of Bank of Scotland during the year were also Directors of HBOS plc. No Director received emoluments for qualifying services to Bank of Scotland in the year ended 31 December 2006 or the comparative period. Full details of the Directors' remuneration are disclosed in the 2006 HBOS plc Annual Report and Accounts within the 'Report of the Board in relation to remuneration policy and practice'.

## 5. Auditors' Remuneration

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

| Group | **2006 Total £m** | 2005 Total £m |
|---|---|---|
| Statutory audit of the Bank and consolidation | **0.7** | 0.5 |
| Fees payable for other services: | | |
| Audit of the Bank's subsidiaries and associates | **2.4** | 2.4 |
| Tax services (compliance and advisory) | **0.9** | 0.6 |
| Services relating to information technology | **0.3** | |
| Services relating to corporate finance transactions | **0.4** | 0.4 |
| Other services | **0.4** | 0.9 |
| **Total other services** | **4.4** | 4.3 |
| **Total** | **5.1** | 4.8 |

In respect of the Bank, statutory audit fees were £50,000 (2005 £50,000) and other fees were £0.1m (2005 £0.5m).

Notes to the Accounts (continued)

### 6. Post Retirement Benefits

The Bank is a participating employer in both a defined contribution pension scheme and a defined benefit pension scheme based upon final pensionable pay, operated by HBOS plc.

The defined benefit scheme is the HBOS Final Salary Pension Scheme ('HBOS FSPS'), which was formed on 3 July 2006 following the merger of the Bank of Scotland 1976 Pension Scheme, in which the Bank was previously a participating employer, with three other schemes in the HBOS Group.

HBOS plc assumed the net liabilities and related deferred tax asset of the Bank of Scotland 1976 Pension Scheme, by way of a capital contribution on 3 July 2006, as disclosed in Note 26.

As there are many companies in the HBOS Group that participate in the HBOS FSPS, the group is unable to identify its share of the scheme assets and liabilities on a consistent and reasonable basis and the HBOS FSPS has been accounted for, in these accounts, as if the scheme was a defined contribution scheme. Full details of the HBOS FSPS are available in the accounts of HBOS plc. The current deficit net of deferred taxation on the HBOS FSPS at 31 December 2006, valued on an IAS 19 basis by a qualified independent actuary, is £545m (Bank of Scotland 1976 Pension Scheme – 2005 deficit net of deferred tax £570m).

The latest full actuarial valuation of the Bank of Scotland 1976 Pension Scheme was carried out at 31 March 2004 and a full actuarial valuation of the HBOS FSPS is being carried out as at 31 December 2006.

The pension expense for the year represents contributions payable by the Bank to both types of pension scheme and amounted to £9m (2005 £18m) for the defined contribution scheme and £125m (2005 £88m) for the defined benefit schemes. There were no outstanding or prepaid contributions at either the beginning or end of the financial year.

### 7. Share-based Payments

The profit of the group is stated after charging an amount of £37m (2005 £32m) in respect of services received by the group which have been settled by way of share-based payment arrangements. This does not include £18m (2005 £2m) in relation to national insurance and income tax costs that are borne by the group.

All staff providing services to the group are employed by the ultimate parent undertaking, HBOS plc, and are remunerated by that company. Note 3 includes the amount charged to the group by HBOS plc in respect of those services.

# Notes to the Accounts (continued)

## 8. Taxation

| | 2006 £m | 2005 £m |
|---|---|---|
| **Current tax** | | |
| Corporation tax charge at 30% | **597** | 568 |
| Relief for overseas taxation | **(51)** | (36) |
| Overseas taxation | **166** | 147 |
| | **712** | 679 |
| Deferred tax (Note 21) | **89** | (1) |
| **Total income tax on profit** | **801** | 678 |

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

| | 2006 £m | 2005 £m |
|---|---|---|
| Profit before taxation | **3,021** | 2,546 |
| Profit multiplied by the standard rate of corporation tax in the UK of 30% | **906** | 764 |
| Effects of: | | |
| (Income not chargeable) | **(4)** | (24) |
| Net effect of differing tax rates overseas | **2** | (8) |
| Book gains covered by capital losses/ indexation | **(87)** | (36) |
| Impairment on investment security | **23** | 12 |
| Adjustments in respect of previous periods | **(22)** | (24) |
| Other | **(17)** | (6) |
| **Total income tax on profit** | **801** | 678 |
| | | |
| **Current tax recognised directly in equity** | | |
| Relating to share plans | **(6)** | |
| Relating to equity securities available for sale | **(10)** | 8 |
| | **(16)** | 8 |
| **Deferred tax recognised directly in equity** | | |
| Relating to share plans | **(19)** | |
| Relating to equity securities available for sale | **20** | (3) |
| Relating to cash flow hedges | **114** | 24 |
| Relating to post employment benefit obligations | **30** | (72) |
| | **145** | (51) |

Notes to the Accounts (continued)

## 9. Financial Instruments Held for Trading

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

| **Group** | **2006** | 2005 |
|---|---|---|
| | **£m** | £m |
| **Financial assets held for trading** | | |
| Debt securities | **34,885** | 29,352 |
| Loans and advances to banks | **11,870** | 9,271 |
| Loans and advances to customers | **2,379** | 3,135 |
| Other assets | **5** | 8 |
| **Total** | **49,139** | 41,766 |
| **Financial liabilities held for trading** | | |
| Debt securities in issue | **376** | 406 |
| Deposits by banks | **10,014** | 2,875 |
| Customer accounts | **11,551** | 21,509 |
| Other liabilities | **393** | 217 |
| **Total** | **22,334** | 25,007 |

A maturity analysis of financial instruments held for trading is included in Note 37.

## 10. Disposal Group

The assets (£1,388m) and liabilities (£909m) of the disposal group comprise those of the Mother Topco Limited group of companies. Mother Topco Limited, a subsidiary undertaking in which the Group has a 58.3% equity interest at 31 December 2006, is the vehicle established to effect the purchase of McCarthy & Stone plc, a UK provider of retirement homes. The assets and liabilities were acquired with a view for subsequent disposal. It is highly probable that this disposal will occur within 12 months of the acquisition date and, in accordance with IFRS 5, 'Non-current assets held for sale and discontinued assets', the assets and liabilities are classified as a disposal group.

## Notes to the Accounts (continued)

### 11. Derivatives

The group's trading derivative transactions are either customer driven and generally matched or are carried out for proprietary purposes within limits approved by the Board. Where a derivative does not qualify for hedge accounting, it is classified below as held for trading.

| | Notional principal amount £m | Group 2006 Fair value Asset £m | Group 2006 Fair value Liability £m | Notional principal amount £m | Bank 2006 Fair value Asset £m | Bank 2006 Fair value Liability £m |
|---|---|---|---|---|---|---|
| Derivatives held for trading | | | | | | |
| Currency rate related contracts | | | | | | |
| Forward foreign currency | 59,221 | 393 | 923 | 413 | 6 | 2 |
| Cross currency swaps | 29,908 | 423 | 452 | | | |
| Options | 1,182 | 26 | 14 | | | |
| | 90,311 | 842 | 1,389 | 413 | 6 | 2 |
| Interest rate related contracts | | | | | | |
| Interest rate swaps | 473,770 | 3,477 | 3,526 | 10,769 | 31 | 44 |
| Forward rate agreements | 248,122 | 46 | 45 | | | |
| Options | 44,203 | 96 | 118 | 24 | | |
| Futures | 48,640 | 222 | 251 | | | |
| | 814,735 | 3,841 | 3,940 | 10,793 | 31 | 44 |
| Equity/index and commodity related contracts | | | | | | |
| Options and swaps | 4,483 | 1,182 | 717 | | | |
| **Total derivatives held for trading** | 909,529 | 5,865 | 6,046 | 11,206 | 37 | 46 |
| **Total derivatives held for hedging** | 409,261 | 2,518 | 3,292 | 765 | 10 | 9 |
| **Total derivatives** | 1,318,790 | 8,383 | 9,338 | 11,971 | 47 | 55 |

Notes to the Accounts (continued)

## 11. Derivatives (continued)

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

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

| | | | Group | | | Bank |
|---|---|---|---|---|---|---|
| | Notional | | 2006 | Notional | | 2006 |
| | principal | | Fair value | principal | | Fair value |
| | amount | Asset | Liability | amount | Asset | Liability |
| | £m | £m | £m | £m | £m | £m |
| Derivatives held for hedging | | | | | | |
| Derivatives designated as fair value | | | | | | |
| Interest rate swaps | **39,617** | **595** | **535** | | | |
| Forward foreign currency | **82** | | **7** | | | |
| Cross currency swaps | **25,252** | **201** | **990** | | | |
| Options | **472** | | **4** | | | |
| | **65,423** | **796** | **1,536** | | | |
| Derivatives designated as cash flow | | | | | | |
| Interest rate swaps | **199,633** | **1,643** | **1,121** | | | |
| Cross currency swaps | **31,782** | **14** | **605** | | | |
| Forward rate agreements | **71,407** | **20** | **19** | **765** | **10** | **9** |
| Futures | **41,016** | **45** | **11** | | | |
| | **343,838** | **1,722** | **1,756** | **765** | **10** | **9** |
| Total derivatives held for hedging | **409,261** | **2,518** | **3,292** | **765** | **10** | **9** |

# Notes to the Accounts (continued)

## 11. Derivatives (continued)

| | Group Notional principal amount £m | Group 2005 Fair value Asset £m | Group 2005 Fair value Liability £m | Bank Notional principal amount £m | Bank 2005 Fair value Asset £m | Bank 2005 Fair value Liability £m |
|---|---|---|---|---|---|---|
| Derivatives held for trading | | | | | | |
| Currency rate related contracts | | | | | | |
| Forward foreign currency | 52,353 | 707 | 534 | | | |
| Cross currency swaps | 12,730 | 125 | 229 | | | |
| Options | 1,016 | 7 | 38 | | | |
| | 66,099 | 839 | 801 | | | |
| Interest rate related contracts | | | | | | |
| Interest rate swaps | 336,990 | 3,856 | 4,261 | 6,443 | 20 | 24 |
| Forward rate agreements | 123,912 | 28 | 31 | | | |
| Options | 42,224 | 142 | 116 | | | |
| Futures | 46,433 | 170 | 176 | | | |
| | 549,559 | 4,196 | 4,584 | 6,443 | 20 | 24 |
| Equity/index and commodity related | | | | | | |
| Options and swaps | 4,112 | 981 | 574 | | | |
| Total derivatives held for trading | 619,770 | 6,016 | 5,959 | 6,443 | 20 | 24 |
| Total derivatives held for hedging | 323,369 | 3,695 | 2,603 | 884 | 10 | 12 |
| Total derivatives | 943,139 | 9,711 | 8,562 | 7,327 | 30 | 36 |

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

Notes to the Accounts (continued)

## 12. Loans and Advances to Customers

Lending exposure before deduction of impairment provisions or taking account of collateral is analysed below.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| Gross loans and advances to customers | **216,816** | 179,403 | **121,841** | 105,963 |
| Impairment losses on loans and advances (Note 13) | **(1,561)** | (1,637) | **(1,148)** | (1,227) |
| **Net loans and advances to customers** | **215,255** | 177,766 | **120,693** | 104,736 |
| Included in the above are loans to: | | | | |
| Subsidiary undertakings | | | **3,017** | 4,679 |
| Fellow subsidiary undertakings | **35,342** | 21,465 | **150** | 51 |
| Ultimate parent undertaking | | 61 | | 61 |
| Jointly controlled entities and associated undertakings | **10,115** | 8,310 | **6,605** | 5,539 |

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

The fair value of Loans and Advances to Customers is disclosed in Note 31. A maturity analysis of Loans and Advances to Customers is shown in Note 37.

The group's lending exposure before impairment provisions and before taking account of collateral is analysed below.

| | **2006** | 2005 |
|---|---|---|
| | **£m** | £m |
| Agriculture, forestry and fishing | **1,405** | 1,315 |
| Energy | **2,125** | 1,675 |
| Manufacturing industry | **5,805** | 6,333 |
| Construction and property | **39,653** | 34,784 |
| Hotels, restaurants and wholesale and retail trade | **12,955** | 12,567 |
| Transport, storage and communication | **4,976** | 2,983 |
| Financial | **40,925** | 29,585 |
| Other services | **19,623** | 17,938 |
| Individuals | | |
| Home mortgages | **53,085** | 42,695 |
| Other personal lending | **11,708** | 11,452 |
| Overseas residents | **24,556** | 18,076 |
| | **216,816** | 179,403 |

For 2006 loans and advances to customers include advances of £14,218m (2005 £11,636m) the majority of which have been sold by subsidiary undertakings of the Bank to bankruptcy remote special purpose vehicles, funded by the issue of commercial paper on terms whereby the rewards and some of the risks of the portfolio have been retained by the subsidiary. Accordingly, all these advances have been retained on the group's balance sheet with the commercial paper being included within debt securities in issue (Note 23).

Notes to the Accounts (continued)

## 12. Loans and Advances to Customers (continued)

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

| | **2006** | 2005 |
|---|---|---|
| | **£m** | £m |
| Gross investment in finance receivables: | | |
| Within one year | **2,863** | 2,803 |
| Between one and five years | **4,037** | 3,982 |
| More than five years | **889** | 880 |
| | **7,789** | 7,665 |
| Less: unearned finance income | **(1,257)** | (1,185) |
| Present value of minimum lease payments | **6,532** | 6,480 |
| | | |
| Analysed as: | | |
| Within one year | **2,476** | 2,417 |
| Between one and five years | **3,397** | 3,379 |
| More than five years | **659** | 684 |
| Finance lease receivables | **6,532** | 6,480 |

At 31 December 2006 total unguaranteed residual values accrued to the benefit of the lessor amounted to £24m (2005 £57m). At 31 December 2006 total accumulated allowance for uncollectible minimum lease payments receivable amounted to £31m (2005 £28m).

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

Notes to the Accounts (continued)

## 13. Impairment losses on loans and advances

| | Group | | Bank | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | £m | £m | £m | £m |
| **At 1 January** | **1,637** | 1,551 | **1,227** | 1,184 |
| New impairment provisions less releases | **986** | 897 | **647** | 648 |
| Amounts written off | **(934)** | (774) | **(685)** | (554) |
| Acquisitions | | 7 | **1** | |
| Disposal of subsidiary undertakings | **(65)** | | | |
| Discount unwind on impaired loans and advances to customers | **(46)** | (54) | **(42)** | (50) |
| Foreign currency translation | **(17)** | 10 | | (1) |
| At 31 December | **1,561** | 1,637 | **1,148** | 1,227 |
| | | | | |
| New impairment provisions less releases | **986** | 897 | **647** | 648 |
| Recoveries of amounts previously written off | **(42)** | (46) | **(26)** | (50) |
| **Net charge to income statement** | **944** | 851 | **621** | 598 |

## 14. Investment Securities

| **2006** | Group | | | | Bank | | | |
|---|---|---|---|---|---|---|---|---|
| | **At fair value through the income statement** | **Available for sale** | **Loans and receivables** | **Total** | **At fair value through the income statement** | **Available for sale** | **Loans and receivables** | **Total** |
| | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| Listed | | | | | | | | |
| Debt securities | | **26,779** | | **26,779** | | | | |
| Equity securities | | **51** | | **51** | | | | |
| **Total listed** | | **26,830** | | **26,830** | | | | |
| | | | | | | | | |
| Unlisted | | | | | | | | |
| Debt securities | **31** | **15,774** | **493** | **16,298** | | **374** | | **374** |
| Equity securities | **172** | **2,208** | | **2,380** | | **23** | | **23** |
| **Total unlisted** | **203** | **17,982** | **493** | **18,678** | | **397** | | **397** |
| | | | | | | | | |
| **Total** | **203** | **44,812** | **493** | **45,508** | | **397** | | **397** |
| | | | | | | | | |
| Comprising: | | | | | | | | |
| Debt securities | **31** | **42,553** | **493** | **43,077** | | **374** | | **374** |
| Equity securities | **172** | **2,259** | | **2,431** | | **23** | | **23** |

Notes to the Accounts (Continued)

**14. Investment Securities (continued)**

| 2005 | Group | | | | Bank | | | |
|---|---|---|---|---|---|---|---|---|
| | At fair value through the income statement | Available for sale | Loans and receivables | Total | At fair value through the income statement | Available for sale | Loans and receivables | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m |
| Listed | | | | | | | | |
| Debt securities | | 22,047 | | 22,047 | | 24 | | 24 |
| Equity securities | 1 | 36 | | 37 | | 7 | | 7 |
| Total listed | 1 | 22,083 | | 22,084 | | 31 | | 31 |
| Unlisted | | | | | | | | |
| Debt securities | 11 | 19,112 | 779 | 19,902 | | | 324 | 324 |
| Equity securities | 105 | 691 | | 796 | | 10 | | 10 |
| Total unlisted | 116 | 19,803 | 779 | 20,698 | | 10 | 324 | 334 |
| Total | 117 | 41,886 | 779 | 42,782 | | 41 | 324 | 365 |
| Comprising: | | | | | | | | |
| Debt securities | 11 | 41,159 | 779 | 41,949 | | 24 | 324 | 348 |
| Equity securities | 106 | 727 | | 833 | | 17 | | 17 |

Investment securities held at fair value through the income statement and as available for sale are recorded at fair value. Investment securities designated as loans and receivables are recorded at amortised cost. The fair value of investment securities is disclosed in Note 31 and a maturity analysis of investment securities is included in note 37.

The fair value movements during the year are £29m and £136m respectively for securities held at fair value through the income statement and available for sale. Within the fair value movement for available for sale is £136m relating to assets subject to fair value hedging.

Of the investment securities held by the Bank that are designated as available for sale the fair value movement during the year is £12m.

In keeping with normal market practice, the group enters into securities lending transactions and repurchase agreements, whereby cash and securities are temporarily received or transferred as collateral. Debt securities with a value of £2,989m (2005 £1,827m) for the group were subject to agreement to repurchase, where the transferee obtains the right to pledge or sell the asset they receive. Debt securities also include securities pledged as collateral as part of securities lending transactions amounting to £11,818m (2005 £11,787m).

Securities held as collateral under reverse repurchase agreements amounted to £33,773m. These are not recognised as assets and are therefore not included above. Of this amount the group had resold or repledged £25,309m as collateral for its own transactions. Debt securities include asset backed securities of £19,017m (2005 £19,497m) which are held in bankruptcy remote special purpose vehicles, funded by the issue of commercial paper on terms whereby some of the rewards and risks of the portfolio have been retained by the group. The commercial paper is included within debt securities in issue (Note 23).

Notes to the Accounts (Continued)

## 15. Interests in Jointly Controlled Entities and Associated Undertakings

| Interests in jointly controlled entities | Acquired book value | Equity adjustments | Share of net tangible assets | Goodwill | Group Book value | Bank Cost |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| At 1 January 2006 | **233** | **(30)** | **203** | **2** | **205** | **2** |
| Acquisitions and subscriptions of capital | **180** | | **180** | | **180** | |
| Disposals | **(15)** | **2** | **(13)** | | **(13)** | |
| Equity accounting adjustments | | **82** | **82** | | **82** | |
| At 31 December 2006 | **398** | **54** | **452** | **2** | **454** | **2** |

The Group's unrecognised share of losses for the year was £36m (2005 £22m). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The share of losses on a cumulative basis is £82m (2005 £53m).

The following amounts are included in the Group's share of jointly controlled entities noted above.

| | Profit after tax | Current assets | Non-current assets | Current liabilities | Non-current liabilities | Equity |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **2006** | **139** | **3,433** | **4,799** | **(4,041)** | **(3,737)** | **454** |
| 2005 | 41 | 1,414 | 3,304 | (1,669) | (2,844) | 205 |

| Interests in associated undertakings | Acquired book value | Equity adjustments | Group Book value | Bank Cost |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| At 1 January 2006 | **114** | **55** | **169** | **67** |
| Acquisitions and subscriptions of capital | **18** | | **18** | |
| Disposals | **(9)** | | **(9)** | |
| Equity accounting adjustments | | **1** | **1** | |
| At 31 December 2006 | **123** | **56** | **179** | **67** |

The Group's unrecognised share of losses for the year was £Nil (2005 £1m). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis is £Nil (2005 £Nil).

The following amounts are included in the Group's share of associates noted above.

| | Profit after tax | Current assets | Non-current assets | Current liabilities | Non-current liabilities | Equity |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **2006** | **13** | **1,936** | **1,344** | **(2,270)** | **(831)** | **179** |
| 2005 | 10 | 1,285 | 1,167 | (1,257) | (1,026) | 169 |

Notes to the Accounts (continued)

## 15. Interests in Jointly Controlled Entities and Associated Undertakings (continued)

### Main Jointly Controlled Entities and Associated Undertakings

| | Nature of Business | Issued Share and Loan Capital | | Group's Interest | Statutory accounts made up to | Principal area of operation |
|---|---|---|---|---|---|---|
| **Jointly controlled entities** | | | | | | |
| AA Personal Finance Limited | Finance | ordinary | £3,000,002 | 50.0%* | December 2006* | UK |
| NFU Mutual Finance Limited | Finance | ordinary | £500,002 | 50.0%* | December 2006* | UK |
| **Associated undertaking** | | | | | | |
| Sainsbury's Bank plc | Banking | ordinary | £140,000,000 | 45.0% | March 2006(a) | UK |
| | | loan | £100,000,000 | 45.0% | | |

* Held by subsidiary undertakings.

(a) 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 2006. On 8 February 2007 the Group's interest increased to 50% and Sainsbury's Bank plc became a jointly controlled entity.

All the interests in jointly controlled entities and associated undertakings are unlisted and incorporated in the UK.

## 16. Interests in Group Undertakings

Interests in Group Undertakings comprise investments in ordinary shares carried at cost less impairment provisions and other borrowed funds loaned to subsidiaries.

| | Banks £m | Others £m | Total £m |
|---|---|---|---|
| At cost at 1 January 2006 | **863** | **1,058** | **1,921** |
| Additions | | **714** | **714** |
| Disposals | | **(32)** | **(32)** |
| Write-down of investments in subsidiary undertakings | | **(87)** | **(87)** |
| Currency translation | | **(23)** | **(23)** |
| At cost at 31 December 2006 | **863** | **1,630** | **2,493** |

The main subsidiary undertakings are as follows:

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

(a) Bank of Scotland holds 100% of the issued preference share capital.

Notes to the Accounts (continued)

## 17. Goodwill and Other Intangible Assets

| 2006 | Group 2006 £m | Bank 2006 £m | Group 2005 £m | Bank 2005 £m |
|---|---|---|---|---|
| Goodwill | **342** | **66** | 410 | 66 |
| Other intangibles | **164** | **108** | 111 | 81 |
| | **506** | **174** | 521 | 147 |

| | Group 2006 £m | Bank 2006 £m | Group 2005 £m | Bank 2005 £m |
|---|---|---|---|---|
| **Goodwill** | | | | |
| At 1 January | **410** | **66** | 413 | 66 |
| Currency translation | **(22)** | | (1) | |
| Acquired through business combinations | | | (2) | |
| Disposals | **(5)** | | | |
| Impairment | **(41)** | | | |
| At 31 December | **342** | **66** | 410 | 66 |

### Goodwill impairment testing

Goodwill has arisen on the acquisition of companies and other businesses. It is subject to a six monthly impairment review by comparing the value in use with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement. The goodwill is allocated to the cash-generating units or groups of cash-generating units that are expected to benefit from the acquisitions concerned. In most cases, the cash generating units represents the actual company or business acquired.

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

The impairment loss of £41m (2005 £Nil) relates to the write down of the goodwill held in respect of a specialist leasing company following an impairment review.

Goodwill is analysed on a divisional basis as follows:

| | 2006 £m | 2005 £m |
|---|---|---|
| Retail | **70** | 70 |
| Corporate | **2** | 42 |
| International | **270** | 298 |
| **Total** | **342** | 410 |

## Notes to the Accounts (continued)

### 17. Goodwill and Other Intangible Assets (continued)

| Other intangible assets<br>Group | **2006**<br>**Purchase Value In-force Investment contract**<br>**£m** | **2006**<br>**Software**<br>**£m** | **2006**<br>**Total**<br>**£m** | 2005<br>Purchase Value In-force Investment contract<br>£m | 2005<br>Software<br>£m | 2005<br>Total<br>£m |
|---|---|---|---|---|---|---|
| **Cost/deemed cost** | | | | | | |
| At 1 January | **2** | **277** | **279** | | 212 | 212 |
| Currency translation | | **(3)** | **(3)** | | 2 | 2 |
| Acquired through business combination | | | | 2 | | 2 |
| Additions | | **92** | **92** | | 78 | 78 |
| Disposals | | **(7)** | **(7)** | | (15) | (15) |
| **At 31 December** | **2** | **359** | **361** | 2 | 277 | 279 |
| **Amortisation** | | | | | | |
| At 1 January | | **168** | **168** | | 127 | 127 |
| Currency translation | | **(5)** | **(5)** | | 1 | 1 |
| Amortisation for the year | | **36** | **36** | | 43 | 43 |
| Disposals | | **(2)** | **(2)** | | (3) | (3) |
| **At 31 December** | | **197** | **197** | | 168 | 168 |
| **Carrying value at 31 December** | **2** | **162** | **164** | 2 | 109 | 111 |

| Other intangible assets<br>Bank | **2006**<br>**Software**<br>**£m** | 2005<br>Software<br>£m |
|---|---|---|
| **Cost/deemed cost** | | |
| At 1 January | **217** | 172 |
| Additions | **53** | 57 |
| Disposals | | (12) |
| **At 31 December** | **270** | 217 |
| **Amortisation** | | |
| At 1 January | **136** | 103 |
| Amortisation for the year | **26** | 35 |
| Disposals | | (2) |
| **At 31 December** | **162** | 136 |
| **Carrying value at 31 December** | **108** | 81 |

Notes to the Accounts (continued)

## 18. Property and Equipment

| **2006** | | | **Group** | | | **Bank** |
|---|---|---|---|---|---|---|
| | **Property** | **Equipment** | **Total** | **Property** | **Equipment** | **Total** |
| | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| **Cost** | | | | | | |
| At 1 January 2006 | **379** | **579** | **958** | **208** | **362** | **570** |
| Currency translation | **(3)** | **(6)** | **(9)** | | | |
| Additions | **32** | **35** | **67** | **25** | **12** | **37** |
| Disposals | **(26)** | **(14)** | **(40)** | **(5)** | **(6)** | **(11)** |
| Disposals of subsidiary undertaking | **(2)** | **(9)** | **(11)** | | | |
| Transfers and other movements | | | | **(6)** | **(6)** | **(12)** |
| **At 31 December 2006** | **380** | **585** | **965** | **222** | **362** | **584** |
| **Depreciation** | | | | | | |
| At 1 January 2006 | **67** | **404** | **471** | **38** | **255** | **293** |
| Currency translation | **(1)** | **(4)** | **(5)** | | | |
| Depreciation for year | **16** | **43** | **59** | **9** | **23** | **32** |
| Disposals | **(1)** | **(7)** | **(8)** | **(1)** | **(4)** | **(5)** |
| Disposal of subsidiary undertaking | **(1)** | **(6)** | **(7)** | | | |
| Transfers and other movements | | | | **(2)** | **(4)** | **(6)** |
| **At 31 December 2006** | **80** | **430** | **510** | **44** | **270** | **314** |
| **Carrying value at 31 December 2006** | **300** | **155** | **455** | **178** | **92** | **270** |

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

Included within Group property and equipment are assets in the course of construction amounting to £47m (2005 £38m) which are not depreciated until the assets are brought into use.

Notes to the Accounts (continued)

## 19. Investment Properties

| Group | **2006 £m** | 2005 £m |
|---|---|---|
| **At 1 January** | **37** | 34 |
| Additions | | 17 |
| Disposals | **(2)** | (14) |
| Fair value movement | **4** | |
| **At 31 December** | **39** | 37 |

Investment properties are carried at their fair value as determined by independent qualified surveyors having recent experience in the location and category of the property being valued. Fair values were determined having regard to recent market transactions for similar properties.

Rental income in respect of the above properties amounted to £2m (2005 £4m) and expenses £Nil (2005 £1m).

## 20. Operating Lease Assets

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

| **Group 2006** | **Cost £m** | **Depreciation £m** | **Carrying value £m** |
|---|---|---|---|
| **At 1 January 2006** | **2,936** | **(1,052)** | **1,884** |
| Currency translation | **(3)** | **(1)** | **(4)** |
| Additions | **1,400** | | **1,400** |
| Disposals | **(1,040)** | **345** | **(695)** |
| Depreciation for year | | **(501)** | **(501)** |
| **At 31 December 2006** | **3,293** | **(1,209)** | **2,084** |

| 2005 | Cost £m | Depreciation £m | Carrying value £m |
|---|---|---|---|
| At 1 January 2005 | 2,655 | (823) | 1,832 |
| Currency translation | 3 | | 3 |
| Additions | 1,138 | | 1,138 |
| Disposals | (860) | 276 | (584) |
| Depreciation for year | | (505) | (505) |
| At 31 December 2005 | 2,936 | (1,052) | 1,884 |

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

| | **2006 £m** | 2005 £m |
|---|---|---|
| Not later than one year | **633** | 568 |
| Later than one year and not later than five years | **627** | 521 |
| Later than five years | **32** | 90 |
| | **1,292** | 1,179 |

## Notes to the Accounts (continued)

### 21. Deferred Tax

| Group | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| Deferred tax liabilities | 699 | 566 |
| Deferred tax assets | (328) | (685) |
| **Net position** | **371** | (119) |

The movement in the net position is as follows:

| Group | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| At 1 January | (119) | (30) |
| Charge to income for the year (Note 8) | 89 | (1) |
| Transferred to current tax | 37 | |
| Charge to equity for the year (Note 8) | 145 | (51) |
| Other movements* | 219 | (37) |
| **At 31 December** | **371** | (119) |

Analysed as follows:

| Deferred tax liabilities | Capital allowances on assets leased to customers | Capital allowances on other assets | Available for sale investments | Cash flow hedges | Other | Total |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| At 1 January 2006 | 343 | 8 | 65 | 63 | 87 | 566 |
| Charge/(credit) to income for the year | (1) | 12 | 8 | | (57) | (38) |
| Trasferred to current tax | | | 4 | | 33 | 37 |
| Charge to equity for the year | | | 20 | 114 | | 134 |
| **At 31 December 2006** | 342 | 20 | 97 | 177 | 63 | 699 |

* The other movement in the year relates primarily to the deferred tax asset on the Retirement Benefit Plans which were transferred to HBOS plc during the year, per note 6, Post Retirement Benefits.

| Deferred tax assets | Employees benefits | Provisions | Effective interest rate adjustment | Other | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| At 1 January 2006 | (252) | (188) | (100) | (145) | (685) |
| Charge/(credit) to income for the year | (9) | 30 | 49 | 57 | 127 |
| Charge/(credit) to equity for the year | 31 | | | (20) | 11 |
| Other movements | 220 | (4) | 2 | 1 | 219 |
| **At 31 December 2006** | (10) | (162) | (49) | (107) | (328) |

At 31 December 2006, a deferred tax liability of £155m (2005 £91m) relating to an investment in a subsidiary has not been recognised because the group controls whether the liability will be incurred and is satisfied that it will not be incurred in the foreseeable future.

Notes to the Accounts (continued)

## 21. Deferred Tax (continued)

| **Bank** | **2006** | 2005 |
|---|---|---|
| | **£m** | £m |
| Deferred tax liabilities | **31** | 22 |
| Deferred tax assets | **(236)** | (486) |
| **Net position** | **(205)** | (464) |

The movement in the net position is as follows:

| **Bank** | **2006** | 2005 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **(464)** | (400) |
| Charge to income for the year | **26** | 21 |
| Charge to equity for the year | **14** | (85) |
| Other movements | **219** | |
| **At 31 December** | **(205)** | (464) |

Analysed as follows:

| **Deferred tax liabilities** | **Capital allowances on other assets** | **Available for sale investments** | **Other** | **Total** |
|---|---|---|---|---|
| | **£m** | **£m** | **£m** | **£m** |
| At 1 January 2006 | **(1)** | **2** | **21** | **22** |
| Charge/(credit) to income for the year | **11** | | **(3)** | **8** |
| Charge to equity for the year | | **1** | | **1** |
| **At 31 December 2006** | **10** | **3** | **18** | **31** |

| **Deferred tax assets** | **Employee benefits** | **Provisions** | **Effective interest rate adjustment** | **Other** | **Total** |
|---|---|---|---|---|---|
| | **£m** | **£m** | **£m** | **£m** | **£m** |
| At 1 January 2006 | **(247)** | **(128)** | **(93)** | **(18)** | **(486)** |
| Charge/(credit) to income for the year | **(7)** | **(9)** | **34** | | **18** |
| Charge /(credit)to equity for the year | **30** | | | **(17)** | **13** |
| Other movements | **219** | | | | **219** |
| **At 31 December 2006** | **(5)** | **(137)** | **(59)** | **(35)** | **(236)** |

## 22. Other Provisions

| | **Group** | **Bank** |
|---|---|---|
| | **£m** | **£m** |
| At 1 January 2006 | **40** | **2** |
| Currency translation | **(2)** | |
| Additional provision in the year | **11** | **1** |
| Utilised in year | **(10)** | |
| At 31 December 2006 | **39** | **3** |

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

Notes to the Accounts (continued)

## 23. Debt Securities in Issue

| | | Group | | Bank |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| Bonds and medium term notes | **58,589** | 51,016 | **1,046** | 1,065 |
| Other debt securities | **89,188** | 75,471 | | |
| | **147,777** | 126,487 | **1,046** | 1,065 |

The group issues debt securities to securitise loans and advances and certain other assets of the group, principally through special purpose vehicles. At 31 December 2006 such debt securities in issue amounted to £30,106m (2005 £30,281m).

Debt securities in issue measured at amortised cost amounted to £144,517m (2005 £125,244m). This includes debt securities in issue subject to fair value hedge designation, such as debt securities relating to securitisation and covered bonds, which have been adjusted to reflect the fair value of the risk being hedged. Debt securities in issue designated at fair value through the income statement amounted to £3,260m (2005 £1,243m).

Notes to the Accounts (continued)

## 24. Other Borrowed Funds

| **Other borrowed funds** | | Group | | Bank |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| Preference shares | **412** | 412 | **412** | 412 |
| Preferred securities | **720** | 845 | | |
| Subordinated liabilities | | | | |
| Dated | **5,086** | 4,353 | **4,204** | 3,410 |
| Undated | **2,490** | 2,731 | **2,811** | 3,021 |
| | **8,708** | 8,341 | **7,427** | 6,843 |

| **Preference shares** | | Group | | Bank |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| 9 1/4% non-cumulative irredeemable preference shares | **300** | 300 | **300** | 300 |
| 9 3/4% non-cumulative irredeemable preference shares | **100** | 100 | **100** | 100 |
| Accrued interest | **12** | 12 | **12** | 12 |
| | **412** | 412 | **412** | 412 |

| **Preferred securities** | | Group |
|---|---|---|
| | **2006** | 2005 |
| | **£m** | £m |
| £250m preferred securities | **250** | 250 |
| £150m preferred securities | **150** | 150 |
| £4m preferred securities | **4** | 4 |
| £285m junior perpetual securities | **285** | |
| £4m preference shares | **4** | |
| £3m preference shares | **3** | |
| £1m preference shares | **1** | |
| US$45m preference shares | **23** | |
| A$1,025m redeemable preference shares | | 436 |
| Accrued interest | | 5 |
| | **720** | 845 |

## Notes to the Accounts (continued)

### 24. Other Borrowed Funds (continued)

| **Dated subordinated liabilities** | | Group | | Bank |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| US$150m 8.85% notes 2006 | | 87 | | 87 |
| £60m 9.00% instruments 2006 | | 60 | | |
| €500m 5.50% instruments 2009 | **335** | 343 | **335** | 343 |
| US$500m notes 2010 | **254** | 290 | **254** | 290 |
| US$150m notes 2011 | **76** | 87 | **76** | 87 |
| €7m floating rate notes 2011 | | 5 | | |
| €12.8m 6.25% instruments 2012 | **9** | 9 | | |
| €325m 6.125% notes 2013 | **218** | 223 | **218** | 223 |
| €1,000m subordinated callable fixed/floating rate instruments 2013 | **671** | 686 | **671** | 686 |
| £250m 6.375% instruments 2019 | **250** | 250 | **250** | 250 |
| €750m 5.5% notes 2012 | **503** | 515 | **503** | 515 |
| US$450m subordinated floating rate notes 2012 | **229** | 262 | **229** | 262 |
| A$75m callable notes 2012 | **30** | 32 | | |
| US$1,000m 4.25% subordinated guaranteed notes 2013 | **509** | 580 | | |
| £330m floating rate subordinated notes 2012 | **330** | 330 | **330** | 330 |
| £300m floating rate subordinated notes 2012 | **300** | 300 | **300** | 300 |
| £700m floating rate subordinated notes 2012 (a) | **700** | | **700** | |
| £300m floating rate subordinated notes 2012 (b) | **300** | | **300** | |
| A$200m instruments 2014 | **81** | 85 | | |
| A$125m instruments 2015 | **50** | 53 | | |
| A$200m instruments 2016 (c) | **81** | | | |
| A$200m instruments 2016 (d) | **81** | | | |
| Fair value hedge adjustments | **36** | 116 | | |
| Unamortised premiums, discounts and issue costs | **(8)** | (10) | **(8)** | (10) |
| Accrued interest | **51** | 50 | **46** | 47 |
| | **5,086** | 4,353 | **4,204** | 3,410 |

(a) On 31 March 2006, £700m floating rate subordinated notes were issued by the Bank, at par, to its parent undertaking HBOS plc. The notes bear interest at the three month libor rate plus 85 basis points.

(b) On 29 December 2006, £300m 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 76 basis points.

(c) On 27 February 2006, A$200m floating rate subordinated notes were issued by a subsidiary of the Bank, at par, to its ultimate parent undertaking HBOS plc. These instruments bear interest at the three month Australian Bank Bill rate plus 85 basis points.

(d) On 29 August 2006, A$200m floating rate subordinated notes were issued by a subsidiary of the Bank, at par, to its ultimate parent undertaking HBOS plc. The notes bear interest at the three month Australian Bank Bill rate plus 83 basis points.

No repayment, for whatever reason, of dated loan capital prior to its stated maturity and no purchase by the relevant undertaking of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the relevant company, the claims of the holders of dated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the company other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the dated loan capital

Notes to the Accounts (continued)

## 24. Other Borrowed Funds (continued)

| **Undated subordinated liabilities** | | Group | | Bank |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| US$300m reset notes | **153** | 174 | **153** | 174 |
| £200m perpetual notes | **200** | 200 | **200** | 200 |
| £300 m perpetual regulatory tier one securities | **300** | 300 | **300** | 300 |
| €500m instruments | **335** | 343 | **335** | 343 |
| US$250 m floating rate primary capital notes | **127** | 145 | **127** | 145 |
| £150m instruments | | 150 | | 150 |
| £150m instruments | **150** | 150 | **150** | 150 |
| JPY 17bn instruments | **73** | 84 | **73** | 84 |
| £100m instruments | **100** | 100 | **100** | 100 |
| JPY 9bn instruments | **38** | 44 | | |
| £300m instruments | **300** | 300 | **300** | 300 |
| £250m perpetual preferred notes | | | **250** | 250 |
| £150m perpetual preferred notes | | | **150** | 150 |
| £150m floating rate subordinated notes | **150** | 150 | **150** | 150 |
| £500m floating rate subordinated notes | **500** | 500 | **500** | 500 |
| Fair value hedge adjustments | **44** | 68 | | |
| Unamortised premiums, discounts and issue costs | **(3)** | (3) | **(3)** | (3) |
| Accrued interest | **23** | 26 | **26** | 28 |
| | **2,490** | 2,731 | **2,811** | 3,021 |

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 company or subsidiary undertaking, the claims of the holders of undated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary undertaking other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the undated loan capital. The undated loan capital is junior in point of subordination to the dated loan capital referred to above.

A maturity analysis of other borrowings is included in Note 37.

Notes to the Accounts (continued)

## 25. Share Capital

| | Group | Bank |
|---|---|---|
| | Ordinary shares | Ordinary shares |
| **Allotted, called up and fully paid** | £m | £m |
| At 1 January 2006 | **410** | **410** |
| Shares issued | **26** | **26** |
| Currency movement | | |
| **As at 31 December 2006** | **436** | **436** |

At 31 December 2006 the authorised share capital comprised:

Ordinary Shares - 1,785m Ordinary shares of 25 pence each (2005 1,785m)

Preference Shares - 150,000 7.754%, non-cumulative perpetual preference shares of £10 each (2005 150,000), 250,000 8.117% non-cumulative perpetual preference shares of £10 each (2005 250,000), 375,000,000 9.25% non-cumulative irredeemable preference shares of £1 each (2005 375,000,000), 125,000,000 9.75% non-cumulative irredeemable preference shares of £1 each (2005 125,000,000). The terms of some of the preference shares when issued are such that these shares are classified as other borrowed funds rather than as issued share capital.

In March 2006, 60m ordinary shares were issued at £10 each. In December 2006, 40m ordinary shares were issued at £10 each.

Notes to the Accounts (continued)

## 26. Reconciliation of Shareholders' Equity

| **2006** | **Share capital** | **Share premium** | **Cash flow hedge reserve** | **Available for sale reserve** | **Other reserves** | **Retained earnings** | **Minority interests** | **Total** |
|---|---|---|---|---|---|---|---|---|
| Group | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| At 1 January 2006 | 410 | 2,951 | 143 | 181 | 4 | 5,708 | 79 | 9,476 |
| **Changes in equity for 2006** | | | | | | | | |
| Foreign currency translation | | | | | **(33)** | | | **(33)** |
| Actuarial loss from retirement benefit plan | | | | | | **71** | | **71** |
| Capital Contribution | | | | | **515** | | | **515** |
| Tax relief on share plans | | | | | | **25** | | **25** |
| Available for sale investments | | | | | | | | |
| Net change in fair value | | | | **186** | | | | **186** |
| Net gains transferred to income statement | | | | **(163)** | | | | **(163)** |
| Cash flow hedges | | | | | | | | |
| Effective portion of changes in fair value taken to equity | | | **187** | | | | | **187** |
| Net losses transferred to income statement | | | **86** | | | | | **86** |
| Profit after tax | | | | | | **2,189** | **36** | **2,225** |
| **Total recognised income and expense** | | | **273** | **23** | **482** | **2,285** | **36** | **3,099** |
| Dividends paid in 2006 | | | | | | **(1,425)** | **(29)** | **(1,454)** |
| Issue of new shares | **26** | **975** | | | | | **76** | **1,077** |
| Other net movements in minority interests | | | | | | | **207** | **207** |
| At 31 December 2006 | **436** | **3,926** | **416** | **204** | **486** | **6,568** | **369** | **12,405** |

In March 2006, 60m ordinary shares were issued at £10 each. In December 2006, 40m ordinary shares were issued at £10 each.

## 26. Reconciliation of Shareholders' Equity (continued)

| **2006** | **Share capital** | **Share premium** | **Cash flow hedge reserve** | **Available for sale reserve** | **Other reserves** | **Retained earnings** | **Minority interests** | **Total** |
|---|---|---|---|---|---|---|---|---|
| Bank | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| At 1 January 2006 | 410 | 2,951 | (7) | 4 | 62 | 3,386 | | 6,806 |
| **Changes in equity for 2006** | | | | | | | | |
| Foreign currency translation | | | | | **(13)** | **(1)** | | **(14)** |
| Actuarial loss from retirement benefit plan | | | | | | **71** | | **71** |
| Capital Contribution | | | | | **515** | | | **515** |
| Tax relief on share plans | | | | | | **23** | | **23** |
| Available for sale investments | | | | | | | | |
| Net change in fair value | | | | **3** | | | | **3** |
| Cash flow hedges | | | | | | | | |
| Effective portion of changes in fair value taken to equity | | | **7** | | | | | **7** |
| Profit after tax | | | | | | **1,818** | | **1,818** |
| **Total recognised income and expense** | | | **7** | **3** | **502** | **1,911** | | **2,423** |
| Dividends paid in 2006 | | | | | | **(1,425)** | | **(1,425)** |
| Issue of new shares | **26** | **975** | | | | | | **1,001** |
| At 31 December 2006 | **436** | **3,926** | | **7** | **564** | **3,872** | | **8,805** |

| 2005 | Share capital (a) | Share premium | Cash flow hedge reserve | Available for sale reserve | Other reserves | Retained earnings | Minority interests | Total |
|---|---|---|---|---|---|---|---|---|
| Group | £m | £m | £m | £m | £m | £m | £m | £m |
| At 1 January 2005 | 410 | 2,951 | 93 | 168 | 11 | 4,514 | 62 | 8,209 |
| Changes in equity for 2005 | | | | | | | | |
| Foreign currency translation | | | | | (7) | | 3 | (4) |
| Actuarial loss from retirement benefit plan | | | | | | (167) | | (167) |
| Available for sale investments | | | | | | | | |
| Net change in fair value | | | | 132 | | | | 132 |
| Net gains transferred to income statement | | | | (119) | | | | (119) |
| Cash flow hedges | | | | | | | | |
| Effective portion of changes in fair value taken to equity | | | 16 | | | | | 16 |
| Net losses transferred to income statement | | | 34 | | | | | 34 |
| Profit after tax | | | | | | 1,845 | 23 | 1,868 |
| Total recognised income and expense | | | 50 | 13 | (7) | 1,678 | 26 | 1,760 |
| Dividends paid in 2005 | | | | | | (484) | (3) | (487) |
| Other net movements in minority interests | | | | | | | (6) | (6) |
| At 31 December 2005 | 410 | 2,951 | 143 | 181 | 4 | 5,708 | 79 | 9,476 |

(a) Share capital has been reduced by £49m and minority interests increased following a reclassification of preference shares and related foreign currency movement in 2005.

Notes to the Accounts (continued)

## 26. Reconciliation of Shareholders' Equity (continued)

| 2005<br>Bank | Share capital<br>£m | Share premium<br>£m | Cash flow hedge reserve<br>£m | Available for sale reserve<br>£m | Other reserves<br>£m | Retained earnings<br>£m | Minority interests<br>£m | Total<br>£m |
|---|---|---|---|---|---|---|---|---|
| At 1 January 2005 | 410 | 2,951 | | 11 | 69 | 2,901 | | 6,342 |
| Changes in equity for 2005 | | | | | | | | |
| Foreign currency translation | | | | | (7) | | | (7) |
| Actuarial loss from retirement benefit plan | | | | | | (168) | | (168) |
| Available for sale investments | | | | | | | | |
| Net change in fair value | | | | (7) | | | | (7) |
| Cash flow hedges | | | | | | | | |
| Effective portion of changes in fair value taken to equity | | | (7) | | | | | (7) |
| Profit after tax | | | | | | 1,137 | | 1,137 |
| Total recognised income and expense | | | (7) | (7) | (7) | 969 | | 948 |
| Dividends paid in 2005 | | | | | | (484) | | (484) |
| At 31 December 2005 | 410 | 2,951 | (7) | 4 | 62 | 3,386 | | 6,806 |

## 27. Dividends

After the balance sheet date a dividend of £525m was proposed by the Directors, but has not been provided for. Ordinary and preference dividends are charged to reserves only when the bank has a contractual obligation to pay.

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

| | **2006**<br>**£m** | 2005<br>£m |
|---|---|---|
| **Ordinary dividends** | | |
| Interim dividend | **958** | 230 |
| Final dividend* | **467** | 254 |
| | **1,425** | 484 |

* The final dividend paid in 2006 relates to 2005 and the amount paid in 2005 relates to 2004.

Notes to the Accounts (continued)

## 28. Commitments and Contingencies

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

| **Group** | **2006 Contract amount £m** | 2005 Contract amount £m |
|---|---|---|
| **Contingent Liabilities** | | |
| Acceptances and endorsements | **62** | 23 |
| Guarantees and assets pledged as collateral security | | |
| Guarantees and irrevocable letters of credit | **4,837** | 4,728 |
| | **4,899** | 4,751 |
| **Commitments** | | |
| Short-term trade related transactions | **120** | 117 |
| Undrawn formal standby facilities, credit lines and commitments to lend | | |
| Up to and including one year | **28,196** | 28,492 |
| Over one year | **21,507** | 17,464 |
| | **49,823** | 46,073 |

| **Bank** | **2006 Contract amount £m** | 2005 Contract amount £m |
|---|---|---|
| **Contingent Liabilities** | | |
| Acceptances and endorsements | **53** | 8 |
| Guarantees and assets pledged as collateral security | | |
| Guarantees and irrevocable letters of credit | **54,066** | 25,075 |
| | **54,119** | 25,083 |
| Amounts included above in respect of guarantees to subsidiary undertakings | **49,768** | 20,692 |
| **Commitments** | | |
| Short-term trade related transactions | **105** | 103 |
| Undrawn formal standby facilities, credit lines and commitments to lend | | |
| Up to and including one year | **19,295** | 19,635 |
| Over one year | **17,118** | 16,077 |
| | **36,518** | 35,815 |
| Amounts included above in respect of commitments to subsidiary undertakings | **81** | 203 |

## Notes to the Accounts (continued)

### 29. Operating Leases

| | Group | | Bank | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| Non cancellable operating lease rentals are payable as follows: | | | | |
| Within 1 year | **64** | 58 | **32** | 33 |
| Between 1 and 5 years | **262** | 191 | **122** | 112 |
| After 5 years | **534** | 390 | **254** | 256 |
| | **860** | 639 | **408** | 401 |

### 30. Capital and Other Commitments

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **£m** | £m |
| Commitments in respect of capital expenditure on property and equipment that is authorised but not provided for in the accounts, for which contracts have been entered into | **11** | 5 |
| Commitments for which contracts have been placed in relation to operating leased assets | **9** | 10 |
| Other financial commitments | | |
| Included in other liabilities are net obligations under finance leases payable as follows: | | |
| Within one year | **1** | 1 |
| Between one and five years | **1** | 1 |

Notes to the Accounts (continued)

## 31. Fair Value of Financial Instruments

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

| 2006 | Derivatives and at fair value through the income statement | | Available for sale | | Loans and receivables | |
|---|---|---|---|---|---|---|
| | Carrying amount £m | Fair value £m | Carrying amount £m | Fair value £m | Carrying amount £m | Fair value £m |
| **Assets** | | | | | | |
| Cash and balances with central banks | | | | | **1,641** | **1,641** |
| Items in course of collection | | | | | **733** | **733** |
| Financial assets held for trading | **49,139** | **49,139** | | | | |
| Derivative assets | **8,383** | **8,383** | | | | |
| Loans and advances to banks | | | | | **126,068** | **126,043** |
| Loans and advances to customers | | | | | **215,255** | **215,591** |
| Investment securities | **203** | **203** | **44,812** | **44,812** | **493** | **493** |
| Other financial assets | | | | | **646** | **629** |
| | **57,725** | **57,725** | **44,812** | **44,812** | **344,836** | **345,130** |

| 2006 | Derivatives and at fair value through the income statement | | Financial liabilities at amortised cost | |
|---|---|---|---|---|
| | Carrying amount £m | Fair value £m | Carrying amount £m | Fair value £m |
| **Liabilities** | | | | |
| Deposits by banks | | | **140,185** | **140,089** |
| Customer accounts | | | **106,829** | **106,838** |
| Financial liabilities held for trading | **22,334** | **22,334** | | |
| Derivative liabilities | **9,338** | **9,338** | | |
| Investment contract liabilities | **96** | **96** | | |
| Debt securities in issue | **3,260** | **3,260** | **144,517** | **144,174** |
| Other borrowed funds | **48** | **48** | **8,660** | **8,790** |
| Other financial liabilities | | | **1,067** | **968** |
| | **35,076** | **35,076** | **401,258** | **400,859** |

Notes to the Accounts (continued)

## 31. Fair Value of Financial Instruments (continued)

| 2005 | Derivatives and at fair value through the income statement | | Available for sale | | Loans and receivables | |
|---|---|---|---|---|---|---|
| | Carrying amount £m | Fair value £m | Carrying amount £m | Fair Value £m | Carrying amount £m | Fair value £m |
| Assets | | | | | | |
| Cash and balances with central banks | | | | | 1,384 | 1,384 |
| Items in course of collection | | | | | 603 | 603 |
| Financial assets held for trading | 41,766 | 41,766 | | | | |
| Derivative assets | 9,711 | 9,711 | | | | |
| Loans and advances to banks | | | | | 90,247 | 91,158 |
| Loans and advances to customers | | | | | 177,766 | 179,839 |
| Investment securities | 117 | 117 | 41,886 | 41,886 | 779 | 1,163 |
| Other financial assets | | | | | 282 | 260 |
| | 51,594 | 51,594 | 41,886 | 41,886 | 271,061 | 274,407 |

| 2005 | Derivatives and at fair value through the income statement | | Financial liabilities at amortised cost | |
|---|---|---|---|---|
| | Carrying amount £m | Fair value £m | Carrying amount £m | Fair value £m |
| Liabilities | | | | |
| Deposits by banks | | | 87,379 | 88,270 |
| Customer accounts | | | 100,299 | 101,259 |
| Financial liabilities held for trading | 25,007 | 25,007 | | |
| Derivative liabilities | 8,562 | 8,562 | | |
| Investment contract liabilities | 98 | 98 | | |
| Debt securities in issue | 1,243 | 1,243 | 125,244 | 125,375 |
| Other borrowed funds | 120 | 120 | 8,221 | 9,133 |
| Other financial liabilities | | | 281 | 248 |
| | 35,030 | 35,030 | 321,424 | 324,285 |

Notes to the Accounts (continued)

## 32. Effective Interest Rates

| | **2006** | 2005 |
|---|---|---|
| | **Yield %** | Yield % |
| **Assets** | | |
| Loans and advances to banks | **4.86** | 4.50 |
| Loans and advances to customers | **7.03** | 6.90 |
| Investment securities | **4.53** | 3.40 |
| **Liabilities** | | |
| Deposits by banks | **4.75** | 4.50 |
| Customer accounts | **4.23** | 4.40 |
| Debt securities in issue | **4.42** | 3.60 |
| Other borrowed funds | **6.50** | 6.50 |

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

Notes to the Accounts (continued)

## 33. Interest Rate Sensitivity Gap

The tables below exclude the carrying amounts of derivative financial instruments and financial assets and liabilities held for trading. The notional principal amounts associated with those derivatives which are used to reduce the Group's exposure to interest rate movements are shown as part of net hedging derivatives. This includes derivatives held for economic hedging purposes which do not meet the hedge accounting requirements of IAS39. The estimated potential loss arising from the Group's exposure to interest rate risk from the Group's trading activities is shown in Note 34 'Trading Value at Risk'. Additional information of the Group's management of interest rate risk is given on page 17 of the Risk Management Report.

| **As at 31 December 2006** | **Up to 1 month £m** | **1 to 3 months £m** | **3 to 12 months £m** | **1 to 2 years £m** | **2 to 3 years £m** | **3 to 4 years £m** | **4 to 5 years £m** | **Over 5 years £m** | **Non interest bearing items £m** |
|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | |
| Loans and advances to banks | **47,895** | **6,666** | **20,247** | **29,921** | **10,047** | **3,917** | **3,477** | **3,326** | **570** |
| Loans and advances to customers | **149,043** | **25,882** | **14,174** | **9,276** | **5,869** | **2,746** | **2,496** | **5,149** | **620** |
| Investment securities | **21,536** | **15,233** | **1,039** | **133** | **337** | **310** | **323** | **3,910** | **2,592** |
| Other assets, prepayments and accrued income | | | | | | | | | **9,430** |
| | **218,474** | **47,781** | **35,460** | **39,330** | **16,253** | **6,973** | **6,296** | **12,385** | **13,212** |
| **Liabilities** | | | | | | | | | |
| Deposits by banks | **71,846** | **42,043** | **16,537** | **4,875** | **1,788** | **320** | **333** | **1,688** | **755** |
| Customer accounts | **70,464** | **10,117** | **4,557** | **762** | **40** | **1,193** | **2,395** | **13,780** | **3,521** |
| Insurance contract liabilities | | | | | | | | | **19** |
| Investment contract liabilities | | | | | | | | | |
| Debt securities in issue | **28,930** | **67,875** | **25,625** | **2,681** | **3,812** | **4,120** | **2,020** | **11,951** | **763** |
| Other borrowed funds | **158** | **3,466** | **566** | **671** | **335** | **504** | **76** | **2,400** | **532** |
| Other liabilities, accruals and deferred income | | | | | | | | | **6,572** |
| Shareholders' equity | | | | | | | | | **12,405** |
| Internal funding of trading book | **(25,022)** | **(1,934)** | **(247)** | **(74)** | **(1)** | **(5)** | **(4)** | **(5)** | **963** |
| | **146,376** | **121,567** | **47,038** | **8,915** | **5,974** | **6,132** | **4,820** | **29,814** | **25,530** |
| **Policyholder liabilities less assets*** | | | | | | | | | **(1)** |
| | **72,098** | **(73,786)** | **(11,578)** | **30,415** | **10,279** | **841** | **1,476** | **(17,429)** | **(12,317)** |
| **Net hedging derivatives** | **(38,997)** | **49,879** | **8,676** | **(30,974)** | **(6,638)** | **241** | **(645)** | **18,459** | |
| **Total interest rate sensitivity gap** | **33,101** | **(23,907)** | **(2,902)** | **(559)** | **3,641** | **1,082** | **831** | **1,030** | **(12,317)** |
| **Cumulative interest rate sensitivity gap** | **33,101** | **9,194** | **6,292** | **5,733** | **9,374** | **10,456** | **11,287** | **12,317** | |

* Assets and liabilities associated with policyholder funds and collective investment schemes shown in Note 37 have been excluded from the repricing policy in the above table. This is on the basis that the underlying interest rate risks inherent in the net assets of the funds are matched by the policyholder liabilities, limiting the impact of these risks on the Group results.

# Notes to the Accounts (continued)

## 33. Interest Rate Sensitivity Gap (continued)

| As at 31 December 2005 | Up to 1 month £m | 1 to 3 months £m | 3 to 12 months £m | 1 to 2 years £m | 2 to 3 years £m | 3 to 4 years £m | 4 to 5 years £m | Over 5 years £m | Non interest bearing Items £m |
|---|---|---|---|---|---|---|---|---|---|
| Assets | | | | | | | | | |
| Loans and advances to banks | 20,049 | 8,188 | 11,642 | 23,661 | 15,537 | 3,848 | 3,191 | 3,708 | 423 |
| Loans and advances to customers | 114,915 | 26,751 | 12,551 | 8,298 | 5,051 | 2,022 | 2,300 | 5,771 | 107 |
| Investment securities | 20,714 | 14,210 | | 187 | 131 | 319 | 241 | 6,483 | 497 |
| Other assets, prepayments and accrued income | | 585 | | | | | | | 8,453 |
| | 155,678 | 49,734 | 24,193 | 32,146 | 20,719 | 6,189 | 5,732 | 15,962 | 9,480 |
| Liabilities | | | | | | | | | |
| Deposits by banks | 51,012 | 13,797 | 12,426 | 1,765 | 3,737 | 1,609 | 348 | 1,978 | 707 |
| Customer accounts | 66,237 | 15,052 | 4,401 | 1,176 | 765 | 33 | 747 | 11,478 | 409 |
| Insurance contract liabilities | | | | | | | | | 17 |
| Investment contract liabilities | | | | | | | | | 98 |
| Debt securities in issue | 28,389 | 57,667 | 18,463 | 3,077 | 2,789 | 4,220 | 4,522 | 6,331 | 1,030 |
| Other borrowed funds | 345 | 2,117 | 386 | 175 | 688 | 351 | 298 | 3,771 | 210 |
| Other liabilities, accruals and deferred income | | | | | | | | | 5,644 |
| Shareholders' equity | | | | | | | | | 9,476 |
| Internal funding of trading book | (13,944) | (2,686) | (1,237) | | (41) | | | | |
| | 132,039 | 85,947 | 34,439 | 6,193 | 7,938 | 6,213 | 5,915 | 23,558 | 17,591 |
| | 23,639 | (36,213) | (10,246) | 25,953 | 12,781 | (24) | (183) | (7,596) | (8,111) |
| Net hedging derivatives | 1,296 | 8,652 | 9,030 | (24,002) | (12,166) | 2,237 | 1,362 | 13,591 | |
| Total interest rate sensitivity gap | 24,935 | (27,561) | (1,216) | 1,951 | 615 | 2,213 | 1,179 | 5,995 | (8,111) |
| Cumulative interest rate sensitivity gap | 24,935 | (2,626) | (3,842) | (1,891) | (1,276) | 937 | 2,116 | 8,111 | |

Notes to the Accounts (continued)

## 34. Trading Value at Risk

The Group's VaR methodology of estimating potential losses arising from the group's exposure to market risk is explained on pages 16 and 17 of the Risk Management report. The group's trading market risk exposure for the year ended 31 December 2006 is analysed below.

| Exposuure | | | Average | | Highest | | Lowest | |
|---|---|---|---|---|---|---|---|---|
| | **As at 31 December** | As at 31 December | | | | | | |
| | **2006** | 2005 | **2006** | 2005 | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m | **£m** | £m | **£m** | £m |
| Total value at risk | **4.5** | 5.7 | **4.2** | 6.1 | **6.5** | 8.8 | **2.9** | 3.7 |
| Included in the above: | | | | | | | | |
| Value at risk relating to interest rates | **2.2** | 1.4 | **2.4** | 1.9 | **4.0** | 3.7 | **1.4** | 0.6 |
| Value at risk relating to foreign currency | **0.2** | 0.3 | **0.3** | 0.6 | **0.8** | 2.5 | **0.1** | 0.1 |
| Value at risk relating to equity risk factor | **0.1** | 0.1 | **0.1** | 0.5 | **0.4** | 1.2 | | |
| Value at risk relating to credit spreads | **2.0** | 3.9 | **1.4** | 3.1 | **3.9** | 4.6 | **0.9** | 1.7 |

For all significant exposures VaR is calculated on a daily basis. Interest rate risk relating to the trading book is principally managed using a sensitivity methodology to measure exposure and set limits. This methodology calculates the present value impact of a one basis point parallel movement in interest rates on the outstanding positions. Credit spread risk is managed using a credit spread VaR and position limits based on credit spread sensitivity. Foreign currency risk is principally managed by the use of position limits. Equity risk is managed through an Equity Index VaR and position limits.

## 35. 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** | | | **2006** | | | 2005 |
|---|---|---|---|---|---|---|
| | **Net investments in overseas operations** | **Borrowing taken out to hedge the net investments** | **Remaining structural currency exposure** | Net investments in overseas operations | Borrowing taken out to hedge the net investments | Remaining structural currency exposure |
| | **£m** | **£m** | **£m** | £m | £m | £m |
| Australian Dollar | **1,560** | **1,458** | **102** | 1,345 | 1,341 | 4 |
| Euro | **975** | **975** | **0** | 569 | 569 | |
| US Dollar | **106** | **99** | **7** | 161 | 161 | |
| Other | **13** | **0** | **13** | 10 | | 10 |
| **Total** | **2,654** | **2,532** | **122** | 2,085 | 2,071 | 14 |

As at 31 December 2006 and 31 December 2005 there are 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 currency exposures is set out on pages 17 and 18 of the Risk Management report.

Notes to the Accounts (continued)

## 36. Assets and Liabilities in Foreign Currencies

| | Group | | Bank | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m |
| The aggregate amounts of assets and liabilities denominated in currencies other than Sterling were: | | | | |
| Assets | **128,513** | 180,991 | **19,861** | 16,037 |
| Liabilities | **133,057** | 203,935 | **13,031** | 10,079 |

The above figures do not reflect the Group's exposure to foreign currency, which is significantly lower as it is hedged by currency derivatives.

Notes to the Accounts (continued)

## 37. Maturity Analysis of Assets and Liabilities

The table below breaks down the Group's primary financial assets and liabilities by remaining contractual maturity. The maturity profile for these assets and liabilities defined as 'financial' have been determined in accordance with groupings that are considered most appropriate for those particular assets and liabilities. The remaining assets and liabilities have been split between those due within one year and those due in one year or more.

| 2006 | Up to 1 month | 1 to 3 months | 3 to 12 months | 1 to 5 years | Over 5 years | Policyholder funds* | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | | |
| Cash and balances with central banks | 1,631 | | 10 | | | | 1,641 |
| Items in the course of collection | 733 | | | | | | 733 |
| Financial assets held for trading | 14,178 | 13,618 | 7,628 | 8,686 | 5,029 | | 49,139 |
| Derivative assets | 141 | 685 | 1,020 | 2,349 | 4,188 | | 8,383 |
| Loans and advances to banks | 25,485 | 6,710 | 20,303 | 68,336 | 5,232 | 2 | 126,068 |
| Loans and advances to customers | 31,732 | 55,156 | 10,972 | 28,803 | 88,592 | | 215,255 |
| Investment securities | 1,379 | 1,278 | 1,062 | 11,076 | 30,618 | 95 | 45,508 |
| Other financial assets | 659 | 2 | | | (16) | 1 | 646 |
| **Total** | 75,938 | 77,449 | 40,995 | 119,250 | 133,643 | 98 | 447,373 |
| **Liabilities** | | | | | | | |
| Deposits by banks | 46,730 | 38,370 | 17,866 | 17,987 | 19,232 | | 140,185 |
| Financial liabilities held for trading | 8,923 | 5,572 | 7,598 | 241 | | | 22,334 |
| Customer accounts | 67,323 | 12,646 | 4,222 | 6,966 | 15,672 | | 106,829 |
| Derivative liabilities | 301 | 1,084 | 1,086 | 2,788 | 4,079 | | 9,338 |
| Insurance contract liabilities | 19 | | | | | | 19 |
| Investment contract liabilities | | | | | | 96 | 96 |
| Debt securities in issue | 17,031 | 52,141 | 26,956 | 28,987 | 22,662 | | 147,777 |
| Other borrowed funds | 122 | 305 | 82 | 1,215 | 6,984 | | 8,708 |
| Other financial liabilities | 1,055 | 8 | | | 3 | 1 | 1,067 |
| **Total** | 141,504 | 110,126 | 57,810 | 58,184 | 68,632 | 97 | 436,353 |

* Assets and liabilities associated with policyholder funds have been excluded from the maturity profile in the above table. This is on the basis that the underlying liquidity risks are for the account of the policyholders and have no direct impact on the Group results. The expected maturities of these assets and liabilities are shown on the following page.

Of the £7bn remaining non-policyholder assets, £4bn is due within one year. Similarly of the £6bn remaining non-policyholder liabilities, £6bn is due within one year.

Notes to the Accounts (continued)

## 37. Maturity Analysis of Assets and Liabilities (continued)

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

| As at 31 December 2005 | Up to 1 month £m | 1 to 3 months £m | 3 to 12 months £m | 1 to 5 years £m | Over 5 years £m | Policyholder funds* £m | Total £m |
|---|---|---|---|---|---|---|---|
| Assets | | | | | | | |
| Cash and balances with central banks | 1,376 | | 8 | | | | 1,384 |
| Items in the course of collection | 603 | | | | | | 603 |
| Financial assets held for trading | 14,992 | 10,251 | 6,504 | 1,826 | 8,193 | | 41,766 |
| Derivative assets | 331 | 599 | 843 | 2,344 | 5,594 | | 9,711 |
| Loans and advances to banks | 20,166 | 6,919 | 11,877 | 45,674 | 5,611 | | 90,247 |
| Loans and advances to customers | 25,874 | 48,984 | 10,017 | 26,673 | 66,218 | | 177,766 |
| Investment securities | 510 | 225 | 1,669 | 7,251 | 33,029 | 98 | 42,782 |
| Other financial assets | 46,222 | 25,427 | 12,068 | 18,405 | 9,283 | | 111,405 |
| Total | 110,074 | 92,405 | 42,986 | 102,173 | 127,928 | 98 | 475,664 |
| | | | | | | | |
| Liabilities | | | | | | | |
| Deposits by banks | 38,450 | 14,155 | 12,566 | 11,439 | 10,769 | | 87,379 |
| Financial liabilities held for trading | 13,727 | 5,106 | 6,021 | 153 | | | 25,007 |
| Customer accounts | 68,292 | 7,396 | 3,704 | 4,815 | 16,092 | | 100,299 |
| Derivative liabilities | 221 | 834 | 778 | 2,297 | 4,432 | | 8,562 |
| Insurance contract liabilities | 17 | | | | | | 17 |
| Investment contract liabilities | | | | | | 98 | 98 |
| Debt securities in issue | 19,290 | 38,322 | 22,405 | 31,848 | 14,622 | | 126,487 |
| Other borrowed funds | 16 | 49 | 170 | 674 | 7,432 | | 8,341 |
| Other financial liabilities | 51,476 | 8,596 | 5,280 | 10,484 | 7,437 | | 83,273 |
| Total | 191,489 | 74,458 | 50,924 | 61,710 | 60,784 | 98 | 439,463 |

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

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

## 38. Acquisitions

On 16 July 2006, the Group acquired a 58.3% equity interest in Mother Topco Limited for £175m. Subsequently, on 31 October 2006, the Mother Topco Limited group of companies acquired 100% of the equity of McCarthy & Stone plc, a UK provider of retirement homes. The cost of this acquisition was £1,128m. The assets and liabilities of the sub-group headed by Mother Topco are classified as a disposal group (see Note 10). The post-acquisition profit after tax of this group of companies was £5m.

Notes to the Accounts (continued)

## 39. Related Party Transactions

The ultimate parent of the group is HBOS plc. A number of banking transactions are entered into with its subsidiaries in the normal course of business. These include loans, deposits and foreign currency transactions. The balances held due and by HBOS plc subsidiaries are shown within the notes to the accounts. The interest income received and paid is principal employer of the group and staff costs amounting to £885m (2005 £826m) were recharged to the group.

In the year ended 31 December 2006, 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 £34m (2005 £37m), of which £14m was outstanding at the year end (2005 £23m).

Included within loans and advances to banks for Bank of Scotland group are amounts to fellow subsidiary undertakings of £119,017m (2005 £78,115m). Included within loans and advances to banks for Bank of Scotland are amounts to subsidiary undertakings of £71,270m (2005 £41,962m) and amounts to fellow subsidiary undertakings of £9,885m (2005 £2,940m).

Included within deposits by banks for Bank of Scotland group are amounts from fellow subsidiary undertakings of £110,368m (2005 £56,665m) and amounts from other associated undertakings of £943m (2005 £830m). Included within deposits by banks for Bank of Scotland are amounts from subsidiary undertakings of £107,882m (2005 £64,181m), amounts from fellow subsidiary undertakings of £8,737m (2005 £4,307m) and amounts from other associated undertakings of £16m (2005 £7m).

## 40. Transactions with Key Management Personnel

For the purposes of IAS 24 'Related Party Disclosures', key management personnel comprise members of the Bank of Scotland Board, the Company Secretary and, as the senior executive committee of the group, the HBOS Executive Committee.

Key management personnel and other colleagues, as well as receiving salary, incentives, shares, pensions and other benefits are entitled to enter into product transactions with Bank of Scotland and its subsidiaries. These product relationships are generally in the form of banking, savings, mortgage, loan, insurance, assurance and investment products.

Any product offerings that are received on beneficial terms compared to the terms received by customers and which give rise to taxable benefit in kind are declared to HM Revenue & Customs and taxed accordingly.

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

**Mortgages, credit cards and term loans**

| | Number of key management personnel | £'000 |
|---|---|---|
| At 1 January 2005 | 6 | 3,462 |
| Amounts advanced during the year | | |
| Interest charged | 4 | 164 |
| Amounts repaid during year | 4 | (1,083) |
| Upon resignation | 2 | (85) |
| At 31 December 2005 | 4 | 2,458 |
| Amounts advanced during the year | | |
| Interest charged | 2 | 7 |
| Amounts repaid during year | 3 | 144 |
| Upon resignation | 5 | (449) |
| **At 31 December 2006** | **5** | **2,160** |

# Notes to the Accounts (continued)

## 41. Transactions with Key Management Personnel (continued)

### Bank, cheque or current accounts

| | Number of key management personnel | Credit balances £'000 | Debit balances £'000 | Net balances £'000 |
|---|---|---|---|---|
| At 1 January 2005 | **5** | **816** | **(60)** | **756** |
| Net movement during the year | **10** | **294** | **(17)** | **277** |
| Upon resignation | **2** | **(118)** | | **(118)** |
| At 31 December 2005 | **7** | **992** | **(77)** | **915** |
| Upon appointment | | | | |
| Net movement during the year | **10** | **6,353** | **(940)** | **5,413** |
| Upon resignation | | | | |
| **At 31 December 2006** | **9** | **7,345** | **(1,017)** | **6,328** |

### Savings and deposit accounts

| | Number of key management personnel | £'000 |
|---|---|---|
| At 1 January 2005 | **3** | **755** |
| Upon appointment | **1** | **105** |
| Amounts deposited during the year | **2** | **1,225** |
| Interest credited | **3** | **14** |
| Amounts withdrawn during the year | **2** | **(888)** |
| Upon resignation | **2** | **(294)** |
| At 31 December 2005 | **2** | **917** |
| Upon appointment | | |
| Amounts deposited during the year | **2** | **306** |
| Interest credited | | |
| Amounts withdrawn during the year | **2** | **(752)** |
| Upon resignation | | |
| **At 31 December 2006** | **2** | **471** |

### Life assurance and investment contracts

| | Number of key management personnel | £'000 |
|---|---|---|
| At 1 January 2005 | **1** | **304** |
| Premiums paid/amounts invested during the year | **1** | **1,231** |
| Other movements including investment returns | **1** | **298** |
| Upon resignation | | |
| Total sum insured/value of investment at 31 December 2005 | **1** | **1,833** |
| Upon appointment | | |
| Premiums paid/amounts invested during the year | | |
| Other movements including investment returns | **1** | **1,851** |
| **Total sum insured/value of investment at 31 December 2006** | **1** | **3,684** |

Notes to the Accounts (continued)

## 42. Segmental Analysis

### Business Sector

| 2006 | Retail | Corporate | Insurance & Investment | International | Treasury & Asset Management | Group Items | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| Net interest income | **837** | **1,857** | | **1,228** | **201** | | **4,123** |
| Net fees and commission income | **273** | **328** | **11** | **150** | **(25)** | | **737** |
| Net trading income | | **25** | | **2** | **250** | | **277** |
| Other operating income | **23** | **915** | | **127** | **18** | | **1,083** |
| **Net operating income** | **1,133** | **3,125** | **11** | **1,507** | **444** | | **6,220** |
| Administrative expenses | **(363)** | **(693)** | | **(526)** | **(154)** | **(133)** | **(1,869)** |
| Depreciation and amortisation | **(15)** | **(512)** | | **(41)** | **(2)** | **(26)** | **(596)** |
| Goodwill impairment | | **(41)** | | | | | **(41)** |
| Other operating expenses | | | | **(19)** | | | **(19)** |
| **Operating expenses** | **(378)** | **(1,246)** | | **(586)** | **(156)** | **(159)** | **(2,525)** |
| Impairment | **(303)** | **(493)** | | **(219)** | | | **(1,015)** |
| **Operating profit** | **452** | **1,386** | **11** | **702** | **288** | **(159)** | **2,680** |
| Share of profits of jointly controlled entities and associated under-takings | | **148** | | **4** | | | **152** |
| Non-operating income | **9** | | | **180** | | | **189** |
| **Profit before taxation** | **461** | **1,534** | **11** | **886** | **288** | **(159)** | **3,021** |
| **Total assets** | **56,544** | **92,262** | **2** | **57,386** | **248,985** | | **455,179** |
| Included in total assets (a) | | | | | | | |
| Interests in jointly controlled entities and associates undertakings | **47** | **535** | | **51** | | | **633** |
| **Total liabilities (a)** | **54,697** | **86,561** | **2** | **54,140** | **247,374** | | **442,774** |
| **Capital expenditure on property, equipment and software** | | **1** | | **62** | **1** | **95** | **159** |

(a) The total assets and liabilities of Corporate include £1,388m and £909m respectively, being the assets and liabilities of the disposal group.

# Notes to the Accounts (continued)

## 42. Segmental Analysis (continued)

| 2005 | Retail | Corporate | Insurance & Investment | International | Treasury & Asset Management | Group Items | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| Net interest income | 911 | 1,689 | 2 | 1,016 | 181 | | 3,799 |
| Net fees and commission income | 188 | 278 | 15 | 137 | (23) | | 595 |
| Net trading income | 3 | 12 | | 3 | 196 | | 214 |
| Other operating income | 38 | 986 | | 83 | 15 | | 1,122 |
| Net operating income | 1,140 | 2,965 | 17 | 1,239 | 369 | | 5,730 |
| Administrative expenses | (347) | (650) | | (443) | (131) | (139) | (1,710) |
| Depreciation and amortisation | (16) | (506) | | (44) | (2) | (37) | (605) |
| Other operating expenses | | | | (18) | | | (18) |
| Operating expenses | (363) | (1,156) | | (505) | (133) | (176) | (2,333) |
| Impairment | (245) | (474) | | (183) | | | (902) |
| Operating profit | 532 | 1,335 | 17 | 551 | 236 | (176) | 2,495 |
| Share of profits/(losses) of jointly controlled entities and associated under-takings | 7 | 46 | | (2) | | | 51 |
| Profit before taxation | 539 | 1,381 | 17 | 549 | 236 | (176) | 2,546 |
| Total assets | 45,582 | 79,453 | 2 | 45,635 | 200,659 | (21) | 371,310 |
| Included in total assets: | | | | | | | |
| Interests in jointly controlled entities and associates undertakings | 56 | 304 | 1 | 13 | | | 374 |
| Total liabilities | 44,087 | 74,779 | 2 | 43,504 | 199,483 | (21) | 361,834 |
| Capital expenditure on property, equipment and software | | 1 | | 108 | 2 | 96 | 207 |

Notes to the Accounts (continued)

## 42. 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.

| | UK | | Rest of world | | Total | |
|---|---|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 | **2006** | 2005 |
| | **£m** | £m | **£m** | £m | **£m** | £m |
| Net interest income | **2,840** | 2,806 | **1,283** | 993 | **4,123** | 3,799 |
| Net fees and commissions income | **431** | 457 | **306** | 138 | **737** | 595 |
| Net trading income | **276** | 212 | **1** | 2 | **277** | 214 |
| Other operating income | **1,022** | 1,052 | **61** | 70 | **1,083** | 1,122 |
| **Net operating income** | **4,569** | 4,527 | **1,651** | 1,203 | **6,220** | 5,730 |
| Administrative expenses | **(1,383)** | (1,253) | **(486)** | (457) | **(1,869)** | (1,710) |
| Depreciation and amortisation | **(563)** | (575) | **(33)** | (30) | **(596)** | (605) |
| Goodwill impairment | **(41)** | | | | **(41)** | |
| Other operating expenses | | | **(19)** | (18) | **(19)** | (18) |
| Operating expenses | **(1,987)** | (1,828) | **(538)** | (505) | **(2,525)** | (2,333) |
| Impairment | **(797)** | (726) | **(218)** | (176) | **(1,015)** | (902) |
| **Operating profit** | **1,785** | 1,973 | **895** | 522 | **2,680** | 2,495 |
| Share of profits of joint controlled entities and associated undertakings | **91** | 53 | **61** | (2) | **152** | 51 |
| Non-operating income | **9** | | **180** | | **189** | |
| **Profit before taxation** | **1,885** | 2,026 | **1,136** | 520 | **3,021** | 2,546 |
| **Total assets** | **378,246** | 309,075 | **76,933** | 62,235 | **455,179** | 371,310 |
| Included in total assets are interests in jointly controlled entities and associated undertakings | **568** | 365 | **65** | 9 | **633** | 374 |
| **Total liabilities** | **370,655** | 303,088 | **72,119** | 58,746 | **442,774** | 361,834 |
| **Capital expenditure on property, equipment and software** | **97** | 99 | **62** | 108 | **159** | 207 |

## 43. 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.