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HBOS plc

Annual Report and Accounts 2008

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Introduction

HBOS 2008 Results

The HBOS 2008 Results contained in this report cover the results of the HBOS Group for the year ended 31 December 2008. Unless otherwise stated, the analysis throughout this document compares the year to 31 December 2008 with the year to 31 December 2007.

Background

The continuing global dislocation in financial markets in 2008 has resulted in exceptional instability and volatility, leading to falling market, investor and customer confidence. This has had a profound effect on the banking sector generally and on HBOS specifically. Since the summer of 2007, it had become increasingly difficult for HBOS to raise funds in wholesale markets. Pressures on the banking and financial services sectors were evident through increases in the cost of insurance against bank defaults, deteriorating economic conditions, increased concerns about credit risk and sustained tight conditions in wholesale money markets, despite measures taken by central banks to increase liquidity. The Board of HBOS sought to restore confidence and stability through an agreement to be acquired by Lloyds TSB, as announced on 18 September 2008.

However turbulence in the markets continued, fuelled by concerns about credit risk and worsening economic conditions. Measures by national authorities and central banks failed to stem this turbulence and restore inter-bank confidence. The UK Government decided that it would be appropriate for the UK banking sector to increase its level of capitalisation. This led to the UK Government announcing, on 8 October 2008, specific and comprehensive measures to ensure the stability of the UK financial system. This included a significant recapitalisation of the UK banking sector together with the introduction of a guarantee by HM Treasury in respect of future short and medium terms debt issuance. On 13 October 2008, the terms of the acquisition by Lloyds TSB were amended and, as part of the UK Government's co-ordinated package of measures, HBOS announced a Placing and Open Offer to raise £11.5bn of new capital (consisting of £8.5bn in ordinary shares and £3.0bn in preference shares). The capital raising, underwritten by the UK Government, was made available to HBOS on condition that the acquisition by Lloyds TSB completed. On 16 January 2009, the acquisition of HBOS by Lloyds TSB completed and the name of the combined group was changed to Lloyds Banking Group plc (LBG).

On 13 February 2009, LBG issued a trading update for the year ended 31 December 2008 which stated, in respect of HBOS, that:

"Since its 12 December 2008 trading update, HBOS's 2008 trading has been further impacted by increasingly difficult market conditions, an acceleration in the deterioration of credit quality and falls in estimated asset values. The Group expects HBOS to report an underlying loss before tax of some £8.5 billion for the year ended 31 December 2008. On a statutory basis, adjusting for the impact of short term fluctuations (c.£0.25 billion), loss on sale of businesses (c.£0.85 billion), FSCS levy (c.£0.2 billion) and goodwill impairment (c.£0.15 billion), the loss before tax is expected to be approximately £10 billion, before the policyholder tax charge which is currently expected to be approximately £0.9 billion. The key elements of the loss are the £4 billion impact of market dislocation and approximately £7 billion of impairments in the HBOS corporate division. The market dislocation has been driven by deterioration in asset quality and falling market valuations. The impairments are, principally as a result of applying a more conservative provisioning methodology consistent with that used by Lloyds TSB, and reflecting the acceleration in the deterioration in the economy, some £1.6 billion higher than our expectations when we issued our shareholder circular at the beginning of November last year."

The HBOS 2008 Results contained in this report are in line with LBG expectations at the time of the 13 February 2009 trading update.

Further information on LBG can be found in the LBG Annual Report and Accounts. This includes pro-forma information (showing the combination of Lloyds TSB and HBOS) including a pro-forma Consolidated Balance Sheet and pro-forma regulatory capital ratios as at 31 December 2008.

Prospects

The prospects for the Group should now be considered in the context of the combined LBG and reference should be made to the LBG Annual Report and Accounts for further information.

The UK banking sector is expected to see continued pressure on earnings from the ongoing dislocation in financial markets and the deteriorating global economic environment. The continuing dislocation in global financial markets is expected to perpetuate the ongoing scarcity of wholesale funding for the banking sector leading to higher funding costs. Valuation for the sector's debt securities and other structured products are expected to continue to come under pressure as the economic slowdown impacts on asset values generally. The reduced supply, and increased cost, of credit in the global economy is putting further strain on consumers, SMEs and large corporate businesses and is a significant factor in driving the deteriorating economic conditions. Rising UK unemployment is expected to result in higher UK sector impairment losses for mortgage and consumer lending. This is in addition to higher impairment losses expected from property based lending as the reduced availability of credit continues to push residential and commercial property prices lower.

Key Performance Indicators

	2008	2007	2006
Statutory (loss)/profit before tax (£m)	(10,825)	5,474	5,706
Underlying (loss)/profit before tax (£m)	(8,490)	5,708	5,537
Net asset value per share (p)[1]	202p	551p	516p
Net asset value per share (p)[1][2]	150p		
Core Tier 1 capital ratio	4.1%	5.7%	
Tier 1 capital ratio	6.0%	7.7%	[3]
Core Tier 1 capital ratio[2]	6.7%		
Tier 1 capital ratio[2]	9.9%		

(1) The net asset value is calculated after deducting equity preference shares of £1,267m (2007 £1,267m) from shareholders' equity excluding minority interests.
(2) Including the net proceeds of £8.3bn arising from the Placing and Open Offer and, in respect of the Tier 1 capital ratio, £3.0bn of proceeds from the issuance of Preference Shares to HM Treasury in January 2009.
(3) On 1 January 2008, HBOS implemented Basel II rules for capital adequacy. Ratios presented for earlier years are not therefore comparable.

Financial Review

	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Underlying net interest income	**8,171**	7,314
Underlying non-interest income	**(1,562)**	5,589
Underlying net operating income	**6,609**	12,903
Underlying operating expenses	**(5,344)**	(5,274)
Underlying profit before provisions	**1,265**	7,629
Impairment losses on loans and advances	**(9,857)**	(2,012)
Non-operating income	**102**	91
Underlying (loss)/profit before tax	**(8,490)**	5,708
Adjusted for:		
Regulatory provisions charge	**(200)**	(122)
Goodwill impairment	**(158)**	(5)
Loss on sale of BankWest and St. Andrews	**(845)**	
Impact of the 2008 change in corporation tax rate on the value of leasing assets		(10)
Short term fluctuations	**(239)**	(115)
(Loss)/profit before tax, excluding policyholder tax	**(9,932)**	5,456
Policyholder tax	**(893)**	18
(Loss)/profit before tax - statutory	**(10,825)**	5,474
Net Interest Margin	**1.60%**	1.63%
Impairment losses as a % of average advances	**2.28%**	0.50%
Cost:income ratio	**80.9%**	40.9%

Basis of Presentation

In order to provide a clearer representation of the Group's underlying business performance the Group presents its results on a basis referred to as 'underlying' which incorporates the following adjustments:

- Excluding regulatory provisions, the impact of the change in corporation tax rates, goodwill impairment, the loss on sale of BankWest and St. Andrews, policyholder tax, and the impact of short term fluctuations (STFs) and changes to economic assumptions for Long Term Assurance Business accounted for on an embedded value basis;

- Operating lease depreciation, impairment on investment securities, changes in insurance and investment contract liabilities, change in unallocated surplus and net claims incurred on insurance contracts are netted against income;

- Share of (losses)/profits of associates and jointly controlled entities is included within underlying non-interest income.

A reconciliation of underlying (loss)/profit before tax to the statutory profit before tax is shown above.

During 2008, certain businesses were transferred between the Retail, Corporate and Treasury divisions. The 2008 Results are reported in line with this new structure and the 2007 divisional comparatives have been restated. There is no impact on the 2007 Group Consolidated Balance Sheet and Income Statement previously published.

Overview of Results

The Group operated in difficult market conditions during 2008. The results were affected by a significant deterioration in credit quality, particularly in the last quarter of 2008 as the UK economy deteriorated and residential and commercial property prices declined. They were also affected by the continuing dislocation in financial markets which led to further sharp falls in the values of our Treasury debt securities portfolio. Statutory loss before tax was £10,825m (2007 profit before tax of £5,474m), which includes a charge of £893m relating to policyholder tax.

The income statement commentary that follows is presented on an underlying basis (see 'Basis of Presentation' above). Underlying loss before tax for the year to 31 December 2008 was £8,490m (2007 profit of £5,708m).

Net Interest Income

Underlying net interest income increased to £8,171m (2007 £7,314m), mainly due to growth in Retail, which benefited from improved margins, and to growth in International and Corporate reflecting increased advances.

The Group net interest margin reduced to 1.60% (2007 1.63%). While the Group margin faced a headwind from higher wholesale funding costs, the decline reflected a change in business mix across the divisions with reductions of 3bps and 23bps in International and Corporate respectively, more than offsetting an increase of 4bps in Retail.

The improvement in the Retail margin reflects the beneficial effect of higher mortgage acquisition, retention and credit card spreads which more than offset higher funding costs. Corporate's margin fell due to slower turnover of the back book which has influenced the timing of fee recognition as well as the increased cost of deposits and higher wholesale funding costs.

Non-interest Income

Underlying non-interest income decreased to negative £1,562m (2007 income of £5,589m). Excluding the negative £4,044m (2007 negative £227m) impact of Market Dislocation, described in further detail in the Treasury divisional section, underlying non-interest income decreased to £2,482m (2007 £5,816m). The significant decline is due to Corporate and reflects significant impairment losses on property related investments made by the Joint Ventures business and private equity fund investments made by the Integrated Finance business, together with a material decline in the trading performance, generated by jointly controlled entities, particularly in the housebuilding and property sectors. In Insurance & Investment, underlying non-interest income was £140m higher, due to lower weather related claims in the General Insurance business in 2008.

Operating Expenses

Underlying operating expenses increased to £5,344m (2007 £5,274m). The increase of £70m includes additional costs arising from planned investments in International, additional marketing spend in General Insurance, partially offset by reduced staff costs in Corporate, benefits from cost reduction initiatives in Retail and lower bonus costs across the Group.

Group cost:income ratio including the impact of Market Dislocation increased to 80.9% (2007 40.9%). The Group cost:income ratio excluding the impact of Market Dislocation was 50.6% (2007 40.2%).

Financial Review continued

Credit Quality
Impairment losses on loans and advances were £9,857m (2007 £2,012m) representing 2.28% of average advances (2007 0.50%). While increases were seen in all three banking divisions, the most significant increase was in Corporate. This increase reflects the worsening economic conditions, which specifically deteriorated in the last quarter of 2008. The higher impairment losses in Corporate were also the result of applying a provisioning methodology more consistent with that used by Lloyds TSB. In Retail, the increase in impairment losses mainly related to secured lending as the difficult economic conditions resulted in higher mortgage arrears, particularly in the specialist book. This, together with a material decline in house prices, resulted in increased provisioning requirements. Similar trends to the UK were evident in our International division, reflecting the deteriorating economies.

Items excluded from underlying (loss)/profit before tax
Regulatory Provisions charge - The regulatory provisions charge of £200m is in respect of the Financial Services Compensation Scheme (FSCS) relating to HBOS's share of expenses, primarily the interest payable on the loan taken out by FSCS to pay compensation to depositors. In 2007 the charge relates to ex gratia refunds of current account service fees, together with the associated administration costs.

Loss on sale of BankWest and St. Andrews - On 19 December 2008, BankWest and St. Andrew's Australia were sold to Commonwealth Bank of Australia for a total consideration of A$2.4bn. The sale generated a loss of £845m, including the write off of £240m of goodwill.

Policyholder tax - IFRS requires that profit before tax includes charges or credits made to policyholders for tax. However, an associated amount is included within tax on profit resulting in there being no effect on profit after tax. The amount of policyholder tax is primarily influenced by investment market performance (such as equities, gilts and property), as this tax is charged or credited based on investment gains or losses. To remove this volatility, policyholder tax effects are excluded from underlying profit to give a more meaningful measure of the Group's performance. Policyholder tax for the year to 31 December 2008 was a charge of £893m (2007 £18m credit). The movement between the two years predominantly relates to a movement in deferred tax provided in respect of unrealised gains and losses on investments held for policyholders and taxable under the policyholder tax rules.

Short term fluctuations - Short term fluctuations represent the impact of fluctuations in investment returns relative to those based on longer term assumptions and variances in actual policyholder tax payable from an expected charge for the year. This amount has increased to a negative £239m (2007 negative £115m) primarily due to falling equity and fixed income markets.

Goodwill impairment - Goodwill impairment principally comprises £72m in respect of the full write down of goodwill held in respect of the acquisition of the ICC business banking division in Ireland and £50m being the write down of goodwill relating to a specialist area of the UK credit card business to a recoverable amount of £20m.

Taxation
The tax credit for the year of £3,409m (2007 tax charge of £1,365m) includes a £893m tax credit (2007 £18m tax charge) in respect of the tax attributable to the policyholder earnings in the Group's UK life companies. The 2007 tax charge of £1,365m includes a credit of £178m in respect of the change in the rate of UK corporation tax. Excluding these, and other items stripped out of underlying (loss)/profit (ie, regulatory provisions, loss on sale of BankWest and St. Andrews, short term fluctuations and goodwill impairments), results in an effective rate of 28% (2007 28%). Included within the tax credit of £3,409m is an overseas tax charge of £233m (2007 £293m).

Balance Sheet Analysis
Loans and advances to customers were £435.2bn (2007 £430.0bn). On a like-for-like basis, excluding BankWest and St. Andrews which were sold in December 2008, loans and advances to customers increased by 7% reflecting an increase of 6% in Corporate, primarily arising from growth in the first half of 2008 and by foreign currency movements and 1% in Retail. In International, loans and advances to customers declined by 9% primarily reflecting the sale of BankWest and St. Andrews.

Customer deposits decreased to £222.3bn (2007 £243.2bn). On a like-for-like basis, excluding BankWest and St. Andrews, the decrease was 2%. This reflected declines in Corporate and Retail, primarily arising as a result of net outflows in September and October, partially offset by an increase in Treasury due to the increased use of repos. Deposit flows have improved following the announcement of the LBG acquisition.

Liquidity and Funding
Following speculation on HBOS's future in mid-September, the HBOS Group suffered deposit outflows, further increasing the Group's reliance on wholesale funding markets. The majority of these deposit outflows were non-bank financial institutions and large corporates, rather than personal account customers. In recent months this position has stabilised with net inflows evident following the announcement of the proposed transaction with Lloyds TSB. Further information on the Group's funding is included in the Risk Management Report on page 26.

Regulatory Capital

On 1 January 2008 HBOS implemented the Basel II rules for capital adequacy and the capital ratios below are therefore shown on a Basel II basis only.

HBOS completed a Rights Issue at the end of July 2008 raising a net £4.0bn of capital. In addition a net equity capital placing of £8.3bn and preference share issuance of £3bn, sponsored by the UK Government, was completed in January 2009. The Tier 1 capital ratio at 31 December 2008 is 6.0% (1 January 2008 7.7%) and the Core Tier 1 ratio is 4.1% (1 January 2008 5.7%). Including the net £11.3bn capital injection in January 2009, the Tier 1 ratio would be 9.9% with the Core Tier 1 ratio at 6.7% at 31 December 2008.

Risk Weighted Assets (RWAs)

RWAs have increased by 6% to £328.0bn (1 January 2008 £309.2bn) driven by the following factors:

- Retail RWAs increased by 10% due to economic conditions increasing average risk weights.

- Corporate RWAs increased by 5% initially due to Loans & Advances growth in the first quarter of the year. Corporate asset growth subsequently slowed, with RWAs reducing in the second half of the year as a result of asset reduction and impairment provisions offsetting the effect of currency retranslations and deteriorating economic conditions.

- In International, RWAs decreased by 5% with the impact of the sale of BankWest reducing RWAs, offset by currency retranslations.

- In Treasury & Asset Management, RWAs growth was 49% primarily due to increased liquidity holdings and an increase in average risk weights due to rating downgrades on asset portfolios.

Tier 1 Capital

Tier 1 capital decreased by £3.9bn during 2008 reflecting the loss attributable to parent company shareholders and the payment of the 2007 final dividend in May 2008. This was partially offset by the issuance of innovative preferred securities of £750m in March 2008 and by the Rights Issue in July 2008.

At 31 December 2008 there was a regulatory restriction on the value of perpetual securities in Tier 1 capital, however, including the proceeds of the Placing and Open Offer the full benefit of preferred securities is recognised within Tier 1.

Tier 2 Capital

The increase in Tier 2 capital during the year is due to dated subordinated debt issues of 175m and US$2bn. In Sterling equivalent terms at 31 December 2008, these new issuances totalled £1,526m. Exchange translations on subordinated debt of £3.5bn also contributed to the increase in Tier 2 capital. At 31 December 2008 there was a regulatory restriction in including the value of debt issues in Tier 2 capital, however including the proceeds of the Placing and Open offer, the full benefit of this capital is included within Tier 2.

Supervisory deductions

Supervisory deductions mainly reflect investments in subsidiary undertakings that are not within the banking group for regulatory purposes. These unconsolidated investments are primarily Clerical Medical, St. James's Place, St. Andrew's Group and Heidelberger Leben. Total supervisory deductions decreased to £5,044m from £5,102m primarily as a result of capital repatriated from the insurance and investment group to the banking group, offsetting increases in embedded value of life policies.

Capital Structure Basel II

	As at 31.12.2008 (Including Placing and Open Offer)* £m	As at 31.12.2008 £m	As at 01.01.2008 £m
Risk weighted assets	**328,023**	**328,023**	309,173
Capital Resources			
Core Tier 1	**21,848**	**13,503**	17,703
Perpetual non-cumulative preference shares	**6,195**	**3,195**	2,781
Innovative Tier 1	**4,576**	**3,092**	3,247
Total Tier 1 capital	**32,619**	**19,790**	23,731
Upper Tier 2	**8,066**	**9,550**	6,241
Lower Tier 2	**11,894**	**10,306**	9,900
Deductions from Tier 2	**(823)**	**(823)**	(912)
Total Tier 2 capital	**19,137**	**19,033**	15,229
Total Supervisory Deductions	**(5,044)**	**(5,044)**	(5,102)
Total Capital Resources	**46,712**	**33,779**	33,858
Tier 1 capital ratio (%)	**9.9%**	**6.0%**	7.7%
Core Tier 1 ratio (%)	**6.7%**	**4.1%**	5.7%
Total capital ratio (%)	**14.2%**	**10.3%**	11.0%
Tier 1 Gearing (%)	**33.0%**	**31.8%**	25.4%

* Includes the net proceeds of £8.3bn Ordinary Shares and £3bn Preference Shares from Government recapitalisation within capital resources. There is no impact on Risk Weighted Assets.

Financial Review continued

Segmental Analysis

Income Statement

Year ended 31 December 2008	Retail £m	Corporate £m	Insurance & Investment £m	International £m	Treasury & Asset Mgmt £m	Group Items £m	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Underlying net interest income[1]	4,237	2,280	(97)	1,474	181[1]		**8,075[1]**	7,314
Underlying non-interest income[1]	1,287	(1,465)	1,731	484	445[1]		**2,482[1]**	5,816[1]
Underlying net operating income[1]	5,524	815	1,634	1,958	626[1]		**10,557[1]**	13,130[1]
Underlying operating expenses	(2,029)	(939)	(895)	(846)	(305)	(330)	**(5,344)**	(5,274)
Underlying operating profit/(loss) before provisions[1]	**3,495**	**(124)**	**739**	**1,112**	**321[1]**	**(330)**	**5,213[1]**	7,856[1]
Impairment losses on loans and advances	(2,230)	(6,669)		(958)			**(9,857)**	(2,012)
Underlying operating profit/(loss)[1]	**1,265**	**(6,793)**	**739**	**154**	**321[1]**	**(330)**	**(4,644)[1]**	5,844[1]
Non-operating income	102						**102**	91
Underlying profit/(loss) before tax (excluding impact of MD)	**1,367**	**(6,793)**	**739**	**154**	**321[1]**	**(330)**	**(4,542)[1]**	5,935[1]
Impact of Market Dislocation					(3,948)		**(3,948)**	(227)
Underlying profit/(loss) before tax	**1,367**	**(6,793)**	**739**	**154**	**(3,627)**	**(330)**	**(8,490)**	5,708
Year ended 31 December 2007[2]								
Underlying profit/(loss) before tax	2,026	2,359	644	757	259	(337)		5,708

(1) Excluding the impact of Market Dislocation in Treasury & Asset Management, comprising £96m in net interest income and £(4,044)m (2007 £(227)m) in underlying non-interest income resulting in a total impact of Market Dislocation of £(3,948)m (2007 £(227)m).
(2) Retail, Corporate and Treasury & Asset Management have been restated to reflect the divisional reorganisation.

Key Balance Sheet and Credit Quality Items

As at 31 December 2008	Retail Secured	Retail Unsecured	Retail Total	Corporate	International	Treasury & Asset Management	Year ended 31.12.2008
Loans and advances to customers (£bn)	**238.5**	**16.8**	**255.3**	**116.4**	**61.0**	**2.5**	**435.2**
Customer deposits (£bn)			**143.7**	**38.5**	**6.6**	**33.5**	**222.3**
Risk weighted assets (£bn)[1]			**73.7**	**171.5**	**56.7**	**25.3**	**328.0**
Impaired loans (£m)	**6,914**	**2,209**	**9,123**	**13,848**	**3,060**		**26,031**
Impaired loans as a % of closing advances (%)	**2.90**	**13.15**	**3.57**	**11.90**	**5.02**		**5.98**
Impairment provisions (£m)	**1,219**	**1,819**	**3,038**	**6,563**	**1,092**		**10,693**
Impairment provisions as a % of impaired loans (%)	**18**	**82**	**33**	**47**	**36**		**41**
As at 31 December 2007							
Loans and advances to customers (£bn)	235.6	17.0	252.6	110.1	67.1	0.2	430.0
Customer deposits (£bn)			154.0	48.4	23.6	17.2	243.2
Risk weighted assets (£bn)[1][2]			67.2	164.1	59.7	17.0	309.2
Impaired loans (£m)	4,234	2,269	6,503	3,218	641		10,362
Impaired loans as a % of closing advances (%)	1.80	13.35	2.57	2.92	0.96		2.41
Impairment provisions (£m)	330	1,889	2,219	832	322		3,373
Impairment provisions as a % of impaired loans (%)	8	83	34	26	50		33

(1) Risk weighted assets include £0.8bn (2007 £1.2bn) attributable to Insurance & Investment.
(2) On 1 January 2008 HBOS implemented the Basel II rules for capital adequacy. These balances are therefore presented on a Basel II basis.

Retail

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 (restated) £m
Net interest income	**4,237**	3,996
Underlying non-interest income	**1,287**	1,265
Underlying net operating income	**5,524**	5,261
Underlying operating expenses	**(2,029)**	(2,045)
Underlying operating profit before provisions	**3,495**	3,216
Impairment losses on loans and advances	**(2,230)**	(1,277)
Underlying operating profit	**1,265**	1,939
Non-operating income	**102**	87
Underlying profit before tax	**1,367**	2,026
Net interest margin	**1.66%**	1.62%
Impairment losses as a % of average advances	**0.88%**	0.52%
Cost:income ratio	**36.7%**	38.9%

Balance Sheet and Asset Quality	Year ended 31.12.2008	Year ended 31.12.2007 (restated)
Loans and advances to customers	**£255.3bn**	£252.6bn
Classification of Advances*	%	%
Secured	**93.4**	93.3
Unsecured	**6.6**	6.7
	100	100
Impaired loans*	£m	£m
Secured	**6,914**	4,234
Unsecured	**2,209**	2,269
Total	**9,123**	6,503
Impaired loans as a % of closing advances	%	%
Secured	**2.90**	1.80
Unsecured	**13.15**	13.35
Total	**3.57**	2.57
Impairment provisions on advances	£m	£m
Secured	**1,219**	330
Unsecured	**1,819**	1,889
Total	**3,038**	2,219
Risk weighted assets	**£73.7bn**	£67.2bn
Customer deposits	**£143.7bn**	£154.0bn

* Before impairment provisions

Financial Performance

Underlying profit before tax in Retail decreased to £1,367m (2007 £2,026m) as a result of increased impairment losses on loans and advances.

Total operating income increased to £5,524m (2007 £5,261m). Net interest income was the main driver, increasing to £4,237m (2007 £3,996m).

Net interest margin increased 4bps to 1.66%, despite the cost of both wholesale and retail funding increasing as a consequence of the dislocation in financial markets and a more competitive retail savings market. The margin improvement mainly reflects the beneficial impact of higher mortgage acquisition and retention spreads.

Underlying operating expenses decreased to £2,029m (2007 £2,045m) and reflect the continued benefit from cost reduction initiatives in prior years together with further cost reduction measures taken during 2008.

Impairment losses increased to £2,230m (2007 £1,277m). Secured impairment losses were £1,125m (2007 £28m) with the charge for unsecured lending at £1,105m (2007 £1,249m). The difficult market conditions have seen total impaired loans increase to 3.57% (2007 2.57%) of closing advances.

Operational Performance

Loans and advances increased to £255.3bn (2007 £252.6bn) due to growth in mortgages, with balances in each of the three unsecured product areas remaining broadly unchanged. Deposit balances reduced to £143.7bn (2007 £154.0bn) caused by the dislocation in financial markets, intense competition for retail funds and outflows caused by the general uncertainty in the banking sector and greater awareness of the Financial Savings Compensation Scheme (FSCS) limit of £50,000 per banking licence.

Mortgages

Given the slowing market and the increased cost of borrowing, price and criteria changes have been made to focus asset growth selectively, both to manage the overall risk profile and improve risk adjusted returns on capital. As a result, the proportion of high loan to value (LTV) business has been reduced, delivering new business LTV of 67% for the full year (2007 65%) against a backdrop where equity for both home purchasers and remortgage customers has been eroded by negative HPI. Gross lending for 2008 was £50bn (2007 £73bn), representing a market share of 20% (2007 20%). Principal repaid was £47bn (2007 £58bn), representing a market share of 22% (2007 23%). As a consequence, net lending was £3bn (2007 £15bn), representing a 9% (2007 15%) market share.

Unsecured lending

In the current economic environment the cautious approach to unsecured lending continues with the acquisition strategy being to target the existing customer base with an increased focus on credit risk and proactively tighten credit availability to existing credit card customers.

Savings and Banking

2008 has been characterised by far greater volatility of flows. Despite these difficult market conditions, HBOS retains its market leading position of Household Sector Liquid assets with a market share of 13.2% (2007 15.6%) and this position, combined with the brand and distribution strength together with innovative products, provides an excellent platform from which to attract future inflows. The competitiveness of the range of current accounts has continued to drive the sales momentum. New bank accounts acquired totalled 960,000 (2007 1 million) and of these 75% (2007 75%) were full facility current accounts.

Corporate

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 (restated) £m
Underlying net interest income	**2,280**	2,172
Underlying non-interest income	**(1,465)**	1,806
Underlying net operating income	**815**	3,978
Underlying operating expenses	**(939)**	(1,000)
Underlying operating (loss)/profit before provisions	**(124)**	2,978
Impairment losses on loans and advances	**(6,669)**	(619)
Underlying (loss)/profit before tax	**(6,793)**	2,359
Net interest margin	**1.92%**	2.15%
Impairment losses as a % of average advances	**5.89%**	0.62%
Cost:income ratio	**115.2%**	25.1%

Balance Sheet and Asset Quality	Year ended 31.12.2008	Year ended 31.12.2007 (restated)
Loans and advances to customers	**£116.4bn**	£110.1bn
Classification of Advances*	**%**	%
Agriculture, forestry and fishing	**1**	1
Energy	**1**	2
Manufacturing industry	**3**	5
Construction and property	**36**	35
Hotels, restaurants and wholesale and retail trade	**10**	10
Transport, storage and communication	**6**	8
Financial	**5**	6
Other services	**10**	12
Individuals	**2**	3
Non-UK residents	**26**	18
	100	100
Impaired loans*	**£13,848m**	£3,218m
Impaired loans as a % of closing advances(1)	**11.90%**	2.92%
Impairment provisions	**£6,563m**	£832m
Risk weighted assets	**£171.5bn**	£164.1bn
Customer deposits	**£38.5bn**	£48.4bn

* Before impairment provisions

(1) 2007 was previously calculated as impaired loans with loss as a percentage of closing advances but has been restated in order to be consistent with 2008.

Financial Performance
Underlying loss before tax was £6,793m (2007 £2,359m profit) due primarily to a significant deterioration in corporate credit conditions, particularly in the second half of 2008.

Underlying net interest income increased to £2,280m (2007 £2,172m) due to the growth in the loan book arising in the first half of the year. This was partially offset by lower margins reflecting slowing of back book churn which has impacted the timing of fee recognition and the increased cost of deposits and higher wholesale funding costs.

Underlying non-interest income decreased to a loss of £1,465m (2007 £1,806m profit). Pronounced falls in estimated values of property and other investments resulted in substantial losses from the investment portfolio, primarily in the private equity and joint ventures businesses.

Underlying operating expenses decreased to £939m (2007 £1,000m) reflecting lower levels of performance based remuneration and lower headcount.

Impairment losses on loans increased to £6,669m (2007 £619m). Impaired loans as a percentage of closing advances increased to 11.90% (2007 2.92%). The level of impairment losses experienced, especially in the last quarter, was principally a reflection of the acceleration in the deterioration in the economy and as a result of applying a provisioning methodology more consistent with that used by Lloyds TSB. The shape of the Corporate book, and in particular its exposure to housebuilders, risk capital (loan stock, preference shares and ordinary shares) and large single credit exposures, exacerbated the impact.

Given the economic environment and the significant deterioration in credit quality and reflecting a provisioning methodology more consistent with that used by Lloyds TSB, the Collective Provision has been strengthened in the year by £1,366m resulting in a provision at the end of the year of £1,500m (2007 £134m).

Operational Performance
Advances increased by 6%. This growth was primarily at the start of the year due to a pipeline of business at the end of 2007. Foreign exchange movements account for 6% of the growth. Customer deposits decreased by £9.9bn to £38.5bn mainly due to the dislocation in financial markets, customers spreading their deposits across several institutions and the draw down by corporates for working capital.

The business is organised by the following asset classes:

In Real Estate as UK property values have fallen, increases in advances has been restricted to a small number of existing customers drawing down existing commitments.

In Commercial existing lending customers and new, primarily deposit led, full banking relationships were focused on.

In Asset Solutions the vehicle finance businesses have been materially impacted in 2008 by residual value and impairment losses on assets.

Specialised Industry Finance (SIF) businesses performed well in 2008 in a difficult market environment.

The Joint Ventures business has seen an extremely challenging 2008 across all sectors in the UK, with housebuilding suffering from falling volume sales and the negative impact on land values. Commercial property has also been adversely impacted by the rapid deterioration in credit markets and the underlying economy significantly reducing values.

Integrated, Structured & Acquisition Finance has been materially impacted by the reduced deal volumes and falling asset values experienced across the private equity sector in the UK and continental Europe. The drawn LBO portfolio debt totalled £6.7bn (end 2007 £6.0bn) with undrawn facilities totalling £1.3bn (end 2007 £1.3bn).

Insurance & Investment

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Net interest expense	**(97)**	(98)
Underlying non-interest income	**1,731**	1,591
Underlying net operating income	**1,634**	1,493
Underlying operating expenses	**(895)**	(849)
Underlying profit before tax	**739**	644

General Insurance Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Net interest expense	**21**	23
Underlying non-interest income	**537**	358
Underlying net operating income	**558**	381
Underlying operating expenses	**(193)**	(149)
Underlying profit before tax	**365**	232

Investment Business Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
New business - insurance contracts	**254**	269
New business - investment contracts	**(236)**	(221)
Expected return on existing business	**378**	361
Actual vs. expected	**62**	122
Expected return on shareholders' net assets	**143**	115
Development expenditure	**(65)**	(67)
Overheads associated with development activity	**(31)**	(39)
Debt financing cost	**(131)**	(128)
Underlying profit before tax	**374**	412

Financial Performance
Underlying profit before tax in Insurance & Investment increased to £739m (2007 £644m).

In 2008, the division contributed £1,135m to the Group capital position, through dividend payments (2007 £312m). Of this, £595m arose from the Investment business demonstrating the continued focus on improving capital efficiency. The majority of this dividend was paid in December 2008 after full consideration of exceptional market conditions and future downside scenarios. The capital strength of the life businesses remains strong.

General Insurance
General Insurance underlying profit increased to £365m (2007 £232m), in part reflecting more benign weather conditions this year, following the flood events in 2007.

Household insurance has performed strongly, driven by increased sales, improved customer retention and claims management, primarily due to lower weather related claims compared to 2007's claims of £135m. Underlying operating expenses increased to £193m (2007 £149m) which included the significant spend in marketing resource in the Motor business to capitalise on growth opportunities available.

Investment Business
Investment underlying profit decreased to £374m (2007 £412m), reflecting the difficult trading conditions which reduced new business volumes, particularly investment bonds.

HBOS adopts a Traditional Embedded Value approach to accounting for insurance and participating investment contracts under IFRS 4. Effective 1 July 2008, certain assumptions in this methodology were changed to bring them more into line with a market consistent approach to embedded value reporting. It is not however fully compliant with the CFO Forum's Market Consistent Embedded Value Principles published in June 2008.

The effect of this change on the IFRS results was to increase embedded value profit before tax by £108m. In addition, the new business contribution in 2008 was £18m higher than would have been reported on the previous assumptions.

On a like-for-like basis the contribution from new business insurance contracts has decreased by 20% to £254m principally due to lower investment bond sales through the Bancassurance channel. New business strain on investment contracts was higher at £236m (2007 £221m) reflecting a shift in business mix, driven mainly by increased strain on mutual funds business.

Actual versus expected experience was £62m (2007 £122m) driven by three principal components. Firstly, a £103m benefit arose from enhancements to the intermediary bond customer proposition, with the result that their accounting treatment changed to an EV basis, accelerating the recognition of profits. With effect from 1 July 2008, in line with evolving industry practice, HBOS moved to a more market consistent version of embedded value, giving a net benefit of £108m. Thirdly, adverse persistency experience (current year and assumption changes), particularly on Bancassurance investment bonds, driven by market uncertainty and adverse publicity, impacted performance by £225m. Additionally a number of individually smaller refinements to the calculation of value of in-force business, actuarial liabilities and other items led to a £76m net benefit.

Operational Performance
General Insurance sales increased to £1,799m of gross written premiums (GWP) (2007 £1,761m). Strong performances in both Motor (up 41%) and Household (up 6%) offset the lower sales in Repayment Insurance (down 15%).

Investment sales measured on a PVNBP basis decreased to £13,659m (2007 £14,775m). 2007 reported sales of £16,551m PVNBP included £1,776m PVNBP in respect of the Guaranteed Growth Bond (GGB) product which is no longer sold given its relatively low profitability.

Overall sales performance demonstrated the benefits of the multi channel diversification, with Intermediary sales up 6%, Wealth Management down 4% and Bancassurance sales down 17%. Positive net fund flows of £1.9bn (2007 £1.7bn) have been delivered, supported by improvements from successful retention initiatives.

International

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Net interest income	1,474	1,088
Underlying non-interest income	484	499
Underlying net operating income	1,958	1,587
Underlying operating expenses	(846)	(714)
Underlying operating profit before provisions	1,112	873
Impairment losses on loans and advances	(958)	(116)
Underlying profit before tax	154	757
Net interest margin	1.90%	1.93%
Impairment losses as a % of average advances	1.50%	0.20%
Cost:income ratio	43.2%	45.0%

Balance Sheet and Asset Quality	As at 31.12.2008	As at 21.12.2007
Loans and advances to customers	£61.0bn	£67.1bn
Classification of Advances*	%	%
Agriculture, forestry and fishing		2
Energy	3	2
Manufacturing industry	4	3
Construction and property	31	27
Hotels, restaurants and wholesale and retail trade	10	9
Transport, storage and communication	3	2
Financial	4	3
Other services	10	8
Individuals:		
Home mortgages	30	40
Other personal lending	5	4
	100	100
Impaired loans*	£3,060m	£641m
Impaired loans as a % of closing advances	5.02%	0.96%
Impairment provisions	£1,092m	£322m
Risk weighted assets	£56.7bn	£59.7bn
Customer deposits	£6.6bn	£23.6bn

* Before impairment provisions.

Financial Performance

Underlying profit before tax decreased to £154m (2007 £757m) reflecting an increase in impairment losses, as a result of a deteriorating economic environment. Operating profit before provisions increased to £1,112m (2007 £873m), reflecting strong income growth across all three International divisions.

Impairment losses increased from £116m in 2007 to £958m in 2008. In Australia and Ireland, the extremely challenging economic and market conditions led to a deterioration in credit quality which resulted in rising arrears and falling asset values. In ENA deteriorating economic conditions across the key markets saw impaired loans increase, however the increase in impairment losses was driven primarily by two large exposures.

Australia

Underlying profit before tax in Australia decreased to £206m (2007 £308m) reflecting an increase in impairment losses which has been particularly prevalent across the Property and Corporate sectors.

The income statement includes 2008 results for the BankWest and St. Andrews businesses up until their disposal on 19 December 2008 to Commonwealth Bank of Australia, and the full year results for all other HBOS Australia businesses.

Ireland

Underlying loss before tax in Ireland was £262m (2007 £184m profit) and reflects a substantial increase in impairment losses from a low base along with higher funding costs. The extremely challenging economic and market conditions have led to a significant deterioration in credit quality and as a consequence, higher impairment losses have been recognised.

Europe & North America

Underlying profit before tax decreased to £210m (2007 £265m), reflecting a deliberate slowdown in new lending activity and an increase in impairment losses, both of which are symptomatic of current economic conditions in a year of economic turbulence across all the operating geographies. Underlying operating profit before provisions increased to £332m (2007 £278m).

Lending and Deposit Growth

Loans and advances were £61.0bn (2007 £67.1bn). Part of this decline reflects a £27.0bn reduction in balances in Australia following the sale of BankWest and St. Andrews. In Ireland, lending increased to £30.7bn (2007 £21.9bn), and in local currency growth was 8%. In ENA, lending increased to £17.5bn (2007 £12.0bn), local currency growth was 10%.

Deposits declined by £17.0bn to £6.6bn (2007 £23.6bn) primarily reflecting the sale of BankWest. On a like-for-like basis, excluding BankWest, deposits fell by £0.8bn to £6.6bn, reflecting significant outflows caused by uncertainty prior to the announcement of the Lloyds TSB acquisition of HBOS and the Irish government deposit guarantee scheme (the Scheme). However, the deposit base increased following the announcement not to join the Scheme.

Treasury & Asset Management

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 (restated) £m
Net interest income[1]	**181**	156
Underlying non-interest income[1]	**445**	655
Underlying net operating income[1]	**626**	811
Underlying operating expenses	**(305)**	(329)
Underlying operating profit[1]	**321**	482
Non-operating income		4
Underlying profit before tax[1]	**321**	486
Impact of Market Dislocation	**(3,948)**	(227)
Underlying (loss)/profit before tax	**(3,627)**	259
Cost:income ratio[1]	**48.7%**	40.6%
Insight's assets under management	**£119.2bn**	£109.1bn
Invista's assets under management	**£6.3bn**	£8.7bn
Risk weighted assets	**£25.3bn**	£17.0bn

(1) Excluding the impact of Market Dislocation.

Financial Performance
Underlying profit before tax (excluding the impact of Market Dislocation) decreased to £321m (2007 £486m). Including the impact of Market Dislocation of £(3,948)m (2007 £(227)m) loss before tax was £(3,627)m (2007 profit before tax of £259m).

Operating Income
Underlying sales of Treasury products to customers remained robust but operating income was adversely affected by the impact of dislocated financial markets on trading revenues.

Operating Expenses
Underlying operating expenses decreased to £305m (2007 £329m) primarily reflecting a reduction in performance related staff costs.

Treasury Debt Securities
As part of its investment credit activities Treasury holds a portfolio of debt securities which are analysed on page 12. The investment credit business has two functions: firstly it manages part of the Group's prudential liquidity portfolio and secondly it takes investment positions principally through the Grampian conduit.

Following the International Accounting Standards Board's (IASB) decision to permit the reclassification of Financial Assets, Treasury reclassified certain securities from assets held for trading into the Available for Sale (AFS) portfolio and, subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS, to Loans and Receivables.

ABS and FRNs with book values (as at 31 December 2008) of £10.1bn and £3.4bn respectively were transferred out of Trading into the AFS portfolio with effect from 1 July 2008. Subsequently, ABS with book values (as at 31 December 2008) of £37.2bn were transferred out of the AFS portfolio and into Loans and Receivables with effect from 1 November 2008. If these assets had not been reclassified during the year additional negative fair value adjustments (NFVA) of £981m would have been recognised in the income statement and the AFS reserve movement would have been reduced by £68m (post tax).

The decrease in ABS to £40.2bn (2007 £41.9bn) was due to paydowns of £4.3bn and NFVA and impairments of £8.6bn, partially offset by the effects of foreign currency movements which resulted in an increase of £11.3bn. The holding of bank CDs have reduced through maturities being replaced with Government backed bonds.

Market Dislocation losses
For the year to 31 December 2008, losses taken to the income statement due to the impact of Market Dislocation on the Treasury debt securities portfolio totalled £3,948m (2007 £227m), after reclassification, as follows:

Income Statement	Year ended 31.12.2008 £m	Year ended 31.12.2007 £m
Negative fair value adjustments	**(2,527)**	(227)
Impairment losses	**(1,421)**	
Total impact of Market Dislocation[1]	**(3,948)**	(227)

(1) Comprising £96m in net interest income and £(4,044)m (2007 £(227)m) in underlying non-interest income.

During the second half of the year a significant deterioration in market sentiment and liquidity has affected the fair value of the ABS portfolio and in particular certain asset classes including Alt-A bonds and CDOs. In addition the adverse trends on credit quality which commenced in the first half of 2008 have intensified in the second half of 2008 and early 2009 and as a result, impairment losses of £0.8bn have been incurred, primarily relating to Alt-A, £0.6bn and ABS CDOs, £0.1bn. As a result of these developments, certain asset classes have been written down significantly at year end, resulting in the Alt-A portfolio with an average carrying mark of 59%, ABS CDOs of 20% and other CBO positions of 53%.

In addition, following the failure of a number of financial institutions in the second half of 2008 impairment losses of £0.6bn have been incurred on the FRN book relating to the exposures to Lehman Brothers, Washington Mutual and Icelandic Banks.

Exposures to monolines
Treasury has credit exposure both through negative basis trades with purchased CDS protection and wrapped bonds. As at 31 December 2008, nominal exposures were £3.7bn of negative basis CDS (2007 £2.8bn) and £2.6bn of wrapped bonds (2007 £2.3bn). The calculated exposure to monolines using the internal methodology at 31 December 2008 was £1.2bn (2007 £0.4bn).

Asset Management
Equity markets have fallen dramatically in 2008, but Insight's strategic focus on Liability Driven Investment (LDI), Fixed Income, Cash and Absolute Return products has been effective. Insight has experienced net inflows of £13.4bn in 2008 (2007 £9.8bn). The majority of these sales are within the Institutional channel and largely into the market leading LDI capability. Overall, net inflows in Insight have more than offset market depreciation such that assets under management have increased by 9% to £119.2bn (2007 £109.1bn). Invista's assets under management declined to £6.3bn (2007 £8.7bn).

Treasury & Asset Management

Treasury debt securities

Treasury's total debt securities portfolio as at 31 December 2008, net of negative fair value adjustments (NFVA) and impairments, is summarised in the following table:

Asset Class	Loans & Receivables £bn	Available for Sale £bn	Fair Value through P&L £bn	Total as at 31.12.08 £bn	Total as at 31.12.07 £bn
Asset Backed Securities					
Direct	20.5		3.0	**23.5**	23.3
Grampian conduit	16.7			**16.7**	18.6
Total ABS	37.2		3.0	**40.2**	41.9
Covered Bonds		4.1		**4.1**	3.2
Bank/Financial Institution Floating Rate Notes (FRNs)		16.0	1.9	**17.9**	17.4(1)
Bank Certificates of Deposit (CDs)		2.9	3.1	**6.0**	15.3(1)
Other(2)		1.8	6.0	**7.8**	2.8
Total Treasury Assets	**37.2**	**24.8**	**14.0**	**76.0**	80.6
Landale		0.7		**0.7**	0.6
Total (net of NFVA and impairment provisions)	**37.2**	**25.5**	**14.0**	**76.7**	81.2

(1) £1.6bn reclassified between CDs and FRNs.
(2) Principally Governments and Supra-nationals.

Exposure to Asset Backed Securities (ABS)

Asset Class	Net Exposure as at 31.12.08 £bn	Average Mark as at 31.12.08 %	Net Exposure as at 31.12.07 £bn	Average Mark as at 31.12.07 %
Mortgage Backed Securities				
US RMBS(1)	**6.9**	**64**	9.3	98
Non-US RMBS	**7.9**	**93**	7.9	99
CMBS(1)	**3.3**	**95**	3.3	99
	18.1	**79**	20.5	99
Collateralised Debt Obligations				
CBO(1)	**2.1**	**49**	3.3	98
CLO(1)	**3.5**	**91**	3.2	99
	5.6	**68**	6.5	99
Personal Sector				
Auto Loans	**1.6**	**98**	1.5	100
Credit Cards	**3.5**	**96**	2.8	99
Personal Loans	**1.1**	**95**	1.0	98
	6.2	**96**	5.3	99
FFELP Students Loans(1)	**7.0**	**94**	5.6	98
Other ABS	**0.6**	**89**	0.7	99
Total Uncovered ABS	**37.5**	**82**	38.6	99
Negative Basis(2)	**2.7**	**70**	3.3	99
Total ABS(3)(4)	**40.2**	**81**	41.9	99

(1) RMBS means Residential Mortgage Backed Securities; CMBS means Commercial Mortgage Backed Securities; CBO means Collateralised Bond Obligations; CLO means Collateralised Loan Obligations; FFELP means Federal Family Education Loan Programme.
(2) Negative basis means bonds held with separate matching credit default swap (CDS) protection.
(3) The total comprises US securities of £24.3bn and Non-US securities of £15.9bn.
(4) There has been no increase in net exposure as a result of the purchase of ABS during the year. Any increase in net exposure is the result of exchange rate movements in excess of paydowns, NFVAs and impairments.

Risk Management

Introduction

During 2008, the global dislocation in financial markets has resulted in exceptional instability and volatility, impacting upon market and investor confidence which has been characterised by a marked reduction in liquidity in the international money markets. This crisis which started in 2007 and has impacted upon financial markets since, led the UK Government to inject liquidity into the financial system and to require (and participate in) recapitalisation of the banking sector to restore confidence to the market.

On 13 October 2008, as part of the co-ordinated package of capital and funding measures for the UK banking sector, implemented by HM Treasury, the Group participated in the Government Funding Package and thereby facilitated access to the UK Government backed provision of liquidity.

Global market and economic conditions continue to pressurise the Group. However, through the injection of capital and liquidity facilitated by the UK Government, both currently and going forward, HBOS remains confident it will navigate through this difficult period, as it becomes part of the Lloyds Banking Group (LBG).

As a wholly owned subsidiary, HBOS is dependent on LBG for funding.

The key dependencies on successfully funding the enlarged Group's balance sheet include the continued functioning of the money and capital market at their current levels; the continued access of the Group to central bank and Government sponsored liquidity facilities, including issuance under HMT's credit guarantee scheme (CGS) and access to the Bank of England's various facilities, limited further deterioration in the Group's credit ratings and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or Government support schemes.

The Lloyds Banking Group was created on 16 January 2009. Subsequently, HBOS has adopted LBG Risk practices. This report discusses Risk practices in effect in HBOS during 2008.

Key risks and uncertainties facing the Group

This section describes the risk factors which are considered to be material in relation to the Group.

These risks should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. Additional risks and uncertainties that are not presently known, or which are currently deemed immaterial, may also have an adverse effect on the Group's operating results, financial condition and prospects.

Each of the Divisions faces key risks and uncertainties in the execution of their strategy. These are set out in the divisional sections of the Business Review, where they can be read in conjunction with the Division's strategy, and financial and operating performance.

Credit Risk: The financial performance of the Group is affected by borrowers ability and willingness to repay amounts lent by the Group

Credit risk arises in the Retail, Corporate & International divisions and the Treasury function, reflecting the risks inherent in the Group's lending activities. Over the last year the banking crisis has impacted the financial services industry resulting in high profile losses and writedowns.

The deteriorating economic outlook, both in the UK and overseas, is also leading to significant increases in impairments. The Group is impacted by the economic downturn and a further worsening of the business environment could impact earnings adversely. This poses a major risk to the Group and its lending businesses in:

- Retail, where rising unemployment impacts the ability of customers to meet repayment dates on unsecured and secured lending and leads to a consequent increase in arrears. Additionally, the downturn in the housing market reduces collateral values for residential property and this impacts upon the profitability of secured lending.
- Corporate, where companies are facing increasingly difficult conditions, resulting in corporate default levels rising and leading to increases in corporate impairments.

Liquidity Risk: The Group may be unable to meet its financial obligations as they fall due or is unable to raise sufficient funds to take full advantage of growth opportunities

This is known as liquidity risk and arises from mismatches in the maturities and the timing of cashflows relating to assets, liabilities and off-balance sheet instruments. HBOS relies and intends to rely increasingly on customer savings and transmission balances, as well as ongoing access to the wholesale lending markets, central bank liquidity facilities such as the Special Liquidity Scheme and the Extended Open Market Operations operated by the Bank of England, and support from HM Treasury's guarantee scheme.

Further information about the approach to managing liquidity risk is explained on pages 25 to 28.

Risk Management continued

Market Risk: Changes in interest rates, credit spreads, foreign exchange rates and commodity and equity prices and other market risks affect the HBOS Group's business and financial results
This is referred to as market risk and is defined as the potential loss in value or earnings of the HBOS Group arising from changes in external market factors such as interest rates, credit spreads, foreign exchange rates, commodity and equity prices and the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions. Changes in interest rate levels, yield curves and credit spreads may affect the interest rate margin realised between lending and borrowing costs.

Further information about the management of, and exposure to, market risk is set out on pages 22 to 25.

Capital: The Group may have insufficient capital resources to meet the regulatory minimum requirements, to finance growth, or to support its credit rating
Capital discipline is a key element of the Group's strategy. Capital is a scarce resource and the task is to deploy it to achieve sustainable returns and add value for shareholders. To strengthen the Group's capital position, HBOS launched a wholly underwritten £4bn Rights Issue in May 2008. However further market pressures, the failure of Lehman Brothers in the US and S&P downgrading of HBOS had a severe impact on the Group, ultimately resulting in the recommended acquisition of HBOS plc by Lloyds TSB Group plc.

Based upon projections by management, assuming the availability of the existing and announced Government Funding Package, the Group believes it has adequate resources to continue in business for the foreseeable future.

The Group's approach to the management of capital is set out on pages 31 to 33.

Insurance and Investment Risk: The Group's earnings may be affected by the potential for loss through adverse claims, expense and persistency experience, from both life and general insurance contracts
Insurance and investment risk and its management is described in more detail on pages 28 to 30.

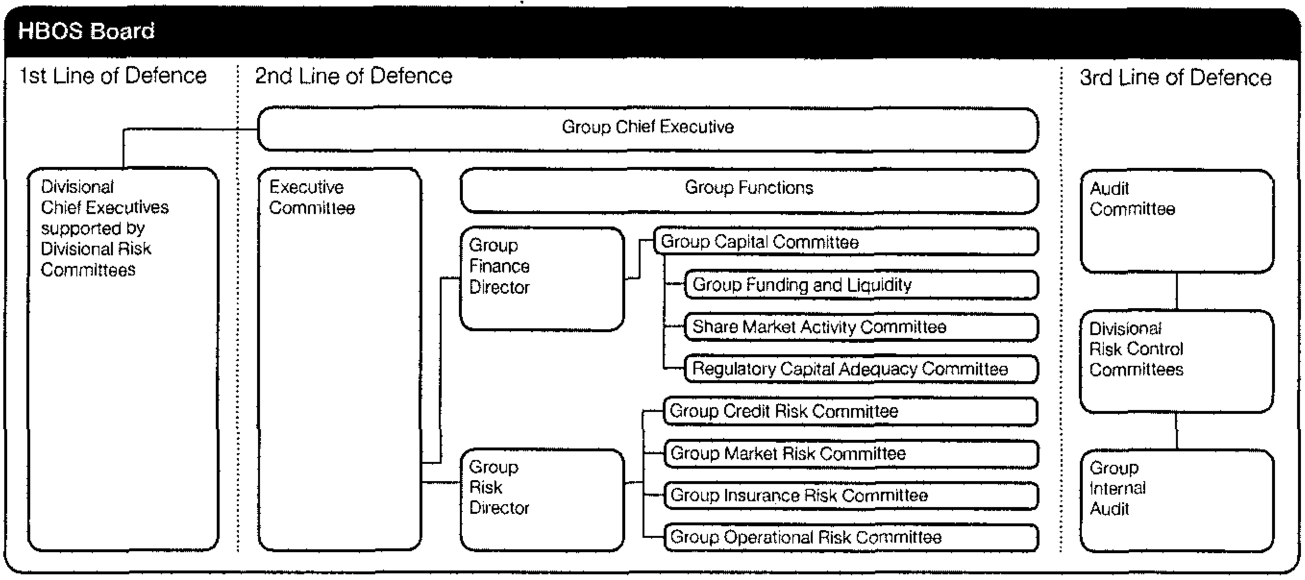
Operational Risk: Operational risks exist in the normal course of the Group's business
In a large organisation with many different processes, IT systems and colleagues, there is a risk that operational losses can result. Examples of the sources of such risks include fraud, systems reliability, human error, failure of key suppliers, IT security, change management, operational outsourcing or failure to comply with legislation or regulation. Further information about the management of operational risk is set out on page 31.

Regulatory Risk: The Group's business and earnings can be affected by changes in financial services laws and regulations in each of the locations in which it operates
Any significant regulatory changes could affect how the Group conducts business and its financial performance. Regulatory risk is explained in detail on pages 31 to 33.

Management and Controls

Governance

The governance model comprises a well established and embedded committee structure and associated control environment across the Group. The business and control environments of St. James's Place plc and Invista Real Estate Investment Holdings plc fall outwith the governance framework described in this section of the Annual Report and Accounts. The framework discussed describes that in effect in HBOS for the financial year.



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'.

1st Line of Defence	RISK MANAGEMENT	• Divisional CEOs • Divisional Risk Specialists • Divisional Risk Committees	• Strategy • Performance • Risk control
2nd Line of Defence	RISK OVERSIGHT	• Group Chief Executive • Executive Committee • Group Functions (inc. Group Risk and Group Finance) • Executive Risk Committees	• Centralised policy management • Independent oversight of risk
3rd Line of Defence	RISK ASSURANCE	• Audit Committee • Divisional Risk Control Committees • Group Internal Audit	• Independent assurance

Risk Management continued

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 four Group Executive Risk Committees - Group Credit Risk Committee, Group Market Risk Committee, Group Insurance Risk Committee and Group Operational Risk Committee develop the policies and parameters within which Divisions are required to manage risk. The Committees provide central oversight by reviewing and challenging the work of the Divisions' own risk committees and considering the application of appropriate risk management techniques.

The specialist Group Risk function, reporting to the Group Risk Director, supports these Committees. Its responsibilities 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 of risk management techniques; and
- to aggregate risks arising in the Divisions and to monitor the overall Group position independently from the Divisions' own analysis.

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 focus 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 and within regulatory ratios.

In judging the effectiveness of the Group's controls, the Board reviews the reports of the Audit Committee and management.

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 assurance that there is an appropriate control structure throughout the Group.

The Audit Committee, supported by Divisional Risk Control Committees, obtains assurance about the internal control and risk management environment through regular reports from Group Functions (including Group Risk and Group Finance) and Group Internal Audit. It also considers external auditors' reports.

Management of Key Risks

(The information set out below, up to and including the section entitled 'General Insurance' on page 30 forms an integral part of the audited financial statements as described in the Accounting Policies section of the Financial Statements on page 48.)

Credit Risk

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

Credit Risk Performance

During the second half of 2008 the pressures being experienced in wholesale and liquidity markets spread to become severe economic deterioration in the UK. This pressure accelerated significantly in quarter four 2008 and saw substantial issues arising in Corporate lending and Treasury investments.

The Corporate Division's Credit Risk Management was unable to react quickly enough to contain the deterioration, exacerbated by HBOS historic levels of exposure concentration within property and property related sectors, giving little room for manoeuvre in a deteriorating market and resulting in impairment losses increasing dramatically.

In addition, Treasury has been materially impacted by the reduction in fair value of the ABS portfolio as a result of credit concerns, poor market sentiment and liquidity pressures. This has been exacerbated following a strategic decision of moving away from using Government bonds to provide liquidity, instead relying on AAA rated Asset Backed Securities and investment grade bank FRNs, which whilst effective in liquidity terms, significantly increased the credit risk profile of the Group.

The credit risk risk profile within HBOS is susceptible to further increases in impairments if the UK economy continues to deteriorate. Additional pressure will also be evident in Treasury's ABS portfolio if US real estate values fall further, resulting in increasing fair value and impairment losses.

Management of Credit Risk

The Group Credit Risk Committee (GCRC), one of the Executive Risk Committees, is chaired by the Group Risk Director and comprises senior executives from across the business Divisions, Group Risk and Group Finance functions. It meets monthly and reviews the Group's lending portfolio, approves Group credit standards, limits and divisional credit risk policies. The Group Credit Risk Policy Statement is approved by the Board on an annual basis. The GCRC also assists the Board in formulating the Group's credit risk appetite in respect of key products and sectors.

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 and forward looking risks of each divisional portfolio to the GCRC (and other senior HBOS committees), Group Credit exercises independent oversight over the effectiveness of credit risk management practices and adherence to approved 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 divisional committees, under lending authorities delegated by the Board (via GCRC). Typically, functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts and credit risk model build and governance.

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

- For retail portfolios, extensive use is made of credit scoring in the assessment of new applications for credit. In addition, 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 and in identifying customers at risk of default. Affordability is a vitally important measure and is reviewed in combination with either application and/or behavioural scores. HBOS has been involved in data sharing initiatives within the industry and makes extensive use of credit bureau files to inform the assessment of customer risk and affordability and to aid responsible lending. Small business customers are assessed for their credit-worthiness in a similar manner to retail customers.

- For corporate portfolios, a full credit assessment of the financial strength of each potential transaction and/or customer is undertaken, including a stress test of key financial aspects of the transaction, awarding an internal risk rating which is reviewed regularly. The same approach is also used for larger SME (small to medium enterprise) customers.

- Within Treasury Division (Treasury), which handles the Group's banking and sovereign related exposures, as well as the Group's structured credit bond (ABS) portfolio held for liquidity and proprietary purposes, focused credit risk policies are established and reviewed by the Group Wholesale Credit Committee (GWCC), a sub-committee of the GCRC. Basel II Advanced IRB compliant models are used to rate banking and sovereign counterparties. Structured credit bonds are reviewed individually by an independent credit function prior to purchase and an internal rating is applied to all exposures. Additional thresholds and limits are applied by rating and by asset class in line with the business strategy. As part of an ongoing portfolio review process, monitoring is performed covering each bond holding, supplemented by stress analyses conducted on a periodic basis.

An additional measure within the credit risk framework is the establishment of product, risk profile, industrial sector and country limits to manage excessive concentrations of risk. Material portfolios, such as mortgages, have approved sub-sector limits to ensure that they remain within plan and tolerance for risk. All such limits are set and monitored by the GCRC.

Standards have been established across the Group for the management of credit risk. All Divisions are independently rated against these internal standards by the Group Credit function (on an annual basis) and work together to continuously improve credit risk management capability. There continues to be significant levels of investment in the development of credit risk rating tools, including enhancements to the portfolio risk measurement systems and in governance arrangements to support operations within the terms of the Basel II Accord. These include principles for development, validation and performance monitoring of credit risk models. The approval process for credit models is dependant upon the materiality of the model, with all models impacting the regulatory capital calculation requiring approval by the Group Model Governance Committee (GMGC), which is a sub-committee of GCRC, and those deemed material to the Group being approved by the Group Capital Committee (GCC).

Internal reporting has developed in response to the introduction of improved rating tools. Senior Management across the Group are now provided with reports assessing the risk profile in terms of Probability of Default and Expected Loss and will continue to do so under the Basel II environment going forward.

Standard Technical Definitions

- PD – Probability of Default. The probability that an obligor enters default in the next 12 months.

- EAD – Exposure At Default. The obligor's credit exposure at the point of default, assuming default occurs within the next 12 months.

- LGD – Loss Given Default. The proportion of an obligor's exposure at default that the lender loses as a result of default, assuming that default occurs within the next 12 months. This is a percentage.

- EL – Expected Loss. The monetary amount expected to lose from an obligor, arising from a default in the next 12 months.

Derived by the formula EL = PD x EAD x LGD.

Scope of HBOS IRB Permission

In the period to 31 December 2007 HBOS operated under what is commonly know as the Basel I regulatory capital regime. Under Basel I the FSA required each bank and banking group to maintain an individually prescribed ratio of total capital to risk-weighted assets, taking into account both balance sheet assets and off-balance sheet transactions. From 1 January 2008 HBOS, in common with UK peers, adopted the Basel II framework through application of the FSA BIPRU rules.

Basel II seeks to augment arrangements and introduces a risk sensitive framework. Basel II is structured to provide a choice of methodologies to determine credit risk regulatory capital requirements, with different levels of complexity.

Risk Management continued

HBOS makes use of the Standardised and Advanced Internal Ratings Based (AIRB) approaches with no portfolios using the Foundation Internal Ratings Based approach.

- Standardised approach. This is an extension of Basel I and requires banks to use external credit ratings to determine risk weightings for rated counterparties. Like Basel I, it groups other counterparties into broad categories and applies regulatory determined risk weightings to these categories.
- Advanced Internal Ratings Based approach (AIRB). This is the most sophisticated approach. Banks use their own internal assessment of PD, EAD and LGD to determine risk weight asset values.

HBOS is approved by the FSA to use the Advanced Internal Ratings Based approach (AIRB) for regulatory capital purposes.

The scope of permission covers all Basel II asset classes, however, HBOS has a model roll-out schedule to complete, predominately in relation to International and Corporate businesses. The roll-out plan and mandatory parallel run will run until the end of 2010.

Beside these, HBOS has a number of small portfolios where, for economic reasons, it is not commercially viable to construct AIRB models. These are typically products which are no longer sold and effectively in run off mode or new products where HBOS has yet to establish the critical mass of data necessary to construct AIRB models. In such cases the Standardised approach is applied.

The models that are used in the regulatory capital calculation also underpin the credit risk measurement framework used by HBOS. It is a regulatory requirement that the models deployed in the capital calculations are used to inform credit related decisions.

Internal Ratings Process

For each IRB asset class the approach has been to build internal models to generate PD's, LGD's and EAD's for products within the asset class. This is summarised below.

Retail Assets - Retail assets include residential mortgages, overdrafts, credit cards and unsecured personal lending exposures. The methodology for Retail assets is transaction based, with a foundation in the scorecards used for application decision and account management. The regulatory EL is mapped to a Lifetime Expected Loss (LEL) which is used in wider business processes, including assessment of risk appetite and pricing.

Corporate Assets - Corporate assets include exposures to corporate and SME entities. The methodology for non specialised lending Corporate assets considers, individually, the obligor PD, the transaction EAD and LGD then combines these to produce the transaction EL. The approach within HBOS to estimating PD has been to undertake a statistical analysis of the obligor's financial statements with a supplementary qualitative but standardised overlay.

This is then calibrated to the historically identified (and where necessary appropriately adjusted) default rate for the portfolio in hand. EAD estimates are based on current exposures plus an additional proportion of the undrawn positions. The LGD component is estimated, taking account of the EAD less any recognisable collateral.

Specialised Lending Assets - This asset class predominantly comprises property investment and property development transactions but also includes major asset financing deals, such as shipping and aircraft. This is a transaction based approach. Where full models are in place, the methodology has been to stochastically assess the transaction's cash flows over its lifetime and use this to calculate the 12 month EL.

Financial Institutions and Sovereign Assets - This comprises exposures to governments together with exposures to bank counterparties. Given the historical limited default data for such portfolios the methodology for these assets has been to predict what rating would be provided by an External Credit Assessment Institution (ECAI) should the obligor have sought one. This rating is then related to a PD value based upon the long run historic information associated with such ECAI ratings. A transaction EAD is estimated based on the product characteristics while LGD is directly associated with the standing of the obligor. These components are then combined to produce the transaction EL.

Within HBOS, all models have been developed internally and there is no use of external models (although there may be reliance on external feeds such as bureau data, PD ratings for external third parties such as tenants, and feeds to Treasury's Bank rating models). Minimum Standards for the development and monitoring of Credit Risk Models are in force across the Group.

In accordance with the HBOS federal structure, credit risk control units have been established within each divisional risk function. Divisional credit teams are independent from business generation teams and are responsible for:

- development, validation, implementation and recalibration of credit risk models;
- monitoring of the ongoing performance of the credit risk models; and
- securing annual approval of all credit risk models from the appropriate body.

The most material internal rating models are approved for use by Group Capital Committee with the remainder at Group Model Governance Committee, which is a sub-committee of GCRC. Group Credit Risk undertake independent technical review of Divisional credit risk models in accordance with the Group's standards. These reviews take place annually or when a model is materially changed and result in a recommendation to the GMGC or Group Capital Committee where the model is approved for use.

Use of Internal Estimates
The Group has introduced IRB models on a phased basis, ensuring that full confidence in the outputs is built up within the credit areas before moving to full use in decisioning.

IRB parameters are being widely used in the divisions particularly in those that will experience the most material benefit under Basel II and for the most material requirements.

Credit approval
Credit assessment and approval within HBOS is mainly conducted at the divisional level in line with the Group Credit Risk Policy Statement (GCRPS) and divisional credit policy statements. The GCRPS requires adherence to the canons of lending appropriate for a financial institution of HBOS's size and sophistication, and in relation to IRB inputs it specifically requires that:

- each borrower must be assigned a credit rating or score, or directly, a probability of default (PD) which is updated at least annually; and
- PD and EL should be considered as part of a credit assessment.

The divisional processes can be broken down into two main categories:

Portfolio level credit approval (defined as low value, high volume automated credit processes and used primarily for assessing retail portfolios). Typically, Lifetime EL and EL estimates generated from/by IRB models are used to set application scorecard cut-offs. Therefore, the level of business accepted via automated decision making processes is directly influenced by IRB outputs. Decisioning and pricing are linked and LEL outputs are also fed into profitability models that are used to make pricing decisions.

Transaction level credit approval (defined as high value, low volume exposures which are addressed directly by credit analysts - used for corporate, corporate SME, financial institution and sovereign asset classes).

In general, the process operates as follows:

- the relationship manager inputs the appropriate information into the models which return PD / EL outputs; and
- an independent credit risk management unit checks the inputs to the model calculations for accuracy and plausibility (and for outputs); and verifies that the correct model has been used.

Credit Limits
The governance process for limits approval is:

- at Group level, limits for products, sectors and countries are set under the authority of GCRC; and
- within the divisions, sanctioning is conducted under a set of agreed delegated lending authorities granted to individuals or credit committees. These delegated authorities have been revised substantially in response to the deteriorating credit conditions.

Divisional risk committees do not make individual credit decisions but are responsible for putting in place appropriate governance arrangements, approving policies and standards and credit risk rating systems and monitoring all aspects of credit risk within their respective divisions.

Pricing
Transaction/portfolio level pricing is set by the divisions who are increasingly basing these decisions on the outputs of the IRB models.

For Retail, pricing and decisioning are intrinsically linked. The lifetime expected losses are fed into the profit model, along with other costs, to allow a price to be set that generates the required return. All pricing decisions have been assessed using the Basel lifetime expected loss to ensure that current pricing passes the required hurdle rates dependent on the risk involved.

For Corporate, the pricing model facilitates the incorporation of pricing infomation into the credit approval process.

For Treasury, the major activities are funding, liquidity and hedging in external markets on behalf of the wider HBOS group. Treasury is not normally a market maker in the markets within which it operates, and is therefore dependent on prices quoted to it by the market.

Portfolio Reporting
Credit risk reporting is conducted at both Group and divisional levels, embedding IRB parameters into management information. This includes analysing PD, LGD, EAD, and EL measures. Model performance and parameter assessment are also presented.

Factors Impacting Loss Experience
The deterioration in the loss experience generally reflects the increasing economic pressures over the year, characterised by declining economic activity, rising unemployment, the contraction of the mortgage market, reduced availability of credit and the fall in house and commercial property values.

The increase in mortgage losses was driven predominantly by increased affordability pressures and reduced attrition from higher risk customers as well as the rise in Loan to Value ratios due to reduced housing values.

The Corporate credit environment has suffered significant deterioration, with an increasing number of customers operating under stressed conditions. In particular, the exposure to the construction and real estate sectors, where there has been historically large concentrations of lending, have been impacted more severely than other sectors. In addition, HBOS strategy was to support relatively high levels of exposure to a small number of long term customer relationships, these single name concentrations have placed the Group at risk of significant loss, should default occur. The general deterioration of the credit environment and associated market dislocation has limited the options available to Corporate to restructure or dispose of distressed assets. As a result, not only has HBOS been impacted earlier and more significantly than most of its peers, it has been very difficult to materially reduce the balance sheet risk profile in reaction to the environment.

Risk Management continued

Likewise, the loss experience within the International businesses reflects the deteriorating economies within which it operates.

Losses experienced in Treasury are due to both the fair value impact of the market dislocation on the Asset Backed Securities portfolio, including Alt A bonds and CDOs and the well publicised failure of certain bank counterparties resulting in credit impairments. The fall in value has been driven largely by credit concerns, poor market sentiment and liquidity requirements.

Credit Risk Mitigation
Collateral is the pledging of assets which in the event of default can be sold in order to realise some, or all, of the outstanding monies. HBOS has documented policies in respect of the criteria for recognition of collateral taken as credit risk mitigation.

HBOS employs a variety of credit risk mitigation techniques in order to mitigate the credit risk faced. These techniques include netting, collateral, guarantees and credit derivatives.

The Retail mortgage portfolios are formally secured on residential properties. Corporate exposures utilise a broad range of collateral types serving to reduce the loss in event of default. Financial collateral is predominantly cash. Other eligible collateral includes first charges on commercial and residential real estate and other physical assets such as aircraft, shipping, commercial vehicles and car fleets.

On-balance sheet netting is recognised where the agreement is legally effective and enforceable and there is an intention and ability to settle on a net or simultaneous basis in all jurisdictions. In recognising the netting agreements HBOS ensures it can determine at any time those assets and liabilities that are subject to the netting agreement.

On-balance sheet netting is recognised in respect of mutual claims between HBOS and its counterparty. This is limited to reciprocal cash balances between HBOS and the counterparty.

For master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions to be recognised for the purposes of the calculation of regulatory capital, they shall:

- be legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counterparty;
- give the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon the event of default, including in the event of the bankruptcy or insolvency of the counterparty; and
- provide for the netting of gains and losses on transactions closed out under a master agreement, so that a single net amount is owed by one party to the other.

HBOS policy is to calculate the market value of collateral taken and periodically reassess it. Notwithstanding, revaluation is undertaken whenever HBOS has reason to believe that a significant decrease in market value has occurred.

Where the collateral is held by a third party, HBOS takes reasonable steps to try to ensure that the third party segregates the collateral from its own assets.

Where real estate is pledged as collateral the value of the property is frequently assessed. More frequent assessment is carried out where the market is subject to significant changes in conditions.

Statistical methods are used to monitor the value of the property and to identify property that requires to be revalued. The property valuation is reviewed by an independent valuer when information indicates that the value of the property may have declined materially, relative to general market prices.

The value of other physical forms of collateral is assessed on a frequent basis and at a minimum once every year. More frequent assessment is required where the market is subject to significant changes in conditions.

HBOS policy is to ensure it has the ability to liquidate the collateral, the ability to establish objectively a price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility or a proxy of the volatility of the value of the collateral. Both initial valuation and revaluation take into account any deterioration or obsolescence of the collateral. Particular attention is paid in valuation and revaluation to the effects of the passage of time on fashion/date-sensitive collateral.

HBOS policy in recognising collateral is that there is the right to physically inspect the collateral, ensuring also that the collateral taken as protection is adequately insured against damage.

Guarantees exist when one entity commits to paying the outstanding monies in event of default of another entity, which has entered into a transaction with HBOS. The Group receives a variety of guarantee types, however, capital calculation recognition is only taken through the use of PD substitution for guarantees provided by appropriate sovereigns and institutions.

Credit derivatives are an investment banking product whereby HBOS pays a premium to a credit protection provider in order to receive the full amount of monies owed should a specific counterparty default on their obligations. In effect, this is a form of insurance policy and is used in Treasury to mitigate Credit Risk.

Counterparty Credit Risk
Internal capital and credit limits
Bank and Sovereign AIRB rating predictor models are used to produce an internal rating for each counterparty within the portfolio. These ratings are mapped across to statistically derived (based upon Moody's history of default data) PD and LGD tables. When combined with EAD, these values determine EL. To determine EAD exposure, values for derivative products are calculated by using the mark-to-market methodology for regulatory purposes and internally developed models for limit management. EL is then used to calculate the minimum capital from which the Risk Weighted Asset (RWA) is derived. Treasury does not use economic capital models, thus RWAs are used to determine regulatory capital.

Securing collateral and establishing credit reserves

Treasury makes active use of collateral and risk mitigation techniques to reduce credit risks in its portfolio. These include the use of collateral (cash, government securities and guarantees), break clauses and netting. In addition, a gross notional control for repo and stock borrowing exists.

To recognise the effects of credit risk mitigation, the mitigation agreements must be valid, enforceable, unconditional and irrevocable. In addition, collateral must be transferred to Bank of Scotland through the passing of title and should be netable on a portfolio basis. Once these and other conditions specified by the credit sanctioner are met, the effect of collateral received is reflected in reductions to all applicable credit exposures and in capital adequacy calculations.

Treasury Collateral Operations are required to actively monitor collateral using established best risk management practices.

Correlation risk

Under the repo framework, the issuer of collateral held and the counterparty the trade is transacted with should be neither the same nor connected. The same rule applies for derivatives under collateral assets standards. Treasury Credit has the discretion to extend the rule to other cases where there is significant correlation.

Financial instruments subject to credit risk

The table below sets out the Group's exposure to credit risk relating to financial instruments before taking account of collateral and other security. Policyholder assets are excluded from the analysis in the table as the underlying credit risks are for the account of the policyholders and have no direct impact on the Group's results, as described further on pages 28 to 30. A full reconciliation between the Group's consolidated balance sheet and financial instruments subject to credit risk is set out in note 48 on page 123.

	Financial instruments subject to credit risk As at 31.12.2008 £m	Financial instruments subject to credit risk As at 31.12.2007 £m
Loans and advances to customers	**435,223**	430,007
Financial assets held for trading	**22,571**	54,681
Debt securities	**71,395**	56,100
Other financial assets	**69,392**	24,256
	598,581	565,044
Contingent liabilities and commitments	**61,217**	78,904
Total	**659,798**	643,948

Loans and advances to customers

Loans and advances to customers are managed on a divisional basis. Information about the credit quality of loans and advances to customers is set out in note 48 on page 124.

Financial assets held for trading

As described above, full credit analysis is undertaken and, based upon that, an internal rating is derived which helps to establish a credit appetite for the issuer or asset intended to be acquired.

As Treasury manages the liquidity of the HBOS Group, its mandate is to try to maintain a high quality credit portfolio and actively uses portfolio techniques to manage and monitor the quality of its portfolios. This includes the use of rating based thresholds, established portfolio level thresholds, asset class limits and sub-limits.

There are also rules governing the types of assets that can be held within Treasury's Liquidity portfolios, Trading and Banking books and for individual Asset Backed Security (ABS) tranche sizes. There are also limits controlling the maximum weighted average life of assets.

Financial assets held for trading are predominantly investment grade investments with 98.8% (2007 99.6%) of inter-bank and structured investment portfolios rated 'A' or above based on an internal credit ratings scale that is, in general, aligned with the ratings scales of the major credit ratings agencies (Moody's, S&P and Fitch).

During the course of 2008 £12.2bn of ABS and FRN assets were transferred from the Trading Book to the AFS Book. Subsequently, £35.4bn of ABS was transferred from the AFS Book into the Loans & Receivables Book.

	As at 31.12.2008 %	As at 31.12.2007 %
AAA	**67.4**	51.5
AA	**19.3**	34.4
A	**12.1**	13.7
Below A	**1.2**	0.4

Debt securities

Debt securities are primarily held within the Treasury or Insurance & Investment Divisions and are predominantly invested in investment grade counterparties with 92.7% (2007 96.5%) of debt securities rated 'A' or above, again based on the internal rating scale.

	As at 31.12.2008 %	As at 31.12.2007 %
AAA	**52.0**	57.8
AA	**23.8**	25.8
A	**16.8**	12.9
Below A	**7.4**	3.5

Other financial assets

Other financial assets include cash and balances at central banks, items in the course of collection, derivative assets, loans and advances to banks and sundry financial assets.

Risk Management continued

Market Risk

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

- changes in external market factors such as interest rates (interest rate risk), foreign exchange rates (foreign exchange risk), credit spreads, 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; and
- the quality of the Group's profits is appropriately managed and its reputation safeguarded.

Risk appetite is set by the Board which allocates responsibility for oversight and management of market risk to the Group Market Risk Committee, an Executive Risk Committee chaired by the Group Risk Director.

The Group devotes considerable resources to ensuring that market risk is captured, modelled and reported, and 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 standards, and the tools used facilitate internal market risk management and reporting.

Market risk is controlled across the Group by setting limits using a range of measurement methodologies. The principal methodologies are Net Interest Income (NII) sensitivity and Market Value (MV) sensitivity for banking books and Value-at-Risk (VaR) for trading books.

All are supplemented by scenario analysis which is performed in order to estimate the potential economic loss that could arise from extreme, but plausible stress events.

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 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 companies. Risk to customers is controlled by adherence to and regular monitoring of investment mandates and, if appropriate, unit pricing systems and controls. In the case of the risk to the companies, individual Boards approve overall risk appetites and policies against which exposure is monitored.

Market risk – principally interest rate, inflation 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.

Interest Rate Risk (Non-Trading)

A key market risk faced by the Group in its non-trading book is interest rate risk. This arises where the Group's financial assets and liabilities have interest rates set under different bases or reset at different times.

The principal Board limit for structural interest rate risk is expressed in terms of potential volatility of net interest income in adverse market conditions. Risk exposure is monitored using the following measures:

- Net Interest Income sensitivity – This methodology comprises an analysis of the Group's current 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 a set of defined parallel interest rate shocks which measure how much current projections would alter over a 12 month period.
- Market Value sensitivity – This methodology considers all re-pricing mismatches in the current balance sheet including those beyond the time horizon of the NII measure. It is also calculated with reference to a set of defined interest rate shocks.

The Board has delegated authority to the Group Market Risk Committee to allocate limits to divisions as appropriate within the overall risk appetite approved by the Board each year. In turn, the Group Market Risk Committee has granted limits which constitute the risk tolerance for each Division.

Banking divisions are required to hedge all significant open interest rate mismatch positions with Treasury and are not permitted to take positions of a speculative nature. A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly as assets; or when, if rates rise, assets cannot be re-priced as quickly as liabilities.

Net Interest Income Sensitivity

The following table shows, split by major currency, the Group's sensitivities as at 31 December 2008 to an immediate up and down 25 basis points change to all interest rates.

Impact of interest rate shift	As at 31.12.2008 + 25 bps £m	- 25 bps £m
Currency		
Sterling	**82.4**	**(119.6)**
US Dollar	**(2.9)**	**2.7**
Euro	**(8.0)**	**8.1**
AU Dollar	**(1.5)**	**1.5**
Other	**(0.3)**	**0.3**
Total	**69.7**	**(107.0)**

Impact of interest rate shift	As at 31.12.2007 + 25 bps £m	- 25 bps £m
Currency		
Sterling	(21.2)	21.6
US Dollar	(0.6)	0.5
Euro	(4.3)	4.3
AU Dollar	0.1	(0.1)
Other	0.1	(0.1)
Total	(25.9)	26.2

Base case projected NII is calculated on the basis of the Group's current balance sheet, forward rate paths implied by current market rates and contractual re-pricing dates (adjusted according to behavioural assumptions for some products); it also incorporates business planning assumptions about future balance sheet volumes and the level of early redemption fees. The above sensitivities show how this projected NII would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

The principal driver of the risk is re-pricing mismatch but the methodology also recognises that behavioural re-pricing assumptions – for example, prepayment rates - are themselves a function of the level of interest rates.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount. Also, it does not incorporate the impact of management actions that, in the event of an adverse rate movement, could reduce the impact on NII.

Basis Risk

Major structural interest rate exposure will largely be addressed by quantifying re-pricing risk, however, there is potentially a material risk relating to basis, ie, the exposure relating to the Group's (net) asset position repricing off a different index than the (net) liability position.

The primary source of basis risk exposure within the Group is in the UK, where HBOS has a net asset position referenced to Bank Rate and a net liability position referenced to short term LIBOR rates. Analogous Bank Rate / LIBOR positions also exist in Ireland.

The following table shows net assets for the Banking Divisions (excluding Treasury) by pricing basis and reflects the major components of the Group's balance sheet as it relates to basis risk.

	2008	2007
Bank Rate	**97.9**	113.0
Variable Market Rates	**(79.5)**	(58.6)
Administered Rates	**(29.4)**	(62.3)
Fixed (including capital and low/ non-interest bearing)	**11.0**	(7.9)

Reserve Sensitivity

The following table shows the market value sensitivity, for a 25 basis point shift, of those items in respect of which a change in market value is reflected in the equity of the Group – principally 'available for sale' assets and cash flow hedges.

Impact of interest rate shift	As at 31.12.2008 + 25 bps £m	- 25 bps £m
Available for sale reserve	**(14.5)**	**14.5**
Cash flow hedge reserve	**84.9**	**(84.9)**
Total	**70.4**	**(70.4)**

Impact of interest rate shift	As at 31.12.2007 + 25 bps £m	- 25 bps £m
Available for sale reserve	(15.7)	15.7
Cash flow hedge reserve	116.1	(116.1)
Total	100.4	(100.4)

Foreign Exchange Risk (Non-Trading)

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

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 currency exposures arise from the Group's investments in overseas subsidiaries, branches and other investments and are noted in the table overleaf.

Risk Management continued

Functional currency of the operation	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	2008 Remaining structural currency exposure £m
AU Dollar	2,015	2,015	
Euro	3,011	3,011	
US Dollar	191	181	10
Other	(23)		(23)
Total	**5,194**	**5,207**	**(13)**

Functional currency of the operation	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	2007 Remaining structural currency exposure £m
AU Dollar	2,023	2,023	
Euro	1,888	1,613	275
US Dollar	97	97	
Other	4		4
Total	4,012	3,733	279

As at 31 December 2008 and 31 December 2007 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.

Trading

The Group's market risk trading activities are principally conducted by Treasury Division. 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 exchange rate exposure. In addition, a number of marketable assets held as part of the liquidity risk management framework are also held in trading books. Such activity gives rise to market risk as a result of movements in credit spread.

The Group employs several complementary techniques to measure and control trading activities including: Value-at-Risk (VaR), sensitivity analysis, stress testing and position limits.

The VaR model, used as part of the Group's management of trading activity, expresses market risk to 99% confidence using a one day holding period. The number provides an indication of the maximum mark-to-market loss which, to this level of confidence, might be incurred on a single day given the size of current trading positions. It is computed using a historical simulation approach and a one year history of price data.

The underlying assumption of VaR is that future price volatility and correlation will not differ significantly from that previously observed. It also implicitly assumes that all positions are sufficiently liquid to be realisable within the chosen one day holding period.

VaR gives no indication of the size of any loss that could occur from extreme adverse price changes (ie, outside the chosen confidence level). For these reasons, stress testing is employed to simulate the effect of selected adverse market movements. Three different types of stress tests are conducted:

- historical scenarios;
- defined scenarios tailored to key vulnerabilities; and
- extreme shocks to single risk factors.

Such measures are particularly relevant when market conditions are abnormal and daily price movements are difficult to source.

The Group's trading market risk exposure for the year ended 31 December 2008 is analysed below.

Owing to the unprecedented level of volatility in the credit markets, VaR has been suspended as a measure for the credit rating portfolio. Positions are now managed using sensitivity measures. The large increase in VaR, relative to 31 December 2007, is due principally to higher price volatility in wholesale markets – the size of underlying trading positions has not changed materially.

Exposure	As at 31 Dec 2008 £m	As at 31 Dec 2007 £m	Average 2008 £m	2007 £m	Highest 2008 £m	2007 £m	Lowest 2008 £m	2007 £m
Total value at risk	**8.4**	13.2	**12.2**	7.6	**18.3**	13.9	5.0	4.0
Interest rates	**8.4**	4.7	**5.5**	3.0	**9.1**	5.9	**2.8**	1.7
Credit spread	**suspended**	8.3	**suspended**	4.3	**suspended**	8.4	**suspended**	1.8
Foreign exchange	**6.1**	1.9	**8.3**	0.6	**16.3**	2.0	**1.3**	0.1
Equity risk factor	**0.1**	0.2	**0.2**	0.2	**1.1**	0.4	**0.0**	0.0

The regulatory capital charge for market risk trading exposures represents only 0.85% (2007 1.87%) of the Group's capital base.

For all significant exposures VaR is calculated on a daily basis and is used by senior management to manage market risk. On a more detailed desk and trader level, to increase transparency interest rate risk relating to the trading book is principally managed using sensitivity methodology to measure exposure and set limits. This methodology calculates the present value impact of a one basis point movement in interest rates on the outstanding positions. Credit spread risk is managed using position limits based on credit spread sensitivity. Foreign exchange risk is principally managed by the use of position limits. Equity risk is managed through Equity Index VaR and position limits.

The VaR model was granted CAD2 recognition by the FSA in December 2007 for general market risk in London for the following risk factors:

- Interest Rate
- Foreign Exchange
- Equity

It is validated by daily backtesting against observed P&L both at the total (diversified) level and at sub-portfolio levels.

Derivatives

In the normal course of 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, credit derivatives, forward foreign exchange contracts and futures. The Group uses derivatives as a risk management tool for hedging interest rate and foreign exchange rate risk.

The Group's activity in derivatives is controlled within risk management limits set by the Board and overseen by the relevant Group Risk Committees. Details of derivative contracts outstanding at the year end are included in Note 17 to the Accounts on pages 76 and 77.

Liquidity 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.

Liquidity Risk is governed by the Group Liquidity Policy Statement which 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, where liquidity is managed on a Group basis, and for overseas banking units subject to specific regulatory requirements. The responsibility for oversight and management of Liquidity Risk is delegated to the Group Capital Committee (GCC).

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 authority to set specific limits and guidelines and responsibility for monitoring and controlling liquidity is delegated by the GCC to the Group Funding & Liquidity Committee (GLFC).

The Group's banking operations in the UK should comply with the FSA's Sterling Stock Liquidity approach for sterling liquidity management and regulatory reporting. A key element of the FSA's Sterling Stock Liquidity Policy is that a bank should hold a stock of high quality liquid assets that can be sold or used via repo, 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 enables the bank to continue business, whilst providing an opportunity to arrange more permanent funding solutions. Limits on the five day sterling net wholesale outflow and the minimum level of stock liquidity have been agreed with the FSA.

HBOS should also adhere to the requirements of other regulatory authorities including the Australian Prudential Regulatory Authority, the Irish Financial Regulator and the Office of the Comptroller of the Currency in the United States, in whose jurisdictions the Group has branches or subsidiaries.

The internal approach to liquidity management has been in place for several years, operating within regulatory requirements. The approach looks at the forecast cash flows across all currencies and at longer timeframes than the regulatory norms. At 31 December 2008, the Group's liquidity portfolio of marketable assets was £77.3bn (2007 £67.0bn), of which £39.5bn (2007 £13.4bn) has been used for repo. The liquidity portfolio is recorded in Treasury and predominantly comprises Treasury debt securities, excluding Grampian and Landale.

Details of the Treasury debt securities portfolio are disclosed on page 11. The assets in the liquidity portfolio are treated in two forms.

Firstly, assets known to be eligible under normal arrangements with the Bank of England, the European Central Bank and the Federal Reserve. Secondly, a substantial pool of high quality assets that allow us to manage through periods of stress taking into account the likely behaviours of depositors and wholesale markets. These approaches are supported by a liquidity framework that includes:

- funding diversity criteria focusing on retail, other customer and wholesale sources;
- sight to one week and sight to one month mismatch limits as a percentage of total wholesale funding for all major currencies and for all currencies in aggregate;
- targets on the appropriate balance of short to medium term wholesale funding; and
- criteria and limits on marketable assets, by asset class for Sterling, US Dollars, Euros, other currencies and for all currencies in aggregate.

Risk Management
continued

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components.

- Firstly, HBOS stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both HBOS name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.

- Secondly, the Group has a Liquidity Contingency Plan embedded within the Group Liquidity Policy Statement which has been designed to identify emerging liquidity concerns at an early stage, so that action can be taken to avoid a more serious crisis developing. This is achieved through the use of Early Warning Indicators (EWIs). Clear guidelines are set out for the management escalation process in the event of EWIs triggering and the actions to be taken (short and medium term), should such an event take place.

In response to the market dislocation that started in the second half of 2007 and intensified in September 2008, the Group has increased vigilance by operating under full contingency arrangements including daily monitoring of funding and liquidity positions with GCC meeting on a weekly basis to monitor and manage the Group Balance Sheet.

Funding

The wholesale funding capacity of the Group is dependent upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position, as well as market sentiment and perception, most evident in share and debt price volatility.

	As at 31.12.2008 £bn	As at 31.12.2007 £bn
Loans and advances to customers	**435.2**	430.0
Customer accounts	**222.3**	243.2
Customer lending less customer accounts	**212.9**	186.8
Customer accounts as a % of loans and advances to customers	**51.0%**	56.6%

It has been the Group's policy to manage its balance sheet profile to ensure customer deposits sourced outside Treasury represent a significant component of overall funding, and GFLC directs and co-ordinates the activities of the Divisions in raising liabilities from a range of sources.

In order to strengthen the Group's funding position, HBOS has over the last few years diversified its funding sources, and also lengthened the maturity profile of market sensitive funding. This has been achieved through:

- widening the wholesale investor base and product set;

- building and maintaining a term issuance programme - securitisation, covered bonds, Medium Term Note programmes; and

- utilising the geographic diversity of New York and Sydney as funding hubs for the Group.

The ability of the HBOS Group to access wholesale funding sources and raise retail deposits on favourable economic terms is dependent on a variety of factors, including a number outside of its control, such as general market conditions including the state of UK and global finance markets, an increase in competitive behaviour, and confidence in the UK banking system in general or the HBOS Group in particular.

Following speculation on HBOS's future in mid-September, the HBOS Group suffered deposit outflows, further increasing the Group's reliance on wholesale funding markets. The majority of these deposit outflows were non-bank financial institutions and large corporates, rather than personal account customers. In recent months this position has stabilised with net inflows evident following the announcement of the proposed transaction with Lloyds TSB.

In wholesale markets, the HBOS Group has previously looked to achieve a geographically diverse investor base and product set of an appropriate maturity profile to ensure it is not overly exposed to short-term market dislocation.

As a result of the increasingly turbulent conditions in the global financial markets in the second half of 2008, there has been a significant deterioration in the inter-bank and term funding markets and a consequent material reduction in the availability of longer-term funding. As a result, HBOS has had to source more shorter-term and overnight funding, with a consequent increase of refinancing risk.

In recent months, the strain in the financial systems has increased substantially, leading to a significant tightening in market liquidity and the threat of a more marked deterioration in the global economic outlook, with a consequent increase in recourse to liquidity schemes provided by central banks. While various governments, including the UK Government, have taken substantial measures to ease the current crisis in liquidity, such as the measures announced in the UK on 8 October 2008 and 13 October 2008, there can be no assurance that these global measures will succeed in improving the funding and liquidity of the markets in which the major banks, including HBOS, operate.

HBOS, as a wholly owned subsidiary, will be dependent on Lloyds Banking Group for funding and expects reliance for the foreseeable future on the continued availability of central bank liquidity facilities (particularly those with the Bank of England) as well as HM Treasury's guarantee scheme for short and medium-term debt issuance.

The Group's wholesale funding sources are shown in the tables overleaf. Tables are prepared on the basis that "retail" is defined using the current statutory definition, ie, administered rate products. Wholesale funding, when issued in a foreign currency but swapped into Sterling, is included at the swap exchanged amount. Wholesale funding is shown excluding any Repo activity and the funding raised in the names of the conduits.

Retail and Wholesale Funding sources Instrument	As at 31.12.2008 £bn	%	As at 31.12.2007 £bn	%
Bank Deposits	**13.7**	**3.3**	33.1	6.7
Deposits from Customers	**24.0**	**5.7**	27.8	5.6
Debt Securities in issue:				
Certificates of Deposit	**51.0**	**12.2**	63.9	12.9
Medium Term Notes	**45.7**	**10.9**	43.2	8.7
Covered Bonds	**29.1**	**7.0**	24.4	4.9
Commercial Paper	**8.9**	**2.1**	16.8	3.4
Securitisation	**35.8**	**8.6**	45.9	9.3
	170.5	**40.8**	194.2	39.2
Subordinated Debt	**22.2**	**5.3**	18.1	3.7
Other	**7.6**	**1.8**	6.9	1.3
Total Wholesale	**238.0**	**56.9**	280.1	56.5
Retail	**180.1**	**43.1**	215.4	43.5
Total Group Funding	**418.1**	**100.0**	495.5	100.0

Wholesale funding – Currency	As at 31.12.2008 £bn	%	As at 31.12.2007 £bn	%
US dollar	**52.8**	**22.2**	105.2	37.6
Euro	**87.4**	**36.7**	79.6	28.4
Sterling	**80.1**	**33.7**	70.3	25.1
Other	**17.7**	**7.4**	25.0	8.9
Total Wholesale Funding	**238.0**	**100.0**	280.1	100.0

Wholesale funding – Residual Maturity	As at 31.12.2008 £bn	%	As at 31.12.2007 £bn	%
Less than one year	**119.4**	**50.2**	166.2	59.3
One to two years	**25.2**	**10.6**	21.6	7.7
Two to five years	**44.1**	**18.5**	46.3	16.5
More than 5 years	**49.3**	**20.7**	46.0	16.5
Total Wholesale Funding	**238.0**	**100.0**	280.1	100.0

The increased use of repo activity as a funding tool has materially impacted the levels of wholesale funding shown in the tables.

The following tables reconcile wholesale figures reported above with those in the Statutory Balance Sheet.

Accounting Classification - as at 31.12.08	Risk Report £bn	Repos and Conduits £bn	Interest Accruals and Other Accounting Adjustments £bn	Statutory Balance Sheet £bn
Debt Securities in Issue	**170.5**	**3.0**	**14.9**	**188.4**
Sub Debt and Other	**29.8**		**0.3**	**30.1**
Deposits by Customers	**204.1**	**18.2**		**222.3**
Bank Deposits	**13.7**	**70.9**	**12.6**	**97.2**
Total	**418.1**	**92.1**		

Accounting Classification - as at 31.12.07	Risk Report £bn	Repos and Conduits £bn	Interest Accruals and Other Accounting Adjustments £bn	Statutory Balance Sheet £bn
Debt Securities in Issue	194.2	12.0	0.3	206.5
Sub Debt and Other	25.0		(0.7)	24.3
Deposits by Customers	243.2			243.2
Bank Deposits	33.1	7.8	0.6	41.5
Total	495.5	19.8		

Risk Management continued

Conduits

HBOS sponsors two conduits, Grampian and Landale, which are special purpose vehicles that invest in highly rated assets and funds via the Asset Backed Commercial Paper (ABCP) market. At 31 December 2008, investments held by Grampian totalled £21.7bn and £0.7bn of assets held by Landale were consolidated. Grampian is a long established, high grade credit investment vehicle that invests in diversified Asset Backed Securities of which over 75.9% are rated AAA by S&P and Aaa by Moody's. Grampian has a liquidity line in place with HBOS which covers all of the assets and programme wide credit enhancement is also provided by HBOS. Grampian has been fully consolidated into the balance sheet. Landale holds both assets originated from the Group balance sheet and third party transactions. Landale has liquidity lines from HBOS and from third party banks, and therefore the former, but not the latter, are consolidated into the balance sheet.

In 2008, there have been occasions when Grampian and Landale (in respect of assets backed by HBOS liquidity lines) have declined to issue Asset Backed Commercial Paper. At these times the conduits were funded through the available liquidity lines rather than through the ABCP market. At 31 December 2008, HBOS had provided funding to the Grampian and Landale conduits of £20.4bn.

General Insurance & Long Term Assurance Business Risks

The general insurance and long term assurance business contracts underwritten by the Group expose HBOS to both investment and insurance risk.

Insurance risk is the potential for loss, arising out of adverse claims from both life and general insurance contracts.

Investment risk is the potential for financial loss arising from the risks associated with the investment management activities of the Group. Investment risk includes market, credit and liquidity risks. The loss can be as a result of:

- **Direct risks relating to changes in the value of Group assets in support of the general insurance and long term insurance contracts;**
- **Indirect risks arising from policyholder funds where the assets and policyholder liabilities are matched; and**
- **Indirect risks associated with the management of assets held on behalf of third parties.**

The Group Insurance Risk Committee, one of the Executive Risk Committees described on page 16, considers regular reports on specified aggregate insurance risks across all of the Group's insurance and investment businesses. It oversees the development, implementation and maintenance of the overall insurance risk management framework, covering insurance risk in each business individually, as well as in aggregate.

As part of the overall Group risk management framework, the Group Insurance & Investment Risk team provides regular support to the Group Market Risk Committee and to the Group Credit Risk Committee on the inter-relationship between insurance risk and investment risks (market, credit and liquidity risks respectively) arising within these businesses, and the development of appropriate policies and standards for the management of those risks.

The majority of the Group's long term insurance and investment contract liabilities are managed within the HBOS Insurance & Investment Division and Insight Investment with approximately 8% (2007 3%) operated by the life businesses outside the UK. Day to day management of insurance and investment risk is undertaken by management supported by specialist risk functions. Use is made of the statutory actuarial roles, both to help ensure regulatory compliance in respect of the authorised insurance companies in the Group and to help meet Group risk management standards.

Long Term Assurance

The insurance and investment business that is transacted by the life insurance companies within the Group comprises unit linked business, fixed benefit business (also known as non-profit business) and with-profits business (described as insurance contracts and investment contracts with discretionary participating features (DPF) written within the with-profits fund).

Several companies within the insurance and investment business transact either unit linked and/or other non-profit business, but all with-profits business is underwritten by Clerical Medical Investment Group Limited (Clerical Medical), a subsidiary of HBOS Financial Services Limited.

The key characteristics of long term assurance that give rise to insurance and investment risk are its long term nature, the guarantees provided to policyholders, the dependency on the performance of investment markets and the extent to which assets backing the contractual liabilities are matched.

The quality, mix and volume of business have a significant influence on the extent of insurance and investment risk assumed by the Group and resulting profits. The quality of business written is influenced by variations in product terms as well as the average premium size, age and term profile within the particular products. Accordingly, the mix in products written may impact on profits, depending on the nature, extent and profitability of new business in addition to existing business. This risk is managed through the application of clear pricing policies that require full financial assessment for each new product, incorporating consideration of expected hurdle rates of return.

Additionally, variations in administration and development costs may impact the available profit margin within the product charges. To manage this risk, there is a regular process of expense budgeting and reporting with appropriate targets set for new insurance and investment products that are developed.

The risks associated with particular sections of the long term assurance business are set out below.

Unit Linked Funds
For unit linked funds, including consolidated collective investment schemes, which comprise 79% (2007 77%) of the Group's long term insurance and investment contract liabilities, investors bear the investment risk, with changes in the underlying investments being matched by changes in the underlying contract liabilities. Similarly, the Group manages a number of collective investment schemes where the investors bear the investment risks. The investor selects from a range of investment opportunities available from the Group in accordance with their personal risk appetite and circumstances.

On a day-to-day basis, cash outflows which are necessitated by investors withdrawing their funds are generally met by cash inflows from new investors. In circumstances where funds are contracting, or to meet unusually high levels of withdrawals, the Group sells assets in the fund in order to meet the cash demands with any dealing costs charged to the underlying unit linked fund and consequently the policyholders. The underlying assets in the unit linked funds are subject to credit and market risks in the form of interest rate, equity prices, foreign exchange and other market risks depending on the fund, including movement in property values. These changes are matched by changes in the unit linked liabilities. Accordingly, the Group is not directly exposed to significant liquidity, credit or market risks, although the investors' benefits will vary as a consequence. Decreases in the capital value of unit linked funds (as a result of falls in market values of equities, property or fixed interest assets) will however reduce the future annual investment management charges that will be earned from unit linked business.

The Group estimates that if the capital value of the unit linked funds, excluding consolidated collective investment schemes, classified as investment contracts had been reduced, on average by 10% for the year, the profit before tax for the year would have decreased by £20m (2007 £22m). For unit linked contracts classified as either insurance contracts or investment contracts with DPF the Group has considered the sensitivities to a number of risks in Note 28 to the Accounts on pages 87 to 89.

Unit linked products provide some discretion for variation in annual administration charges, and therefore management of variations in expenses may be achieved through variation in charges.

An additional risk the Group faces, in respect of unit linked business, is the risk that increases to surrender rates for both insurance and investment contracts reduce the value of future investment management charges. Actions to control and monitor this risk include charges applicable on some products where the investor surrenders early, regular experience monitoring, consideration of the sensitivity of product profitability to levels of lapse rates at the product development stage; and initiatives within the relevant businesses to encourage customer retention.

Non-Profit Business
The Group has a diversified portfolio of life insurance and annuity policies within its portfolio of non-profit insurance contracts, which includes the insurance risk component of unit linked policies classified as insurance contracts. The principal investment risk in respect of the non-profit business is interest rate risk which arises because assets and liabilities may exhibit differing changes in value as a result of changes in interest rates. This may potentially impact on the results and the capital position. The investment risk also includes the risk of increases in corporate bond yield spreads over government risk free yields or the ratings downgrade of certain securities, both of which reduce the capital value of the bonds. These risks are controlled by processes carried out to help ensure an appropriate level of matching is maintained in the funds so that changes in fixed interest assets backing the non-profit business are substantially mitigated by offsetting changes in liabilities, (as the discount rate used in valuing the liabilities is linked to that of the matching assets). These processes include the use of and monitoring against fund mandates.

The ultimate amounts payable under these policies are sensitive to general trends in mortality rates. For annuitants comprising 3% (2007 3%) of the Group's long term insurance and investment contract liabilities, there is a risk that increases to life expectancy through medical advances will prove greater than that anticipated. For protection business, the risk is that an unforeseen event such as a natural disaster will cause a material increase in death rates.

The extent of the Group's exposure to insurance risks is set out in Note 30 to the Accounts on pages 90 to 93.

Risk Management continued

With-Profits Fund

The insurance and investment business includes the Clerical Medical With-Profits Fund which comprises 17% (2007 17%) of the Group's long term insurance and investment contract liabilities. The with-profits fund takes some investment risks with the aim of enhancing policyholder returns but aims to limit payouts to policyholders to that supportable by the with-profits fund's assets.

For 'unitised' with-profits contracts the Group receives an annual management charge. For 'traditional' with-profits contracts, which form the minority of the with-profits fund business, the Group receives one ninth of bonuses declared to policyholders as long as there is a distributable surplus within the fund.

Ordinarily, variations in the capital value of the fund's assets would result in variations in the level of benefits available to the with-profits contract holders and accordingly a variation in the insurance and investment contracts with DPF liabilities. Included in the with-profits fund are certain contracts with minimum payment guarantees at certain policy durations and on death. Of these with-profits contracts issued between 1997 and 2001, a significant proportion have guaranteed benefits which are in the money at the balance sheet date.

The costs of meeting these guarantees, up to a certain level, are met by charges to the benefits for all with-profits contract policyholders. The amount of these guaranteed benefits, net of charges to be levied on policyholder funds, was less than 2% (2007 1%) of the Group's long term insurance and investment contract liabilities at the balance sheet date. Above this level the costs are met by the free assets of the fund (the assets maintained in the fund which are not held to meet contractual liabilities). There remains a risk that Clerical Medical may suffer an additional charge in exceptional circumstances where even after management action, the fund is unable to meet the costs of guarantees within the fund. This is set out in the *Principles and Practices of the With-Profits Fund*, available from the Clerical Medical Investment Group website (www.clericalmedical.co.uk).

As well as pooling of risks, the other important measures in controlling the investment risk within the with-profits fund include having agreed management actions to adjust the nature and extent of investment exposure in response to certain investment conditions; by recognising and holding appropriate levels of risk capital; by restricting holdings to assets which meet admissibility criteria; and by using derivative strategies to reduce downside risk.

Accordingly, the insurance and other investment risks (credit, liquidity and market risks) within the with-profits fund are generally expected to be borne by the with-profits insurance and investment contracts with DPF policyholders except in the extreme scenarios. The sensitivity of the Group result to certain changes in key variables relating to insurance and investment contracts with DPF within the with-profits fund have been included in Note 30 to the Accounts on pages 90 and 93.

Additionally, in order to demonstrate the sensitivity of the with-profits fund to certain key market variables, and consequently the ability of the with-profits fund to meet its policyholders' expectations, the Group has set out a sensitivity analysis of unallocated divisible surplus in Note 32 to the Accounts on page 94.

General Insurance

For general insurance household contracts the most significant risks to claims experience arise from weather events. For repayment insurance contracts the most significant risks arise from changes in economic conditions.

The Group manages its exposure to insurance risk through a strategy which includes limitation of the nature of the risks underwritten and allowance within the price charged for the underlying risks. This allowance for risks is based on both external information and HBOS's own experience data. For all classes of insurance there are pricing models that are regularly adjusted for actual claims experience. For household insurance the Group limits its exposure to large weather events through the use of reinsurance. Any reinsurance purchased must have a minimum credit rating, and if that rating is breached no further business is placed with that provider.

The majority of claims are reported and settled within 12 months and generally there is limited reserving uncertainty for events before the balance sheet date.

For some renewable contracts (household, travel and some repayment insurance), the longer term exposure to risk is managed in conjunction with the ability to re-price contracts to take account of changes in the level of risk within those contracts.

Set out in Note 30 to the Accounts on page 93 are the Group's general insurance claim provisions by policy type.

(End of information that forms an integral part of the audited financial statements.)

Operational Risk

Operational Risk exists in the normal conduct of business and is the risk of loss resulting from inadequate or failed internal processes or systems, or from people-related or external events. 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 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 the infrastructure has been to focus on the explicit risk management of specialist areas that underpin the HBOS Operational Risk Framework. Each specialist risk area is supported by a relevant specialist Group Function. The specialists' role is to ensure that appropriate risk management practice is operating across their 'community'. The key elements of the Group specialists' roles are:

- Set and maintain policy.
- Provide opinion on the effectiveness of risk management for their area of specialism.

The Group Business Risk function co-ordinates the specialist areas, designs and maintains Group-wide risk systems and a specialist portfolio management team undertakes the detailed modelling required to assess risk exposure using internal and external loss event information. External information is available through HBOS membership of the Operational Risk Data Exchange (ORX). ORX provides anonymous information from a number of international banks which assist in the identification, assessment and modelling of operational risk.

The FSA granted HBOS Advanced status under Basel II and consequently the Group utilises the Advanced Measurement Approach (AMA) for regulatory capital reporting in most of its businesses. HBOS does not currently use insurance or expected losses to offset its regulatory capital requirement.

Regulatory Risk

The Financial Services Authority is the main regulator for HBOS, although the Group's 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 a choice of supplier and product and are more demanding of financial services providers. The Group supports the FSA's Treating Customers Fairly initiative and has set clear principles for doing business. This is supported by ongoing maintenance of procedures across the Group, with associated enhancement and development where necessary. The objective is to meet the requirements of shareholders through meeting customer needs.

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

- Identify and assess the impact of, respond to and where possible 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 co-ordination 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 the Board.

(The information set out below ending before the section entitled 'Capital Requirements' on page 33 forms an integral part of the audited financial statements as described in the Accounting Policies section of the Financial Statements on page 48.)

Capital Management

Capital management within HBOS has Board visibility and is managed primarily through the capital planning process, which in turn forms part of the overall Group Business Plan. The capital planning process assists in determining the optimal amount of capital that should be held by the Group and the most appropriate mix between the different components of capital, subject to regulatory limits. The day-to-day management of the Group's capital is delegated to the Group Capital Committee with support from underlying committees, including the Group Regulatory Capital Adequacy Committee.

Risk Management
continued

The Group Capital Committee is responsible for establishing the strategic and management framework for the assessment and allocation of capital within the parameters set by the Board through the agreed terms of the Group Business Plan and the approved Risk Appetite. The committee monitors compliance with the capital plan, including stress and scenario analysis, contingency planning and capital management strategies.

The Group Capital Committee supports wider business planning and decisions by analysing business levels that are sustainable under internal capital generation, what options are available with regards to the levels of capital generated by the business and also reviews and provides oversight on business cases that are put forward for inorganic activity.

As part of its capital management remit, the Group Capital Committee also ensures compliance with the Group Capital and Funding Policy. This policy is reviewed annually and approved by the Board.

The policy covers the following key areas:

- Capital planning management process and responsibilities;
- The type and level of capital required and held by the Group;
- Monitoring and controlling capital plans and forecasts; and
- Subsidiary regulated entities and capital transferability.

For the latter, the policy governs the transferability of capital around the Group subject to guiding principles which require that all subsidiary regulated entities within the Group must hold sufficient capital to ensure that they continue to meet their individual regulatory capital ratios as imposed by the local regulator. Each regulated entity is required to set out their capital plans for approval by the Group Capital Committee.

Surplus capital held at regulated entity levels may be released up to HBOS plc level in the form of dividends or capital repatriation.

The capital planning process ensures Divisions and regulated legal entity 'owners' commit to and are monitored against key drivers, including:

- Risk Weighted Assets and Expected Losses;
- Other deductions from capital;
- Non-equity capital and gearing; and
- Surplus capital and agreed utilisation.

The capital plan is monitored on a continuous basis. It is updated formally as part of the annual planning and quarterly reforecasting cycles, in line with the Group Business Plan, with additional revisions made in the intervening periods as necessary.

The capital plan is stressed under demanding economic scenarios with both common and specific univariate sensitivity analysis undertaken.

The Group Capital Committee receives a monthly update and review of the capital position of the Group. Summary MI is also passed to the Executive Committee and the Board. A reconciliation of monthly actual data to forecast is also completed with commentary on variances and submitted to the Group Capital Committee.

Throughout 2008 the Group Capital Committee has met weekly in order to maintain an up-to-date view of market conditions and key capital ratios and to ensure issues arising are identified and actioned promptly. The Group's on-going capital strength has been a core focus of the Group Capital Committee during the year.

The Group Regulatory Capital Adequacy Committee is responsible for supporting the Group Capital Committee in its capital management role. It achieves this through establishing policies and minimum standards to measure and monitor the financial capital resource requirements of the Group in accordance with the Group's risk profile and appropriate regulatory requirements. The Committee relies on input from the specialist executive risk committees (the Group Credit Risk Committee, the Group Market Risk Committee and the Group Operational Risk Committee).

Where capital requires to be raised, it is the Group's policy to issue capital in a range of different forms and also from diverse sources to spread the investor base. HBOS plc raises the non-equity Tier 1 capital and subordinated debt for all the Group's businesses, with the exception of Clerical Medical which is permitted to raise capital separately as part of the overall Group capital plan to spread the investor base for subordinated debt.

The types of capital held by the Group are subject to regulatory limits which have been established to ensure that restrictions are placed on the extent to which certain types of capital, such as innovative Tier 1, are eligible for inclusion within a firm's capital resources.

The regulatory limits specify that:

- at least 50 per cent of Tier 1 Capital must be 'Core' Tier 1;
- the amount of innoviate Tier 1 cannot exceed 15 per cent of overall Tier 1 Capital;
- qualifying Tier 2 Capital cannot exceed Tier 1 Capital; and
- qualifying dated subordinated loan capital may not exceed 50 per cent of Tier 1 Capital.

There are also limitations on the amount of collectively assessed impairment provisions which may be included as part of Tier 2 Capital.

The principal forms of capital are included in the following balances on the consolidated balance sheet: called up share capital, share premium account, other reserves, retained earnings and other borrowed funds.

In July 2008 HBOS raised £4.0bn (net) of capital through a rights issue. Subsequent to the year end a further £11.3bn (net) of capital was raised. This comprised of £8.3bn of ordinary shares raised through a Placing and Open Offer exercise supported by the UK Government and £3.0bn of preference shares subscribed to HM Treasury.

The latter capital raising exercise was made in support of the Proposed Government Funding initiative devised to stabilise the UK banking system and was conditional on the completion of the acquisition of HBOS by Lloyds TSB Group plc.

(End of information that forms an integral part of the audited financial statements).

Capital Requirements
The FSA requires each bank and banking group to maintain adequate capital resources to meet their total capital requirements (Pillar 1 and Pillar 2) under the Basel II Framework. This includes any additional capital requirements identified through the firm's or group's Individual Capital Guidance.

The FSA supervises HBOS on a regulatory consolidated basis and as such receives information on the capital adequacy of, and sets capital requirements for, HBOS as a whole. A similar function is performed at sub-group levels within the business, including at Bank of Scotland Group level.

Individual banking and insurance subsidiaries are directly regulated by either the FSA or their local supervisors, who set their capital adequacy requirements. This includes supervision on a 'solo consolidation' basis.

HBOS must at all times monitor and demonstrate compliance with the relevant regulatory capital requirements of the FSA. The Group has in place, extensive processes and controls to monitor the Group's capital adequacy and frequent reporting of the Group's capital position and associated data and analysis is made to the FSA under the Integrated Regulatory Reporting Regime.

Capital Structure
- Tier 1 Capital comprises shareholders' funds, innovative Tier 1 securities and minority interests, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at the Tier 1 Capital position.

- Tier 2 Capital comprises qualifying subordinated loan capital, certain collectively assessed impairment provisions, and unrealised gains arising on the fair valuation of equities held as available for sale.

In addition the excess of Expected Loss over and above any accounting impairment provisions made is deducted 50% from Tier 1 Capital and 50% from Tier 2 Capital. Other regulatory deductions made on a similar basis relate to securitisation positions held and material holdings.

From the total of Tier 1 and Tier 2 Capital the carrying amounts of unconsolidated investments (including holdings in insurance operations), investments in the capital of other banks, and certain regulatory items are deducted.

Movements in Tier 1 Capital and the capital structure of the Group are given on page 136.

Pillar 2 Capital Requirements
In order to satisfy the requirements of Pillar 2, HBOS is required to perform an Internal Capital Adequacy Assessment Process (ICAAP).

The HBOS ICAAP is based upon a 'Pillar 1 Plus' approach whereby the 'Pillar 1' regulatory capital requirements for Credit Risk, Operational Risk and Market Risk (Trading Book) are supplemented by consistent assessments of the key risks not captured under Pillar 1, of which the most material are Pension Obligation Risk and Concentration Risk.

The individual risk assessments are aggregated with no allowance for inter-risk diversification, generating a total internal capital assessment which is incrementally greater than the total Pillar 1 amount. The total minimum regulatory capital requirement is set by the FSA taking into account this internal assessment. A strong capital buffer, defined as the amount by which the total capital resources exceed the total capital requirement, is held.

The current capital planning forecasts show a satisfactory capital buffer even in a deteriorating economic scenario, significantly bolstered by the post year end capital injection.

Pillar 3 Disclosures
The HBOS plc Basel II Pillar 3 Disclosures for the year ended 31 December 2008 will be published online during the second quarter of 2009.

These disclosures will represent the first full set of Pillar 3 disclosures to be published by HBOS under the Basel II Framework.

The purpose of Pillar 3 is to communicate the firm's risk management practices, its approach to capital management, its capital resources and Pillar 1 capital requirements and to provide a detailed analysis of its credit risk exposures.

Pillar 3 disclosures build on a number of equivalent disclosures made within the Annual Report and Accounts, providing greater detail and analysis.

Directors' Report

The Directors present the Annual Report and Accounts to the members of HBOS plc in respect of the HBOS Group (the Group) for the year ended 31 December 2008.

Principal Activities
HBOS plc is the holding company of the Group. The principal activities of the Group are the provision of banking and other financial services through branches and offices in the UK and overseas. A list of the main subsidiary undertakings, and the nature of each company's business, is given in Note 22 on pages 82 and 83.

On 21 July 2008 the Company confirmed that it had raised £4.0bn through a fully underwritten rights issue which offered 2 new ordinary shares for every 5 existing ordinary shares at 275 pence per share.

On 13 October 2008, HBOS announced a Placing and Open Offer to raise £11.5bn of new capital (consisting of £8.5bn in ordinary shares and £3.0bn in preference shares) as part of a co-ordinated package of capital and funding measures for the banking sector implemented by HM Treasury. The capital raising was made available to HBOS on condition that the acquisition by Lloyds TSB Group plc (now Lloyds Banking Group plc) completed. On 16 January 2009 the entire issued share capital of HBOS was acquired by Lloyds Banking Group plc, pursuant to a Scheme of Arrangement under sections 895 to 899 of the Companies Act 2006.

On 19 December 2008, the Company sold its St. Andrews and BankWest businesses to the Commonwealth Bank of Australia.

Business Review
The Companies Act 2006 requires the Directors' Report to include a Business Review of the Group giving a fair review of the business of the Group and a description of the principal risks and uncertainties facing it.

The Group's development and performance during the year, position at the year end and likely future prospects are reviewed in the Divisional Reviews on pages 7 to 12, the Introduction on page 2, the Risk Management report on pages 13 to 33 with financial aspects covered in the Financial Review on pages 3 to 6. The information in each of these sections and in the rest of this Directors' Report, which fulfils the requirements of the Business Review, is incorporated into this Directors' Report by reference.

The Annual Report and Accounts, including this Directors' Report, have been prepared solely for the Company's members as a body. To the extent permitted by law, the Company, its Directors, employees, agents and advisers disclaim liability to any other persons in respect of information contained in the Annual Report and Accounts. By their nature, statements containing risks and uncertainties facing the HBOS Group, and any other forward-looking statements, involve uncertainty, since future events and circumstances can cause results and developments to differ materially from those anticipated. The forward-looking statements reflect the knowledge and information available at the date of preparation of the Annual Report and Accounts and the Company undertakes no obligation to update these forward-looking statements. Nothing in the Annual Report and Accounts shall be construed as a profit forecast.

Results and Dividends
The Group's loss attributable to shareholders for the year ended 31 December 2008, as shown in the Consolidated Income Statement, was £(7,499)m (2007 £4,045m profit). A Capitalisation amount totaling £320m, equivalent to 6.07 pence per existing ordinary share, was allocated on 6 October 2008 at an issue price of 232 pence per new share (being the value per share implied by the then terms of the proposed acquisition of HBOS by Lloyds Banking Group plc); this resulted in the issue of 137,482,576 ordinary shares, equating to 1 new share for every 38.2207578 existing ordinary shares held. No final dividend is being proposed for the year.

Going Concern
As set out in the 'Principles Underlying Going Concern Assumption' of the Basis of Preparation section of the Notes to the Accounts, 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.

Directors
The Directors in office at the date of this report are W C G Berndt*, Sir Victor Blank*, E Brown*, J E Daniels*, J Dawson, P A Gore-Randall, J P du Plessis*, P N Green*, Sir Julian Horn-Smith*, A G Kane*, Lord Leitch*, Sir David Manning*, C J McCall*, M A Scicluna*, G T Tate*, T J W Tookey*, D J Watkins and H A Weir*.

C W Dunstone stood down as a Non-executive Director at the Annual General Meeting (AGM) on 29 April 2008. P J Cummings, M H Ellis and C Matthew served as Executive Directors, A H Hornby as Chief Executive, Lord Stevenson as Chairman and Sir Ron Garrick as Deputy Chairman/Senior Independent Director, throughout the year and all resigned from the Board on 16 January 2009. R J Cousins, A J Hobson, K E D Jones, J E Mack, C L McConville and K A Nealon served as Non-executive Directors throughout the year and resigned from the Board on 16 January 2009.

* appointed 16 January 2009.

The powers of the Directors, along with provisions relating to their appointment and replacement, are set out in the Articles of Association and governed by UK company law. Any alteration to the Articles of Association must be approved by shareholders. The specific authorities delegated to Executive Directors during the year were set out in a detailed Board Control Manual.

The Company provides directors' and officers' liability insurance, giving appropriate cover for legal action brought against its Directors, and has also agreed to indemnify Directors in circumstances where they are not considered to be culpable. The indemnity, which is a qualifying third party indemnity provision for the purpose of the Companies Act, is for the benefit of all of the Company's current Directors.

Directors' share interests

The beneficial interests of the Directors and their immediate families in the ordinary shares of HBOS plc at 31 December 2008 are set out below:

	Number of Shares at 31.12.08	Number of Shares at 31.12.07
Chairman		
Dennis Stevenson	**584,550**	406,892
Executive Directors		
Peter Cummings	**274,532**	131,407
Jo Dawson	**259,846**	106,654
Mike Ellis	**544,454**	350,545
Philip Gore-Randall	**15,331**	-
Andy Hornby	**1,037,175**	608,031
Colin Matthew	**627,619**	361,844
Dan Watkins	**114,396**	63,251
Non-executive Directors		
Richard Cousins	**8,107**	5,644
Sir Ron Garrick	**49,544**	33,002
Anthony Hobson	**10,774**	7,500
Karen Jones	**15,693**	10,255
John E Mack	**14,366**	6,000
Coline McConville	**15,672**	10,910
Kate Nealon	**21,374**	12,879

Corporate Governance

The Board held 17 meetings during the year at which the most important decisions affecting the Company were taken. The Board also oversaw the Company's performance and set the framework for how authority and accountability was delegated throughout the Group.

The Board included, throughout the year, a balance of Executive Directors who managed the business on a day-to-day basis and independent Non-executive Directors. The roles of Chairman and Chief Executive were separate.

The Board was also supported by a structure of committees which included an Audit Committee (itself supported by a structure of Divisional Risk Control Committees), a Nomination Committee and a Remuneration Committee. Membership of each of the three main committees during 2008 was as below:

Audit	Nomination	Remuneration
A J Hobson (chair)	Sir Ron Garrick (chair)	K E D Jones (chair)
C L McConville	R J Cousins	R J Cousins
J E Mack	A H Hornby	Sir Ron Garrick
K A Nealon	K E D Jones	C L McConville
John Ormerod**	C L McConvile	
(resigned 25.07.2008)	Lord Stevenson	

** John Ormerod was neither an HBOS Director nor an employee of the Group.

Corporate Responsibility

The approach of HBOS to Corporate Responsibility (CR) has focused on best serving the diverse interests of key stakeholders, whose views and concerns informed strategy. HBOS has worked to integrate CR into its overarching management framework with the Board reviewing CR strategy and performance annually.

Customers

HBOS aims to provide customers with value for money products supported by simple customer communications, for example clear summary boxes on product statements.

Colleagues

Against a background of unprecedented financial turmoil in global markets, a focus on strong leadership at all levels has never been more important. HBOS-U, the corporate university, was extended to all leaders during 2008. In the second half of 2008 HBOS-U focused on performance, change, leadership and managing ambiguity.

Directors' Report continued

	2008
Number of colleagues participating in development through HBOS-U in 2008	15,000
Percentage of participants who valued the development received through HBOS-U	96%

The Group's Total Reward strategy seeks to align colleague reward with personal, Divisional and Group performance. A number of employee share schemes operated throughout the year. Further details of these plans are set out in Note 40 to the Financial Statements on page 108.

During the year HBOS used a multi-media approach when communicating with colleagues throughout the Group. This included e-mail, electronic and printed magazines, intranets, business television and face-to-face communication. A Group-wide electronic magazine, entitled HBOS Today, was used to update colleagues on key business news. It was issued as required (rather than on a set publishing cycle). In 2008 37 issues were published. Topical news stories were also placed on the Company's intranet site.

The views of HBOS colleagues were sought on a regular basis, most notably through opinion surveys conducted by MORI and through regular consultation with the recognised trade unions ACCORD and Unite, with whom the Company has entered into a partnership agreement.

HBOS is recognised by Jobcentre Plus as 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 and provide retraining accordingly. 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.

Stakeholder engagement
In discharging their duties, the Directors have had regard to the interests of key stakeholders as well as to any other factors likely to impact on the success of the Company. Consideration of these matters is fully integrated within the Board's decision making processes.

In 2008 HBOS launched a new Supplier Risk Management Framework to improve consistency in the way CR risks and issues were managed in the supply chain. The Framework significantly improved governance in the supply chain. HBOS has continued to maintain contact with key consumer groups including Which?, Citizens Advice and the Financial Services Consumer Panel.

The Group spends approximately £2.4bn per annum with external suppliers (excluding rents and rates). HBOS recognises the importance of suppliers as stakeholders in its business and the importance of ensuring that it builds effective, competitive relationships that add value for its customers and shareholders. A dedicated Procurement function operated within the HBOS Group throughout the year and co-ordinated contract negotiations, management of these key relationships, setting policy and ensuring that appropriate risk management processes were put in place in respect of contracts above certain financial thresholds.

Payment Policy
For the forthcoming period the Group's policy for the payment of suppliers will be as follows:

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

The Company complies with the Better Payment Practice Code. Information regarding this Code and its purpose can be obtained from the Better Payment Practice Group's website at www.payontime.co.uk.

The Company's main trading subsidiary undertaking, Bank of Scotland plc, had trade creditors outstanding at 31 December 2008 representing 19 days of purchases. The Company owed no amounts to trade creditors at 31 December 2008.

Community, Charitable Donations and Environment
As part of its community investment strategy, during the year, the Group made charitable donations in the UK of £9.5m. The majority of donations were made to the HBOS Foundation, which provides grants to charities to fund initiatives primarily relating to financial literacy and money advice. In addition, all funds raised by colleagues, customers and shareholders for the Million £ Challenge were matched by the HBOS Foundation and went to CLIC Sargent, Age Concern and Diabetes UK. Further to this, a total of £1.1m has been made available to charities as a result of their affinity to the Visa Charity credit cards offered by the Group. The affinity cards are offered in partnership with specific charities such as Cancer Research UK, the NSPCC and the SSPCA.

In 2008, HBOS launched a new strategy to control use of paper, including increasing the use of 100% recycled paper, reducing the overall use of paper and increasing recycling. During 2008 100% recycled paper was introduced for office paper, business cards and compliments slips.

	2008	2007
UK CO2 emissions (tonnes)	**55,272***	53,577
Water use (m3)	**540,000**	531,477
Total waste (tonnes)	**19,306**	17,944
% waste recycled	**55.3%**	51.5%

* In 2008 DEFRA introduced changes to the conversion factors used to calculate CO2 emissions from renewable energy consumption and travel. HBOS purchased 100% renewable electricity for the entire UK estate in 2008. The total CO2 emissions reported above have been calculated using the old conversion factors to provide a more accurate like for like comparison. Using the new guidelines, the total emissions for 2008 would increase to 231,415 tonnes. In 2009, a priority for the Lloyds Banking Group will be to baseline environmental impacts across the combined Group.

Political Donations
It is HBOS policy not to make donations to political parties or incur political expenditure and the Company made no political donations in the year. However the law in this area is extremely broad in scope and could potentially capture legitimate business activities not in the ordinary sense considered to be political donations or political expenditure. To avoid inadvertent infringement, at its 2008 AGM the Board obtained shareholders' approval for the Company to make donations to EU Political Organisations and/or to incur EU Political Expenditure up to defined limits.

Share Capital
Details of the structure of the Company's share capital as at the year end, as well as movements in the authorised and issued share capital during the year, are provided in Note 39 to the Financial Statements on page 107.

For the purposes of the Companies Act 2006, as at 31 December 2008 the Company had issued ordinary and preference share capital of £1,952m, comprising £1,352m (69%) in ordinary shares and £600m (31%) in preference shares (for the purposes of this calculation, the nominal value of certain preference shares denominated in US dollars has been translated at the exchange rate prevailing on 31 December 2008). Holders of ordinary shares enjoy the rights accorded to them under UK company law including the right to receive the Company's Annual Report and Accounts, to attend and speak at general meetings, to appoint proxies and to exercise voting rights. Holders of preference shares have limited voting rights and in general may only vote on a variation of class rights, on a resolution to wind up the Company or in the event of the preference dividend being unpaid. Further details regarding the rights and obligations attaching to share classes are contained in the Articles of Association.

At 31 December 2008 there were no restrictions on the transfer of shares; prior approval was not required from the Company nor from other holders for such a transfer. No limitations were placed on the holding of shares and no class of shares carried special rights with regard to the control of the Company. No restrictions were placed on voting rights other than as outlined above with respect to preference shares. At 31 December 2008 the Company was not aware of any agreements between shareholders that may restrict the transfer of shares or exercise of voting rights.

Directors' Report continued

Disclosable Interests	Number of Shares	Percentage of Issued Share Capital	Nature of Holding
Legal & General Group plc and/or its subsidiaries	224,431,407	4.15%	Direct
	25,274,214	0.47%	Indirect
AXA SA	53,078,621	0.98%	Direct
	596,217,137	11.03%	Indirect

Disclosable Interests
As at 31 December 2008 there was a disclosable interest in the voting rights of the Company, as notified to the Company in accordance with Chapter 5 of the UK Listing Authority's Disclosure & Transparency Rules, as shown in the table above. Other than as shown, the Company was not aware of any ordinary shareholder with an interest of 3% or more in the issued share capital of the Company at 31 December 2008.

Significant Agreements
The Placing and Open Offer to raise £11.5bn of new capital (consisting of £8.5bn in ordinary shares and £3.0bn in preference shares) as part of a co-ordinated package of capital and funding measures for the banking sector implemented by HM Treasury was made available to HBOS on condition that the acquisition by Lloyds Banking Group plc completed. Other than this, in terms of the Companies Act 2006, the Company had not, as at 31 December 2008, identified any significant agreements that would take effect, alter or terminate on a change of control of the Company. Throughout the year the Company was a party to certain non-material agreements (including, for example, joint venture agreements and trust deeds relating to certain employee share plans) that did contain change of control provisions in the event of the takeover of the ultimate parent company but these were not considered to be significant on an individual basis.

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 appoint PricewaterhouseCoopers LLP as auditors of the Company in the place of the outgoing auditors will be put to the 2009 AGM.

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware:

- **there is no relevant audit information (as defined by section 234ZA of the Companies Act 1985) 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
26 February 2009

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.

Company law requires the Directors to prepare Group and parent Company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law 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 IFRSs as adopted by the EU to present fairly 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 IFRSs 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, the Directors are also responsible for preparing a Directors' Report that complies with that law.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Independent auditors' report to the members of HBOS plc

We have audited the Consolidated and Parent Company financial statements (the 'financial statements') of HBOS plc for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated and Parent Company Balance Sheets, the Consolidated and Parent Company Cash Flow Statements, the Consolidated and Parent Company Statements of Recognised Income and Expense, and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Company's 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 Company'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 Company and the Company'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 39.

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

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether 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 Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the 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 judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

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

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the Consolidated 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 2008 and of its loss for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- the Parent Company 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 Company's affairs as at 31 December 2008;
- the Parent Company 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

KPMG Audit Plc
Chartered Accountants
Registered Auditor
Edinburgh

26 February 2009

Consolidated Income Statement
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
Interest income		**37,411**	35,012
Interest expense		**(29,240)**	(27,708)
Net interest income	1	**8,171**	7,304
Fees and commission income		**2,305**	2,378
Fees and commission expense		**(1,178)**	(1,118)
Net earned premiums on insurance contracts	5	**5,344**	5,616
Net trading (expense)/income	2	**(2,878)**	178
Change in value of in-force long term assurance business		**(300)**	16
Net investment (expense)/income related to insurance and investment business		**(9,524)**	4,613
Other operating income		**1,672**	2,304
Net operating income	3	**3,612**	21,291
Change in investment contract liabilities	6	**12,816**	(2,538)
Net claims incurred on insurance contracts	5	**(3,703)**	(2,952)
Net change in insurance contract liabilities		**(3,863)**	(2,244)
Change in unallocated surplus	32	**942**	50
Administrative expenses	7	**(5,114)**	(4,979)
Depreciation and amortisation:			
Intangible assets other than goodwill	23	**(209)**	(193)
Property and equipment	24	**(221)**	(224)
Operating lease assets	26	**(1,178)**	(985)
		(1,608)	(1,402)
Goodwill impairment	23	**(158)**	(5)
Operating expenses		**(688)**	(14,070)
Impairment losses on loans and advances	12 (a)	**(9,857)**	(2,012)
Impairment losses on investment securities	12 (b)	**(2,193)**	(60)
Operating (loss)/profit		**(9,126)**	5,149
Share of (loss)/profit of jointly controlled entities	21	**(669)**	234
Share of loss of associates	21	**(287)**	
(Loss)/profit on sale of businesses	4	**(743)**	91
(Loss)/profit before taxation	11	**(10,825)**	5,474
Tax on (loss)/profit	13	**3,409**	(1,365)
(Loss)/profit after taxation		**(7,416)**	4,109
Profit of subsidiary acquired with a view to resale			4
(Loss)/profit for the year		**(7,416)**	4,113
Attributable to:			
Parent company shareholders		**(7,499)**	4,045
Minority interests		**83**	68
		(7,416)	4,113
Earnings per ordinary share	14		(Restated)
- Basic		**(167.8)p**	103.4p
- Diluted		**(167.8)p**	102.8p

Consolidated Balance Sheet
As at 31 December 2008

	Notes	2008 £m	2007 £m
Assets			
Cash and balances at central banks	53	**2,502**	2,945
Items in course of collection		**445**	945
Financial assets held for trading	16	**22,571**	54,681
Derivative assets	17	**51,810**	14,141
Loans and advances to banks		**17,645**	7,683
Loans and advances to customers	18	**435,223**	430,007
Investment securities	20	**133,372**	127,659
Interests in jointly controlled entities	21	**938**	1,351
Interests in associates	21	**223**	373
Goodwill and other intangible assets	23	**2,375**	2,790
Property and equipment	24	**1,433**	1,494
Investment properties	25	**3,045**	4,731
Operating lease assets	26	**3,967**	4,643
Deferred costs	27	**1,181**	1,101
Retirement benefit asset	33	**629**	
Value of in-force long term assurance business	28	**2,992**	3,184
Other assets	29	**4,851**	7,468
Current tax assets		**983**	
Deferred tax assets	34	**2,556**	70
Prepayments and accrued income		**1,176**	1,751
Total Assets		**689,917**	667,017
Liabilities			
Deposits by banks		**97,150**	41,513
Customer accounts		**222,251**	243,221
Financial liabilities held for trading	16	**18,851**	22,705
Derivative liabilities	17	**38,905**	12,311
Notes in circulation		**957**	881
Insurance contract liabilities	30	**30,712**	26,864
Investment contract liabilities	31	**39,482**	52,828
Unallocated surplus	32	**551**	1,493
Retirement benefit liabilities	33	**152**	347
Current tax liabilities		**58**	370
Deferred tax liabilities	34	**227**	2,600
Other liabilities	35	**5,109**	5,072
Accruals and deferred income		**3,099**	3,630
Provisions	36	**347**	175
Debt securities in issue	37	**188,448**	206,520
Other borrowed funds	38	**30,119**	24,253
Total Liabilities		**676,418**	644,783

	Notes	2008 £m	2007 £m
Shareholders' Equity			
Issued share capital	39	**1,550**	1,131
Share premium	41	**6,709**	2,997
Other reserves	41	**(5,616)**	154
Retained earnings	41	**9,556**	17,567
Shareholders' Equity (excluding minority interests)		**12,199**	21,849
Minority interests	41	**1,300**	385
Total Shareholders' Equity	41	**13,499**	22,234
Total Liabilities and Shareholders' Equity		**689,917**	667,017

Approved by the Board on 26 February 2009 and signed on its behalf by:

Jo Dawson
Director

Philip Gore-Randall
Director

PA Gore-Randall

Tim Tookey
Director

Dan Watkins
Director

Consolidated Statement of Recognised Income and Expense
For the year ended 31 December 2008

	2008 £m	2007 £m
Net actuarial gains from defined benefit plans (net of tax)	**568**	312
Foreign exchange translation	**187**	2
Available for sale investments:		
Net change in fair value (net of tax)	**(5,897)**	(333)
Net gains transferred to the income statement (net of tax)	**(17)**	(201)
Impairment recognised in income statement (net of tax)	**915**	17
Cash flow hedges:		
Effective portion of changes in fair value taken to equity (net of tax)	**(2,802)**	(216)
Net losses/(gains) transferred to the income statement (net of tax)	**1,844**	(292)
Net expense recognised directly in equity	**(5,202)**	(711)
(Loss)/profit for the year	**(7,416)**	4,113
Total recognised income and expense	**(12,618)**	3,402
Attributable to:		
Parent company shareholders	**(12,701)**	3,334
Minority interests	**83**	68
	(12,618)	3,402

Consolidated Cash Flow Statement
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
(Loss)/profit before taxation		**(10,825)**	5,474
Adjustments for:			
Impairment losses on loans and advances		**9,857**	2,012
Impairment losses on investment securities		**2,193**	60
Impairment losses on property under construction		**10**	
Depreciation and amortisation		**1,608**	1,402
Goodwill impairment		**158**	5
Interest on other borrowed funds		**1,579**	1,229
Pension charge for defined benefit schemes		**171**	146
Cash contribution to defined benefit schemes		**(225)**	(295)
Exchange differences[1]		**1,311**	(769)
Movement in derivatives held for trading		**1,193**	(1,487)
Other non-cash items		**4,276**	45
Net change in operating assets		**(14,265)**	(78,714)
Net change in operating liabilities		**7,468**	68,470
Net cash flows from operating activities before tax		**4,509**	(2,422)
Income taxes paid		**(797)**	(895)
Cash flows from operating activities		**3,712**	(3,317)
Cash flows from investing activities		**863**	(289)
Cash flows from financing activities		**1,343**	298
Net increase/(decrease) in cash and cash equivalents		**5,918**	(3,308)
Opening cash and cash equivalents		**6,185**	9,493
Closing cash and cash equivalents	53	**12,103**	6,185

(1) Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

Investing Activities

	2008 £m	2007 £m
Sale of other intangible assets	**409**	31
Purchase of other intangible assets	**(306)**	(249)
Sale of property and equipment	**185**	182
Purchase of property and equipment	**(410)**	(307)
Purchase of investment properties	**(129)**	
Sale of investment properties	**398**	58
Investment in subsidiaries		(41)
Disposal of subsidiaries	**1,110**	115
Investment in jointly controlled entities and associates	**(489)**	(396)
Disposal of jointly controlled entities and associates	**75**	176
Dividends received from jointly controlled entities	**12**	132
Dividends received from associates	**8**	10
Cash flows from investing activities	**863**	(289)

Financing Activities

	2008 £m	2007 £m
Issue of ordinary shares	**4,131**	146
Issue of equity preference shares to minority shareholders	**750**	
Share capital buyback		(500)
Purchase of own shares	**(189)**	(212)
Disposal of own shares	**101**	35
Issue of other borrowed funds	**2,285**	4,742
Repayments of other borrowed funds	**(3,021)**	(928)
Interest on other borrowed funds relating to the servicing of finance	**(1,505)**	(1,199)
Minority interest acquired	**242**	
Repayment of capital to minority interests	**(110)**	
Equity dividends paid	**(1,286)**	(1,747)
Dividends paid to minority shareholders in subsidiaries	**(55)**	(39)
Cash flows from financing activities	**1,343**	298

Company Balance Sheet
As at 31 December 2008

	Notes	2008 £m	2007 £m
Assets			
Amounts owed by Group entities	22	**50,157**	38,885
Derivative assets	17	**2,638**	162
Investment securities	20		1
Intangible assets	23	**4**	6
Retirement benefit asset	33	**629**	
Other assets	29	**185**	395
Deferred tax assets	34		85
Prepayments and accrued income		**171**	
Investments in subsidiaries	22	**15,783**	14,475
Total Assets		**69,567**	54,009
Liabilities			
Amounts owed to Group entities		**36,450**	29,267
Derivative liabilities	17	**55**	56
Retirement benefit liabilities	33	**104**	360
Deferred tax liabilities	34	**161**	
Other liabilities	35	**296**	204
Accruals and deferred income		**100**	68
Other borrowed funds	38	**22,235**	15,503
Total Liabilities		**59,401**	45,458
Shareholders' Equity			
Issued share capital	39	**1,550**	1,131
Share premium	41	**6,709**	2,997
Other reserves	41	**67**	69
Retained earnings	41	**1,840**	4,354
Total Shareholders' Equity	41	**10,166**	8,551
Total Liabilities and Shareholders' Equity		**69,567**	54,009

Approved by the Board on 26 February 2009 and signed on its behalf by:

Jo Dawson
Director

Philip Gore-Randall
Director

PA Gore-Randall

Tim Tookey
Director

Dan Watkins
Director

Company Statement of Recognised Income and Expense
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
Net actuarial gain from defined benefit plans (net of tax)		**593**	261
Net income recognised directly in equity		**593**	261
(Loss)/profit after taxation	15	**(1,902)**	1,731
Total recognised income and expense		**(1,309)**	1,992
Attributable to:			
Parent company shareholders		**(1,309)**	1,992

Company Cash Flow Statement
For the year ended 31 December 2008

	Notes	2008 £m	2007 £m
(Loss)/Profit before taxation		**(1,949)**	1,652
Adjustments for:			
Impairment losses on investment in subsidiaries		**4,192**	
Dividends received		**(2,374)**	(2,013)
Interest on other borrowed funds		**1,068**	776
Pension charge for defined benefit schemes		**(20)**	(11)
Cash contribution to defined benefit schemes			(105)
Other non-cash items		**(19)**	9
Net change in operating assets		**(7,551)**	(728)
Net change in operating liabilities		**8,814**	4,309
Net cash flows from operating activities before tax		**2,161**	3,889
Income taxes received		**245**	29
Cash flows from operating activities		**2,406**	3,918
Cash flows from investing activities		**(5,581)**	(3,832)
Cash flows from financing activities		**3,868**	(169)
Net increase/(decrease) in cash and cash equivalents		**693**	(83)
Opening cash and cash equivalents		**1,177**	1,260
Closing cash and cash equivalents	53	**1,870**	1,177

Investing Activities

	2008 £m	2007 £m
Investment in subsidiaries	**(5,500)**	(2,480)
Advances to Group entities	**(2,455)**	(3,365)
Dividends received	**2,374**	2,013
Cash flows from investing activities	**(5,581)**	(3,832)

Financing Activities

	2008 £m	2007 £m
Issue of shares	**4,131**	146
Ordinary share buyback including costs		(500)
Issue of other borrowed funds	**2,284**	2,746
Repayment of other borrowed funds	**(267)**	
Equity dividends paid	**(1,286)**	(1,747)
Interest on other borrowed funds relating to servicing of finance	**(982)**	(752)
Purchase of own shares	**(12)**	(62)
Cash flows from financing activities	**3,868**	(169)

Notes to the Financial Statements

Accounting Policies

Financial Statements

The financial statements of HBOS plc comprise the Consolidated Income Statement and the Consolidated and Company Balance Sheets, Cash Flow Statements and Statements of Recognised Income and Expense together with the related Notes to the Financial Statements. The notes include information contained in the Risk Management section of the Business Review on pages 13 to 33 that are cross-referenced into the financial statements. These disclosures are required under IAS 1 'Presentation of Financial Statements' relating to the management of capital and IFRS 7 'Financial Instruments: Disclosures' relating to the nature of risks and their management. These disclosures form an integral part of the financial statements and are prefaced as such on the respective pages.

Statement of Compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) as adopted by the European Union. The standards applied by the Group and Company are those endorsed by the European Union and effective at the date the financial statements are approved by the Board. However, the Group has not utilised the carve-out provisions in respect of full fair value and portfolio hedging of core deposits in IAS 39 'Financial Instruments: Recognition and Measurement' as adopted by the European Union and has implemented the principles of IFRIC 12 Service Concession Arrangements although this has an immaterial effect on the financial statements. Consequently, the financial statements comply with International Financial Reporting Standards.

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

Basis of Preparation

a) Principles Underlying Going Concern Assumption

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

In the context of this continued turbulence and uncertainty in the financial markets, combined with a deteriorating global economic outlook, the Group has also taken steps to strengthen its capital position in order to provide a buffer against further shocks arising from the financial systems and to ensure that it remains competitive. On 15 January 2009, in conjunction with the takeover of the Group by Lloyds TSB Group plc (Note 57), the Group raised £11,345m (net after costs) in preference and ordinary share capital (Note 39).

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

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

Based upon projections prepared by Lloyds Banking Group plc management which take into account the acquisition on 16 January 2009 of the Group (Note 57) and together with the Lloyds Banking Group's current ability to fund in the market and assumption that announced Government sponsored schemes will continue to be available, the Directors are satisfied that the Company and the Group have adequate resources to continue in business for the foreseeable future. The Group has received confirmation that it is the current intention of Lloyds Banking Group plc to ensure that the Group's subsidiaries should have at all times for the foreseeable future access to adequate resources to continue to trade and meet their liabilities as they fall due. Accordingly, the financial statements of the Company and the Group have been prepared on a going concern basis.

b) Basis of Measurement

The financial statements have been prepared under the historical cost basis, except that the following assets and liabilities which 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. In addition insurance contracts, investment contracts with discretionary participation features and value of in-force long term assurance business included in the insurance and investment business are prepared on the basis set out in the applicable accounting policy.

IFRS Applied in 2008

The following IFRS amendments have been applied in 2008:

Amendments to IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'.

In view of the ongoing market dislocation and the deterioration of the world's financial markets, the Group transferred certain asset backed securities (ABS) and floating rate notes (FRNs) from the 'held for trading' classification to the 'available for sale' classification with effect from 1 July 2008 at their fair values at that date. Subsequently, in light of increasing illiquidity in the markets for ABS, the Group changed the classification of ABS from 'available for sale' to 'loans and receivables' with effect from 1 November 2008. There have been no other reclassifications in the year. Thereafter the recognition and measurement principles of IAS 39 are followed. Disclosure of these reclassifications is given in Note 45.

The following IFRIC interpretations have been applied in 2008:

IFRIC 11 IFRS 2 'Group and Treasury Share Transactions'.
IFRIC 11 provides guidance on accounting in the separate financial statements of subsidiaries for transactions where a parent grants rights to its equity instruments directly to the employees of subsidiaries and where the subsidiary grants to its employees rights to the equity instruments of the parent. The application of this interpretation has not affected the company financial statements as costs are recharged to the subsidiaries on the basis prescribed in the interpretation.

IFRIC 14 'The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'.
This interpretation has been applied in full within these financial statements. However, due to the financial rules of the Group's defined benefit schemes, its application has not impacted upon the Group's recognition or measurement of pension assets and liabilities under IAS 19 'Employee Benefits', nor is it expected to at future reporting dates.

The accounting policies below have been consistently applied to all periods presented in these financial statements. Certain comparative amounts have been reclassified to conform to the current year's presentation.

Basis of Consolidation

The consolidated financial statements include the results of the Company and its subsidiary undertakings (and, where appropriate, special purpose vehicles), together with the Group's interests in associates and jointly controlled entities.

The financial statements of entities controlled by the Group are consolidated in 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 so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. When assessing whether or not a special purpose entity (SPE) that has been sponsored by the Group should be consolidated or not, the Group considers the indicators of control that are included in the Standing Interpretations Committee (SIC) Interpretation 12 'Consolidation – Special Purpose Entities' and if these are met the SPE is included in the consolidation.

Open Ended Investment Companies (OEICs) where the Group, through the Group's life funds, has a controlling interest are consolidated. The unit holders' interest is reported in investment contract liabilities.

All intra-group balances, transactions, income and expenses are eliminated on consolidation.

Recognition and Derecognition of Financial Assets and Liabilities

The Group recognises loans and advances to customers and banks, deposits by banks, customer accounts, debt securities in issue, other borrowed funds and other financial assets and liabilities upon origination.

The Group derecognises a financial asset when the contractual rights to the cash flows from the asset expire or it transfers the right to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in the transferred financial asset that is created or retained by the Group is recognised as a separate asset.

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled or expired.

Derivatives

Derivatives are measured at fair value and initially recognised 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 from changes in fair value is taken to net trading income, except for interest from derivatives used for economic hedging purposes that do not qualify for hedge accounting treatment which is 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 is 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 continually. 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 are 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. The amount deferred in reserves remains until the designated transaction occurs at which time it is released and accounted for in the income statement in line with the treatment of the hedged item. Where the hedge relationship subsequently proves ineffective, or where the hedged item is settled early or is terminated, the associated gains and losses that were recognised directly in reserves are reclassified to the income statement through net trading income. Where the hedging instrument expires or is terminated before the forecast transaction occurs, the associated gains and losses recognised in reserves remain deferred until the forecast transaction occurs.

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

Notes to the Financial Statements continued

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 separately on the 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. Changes in fair value are taken to the income statement through net trading income, and the host contract is accounted for in accordance with the policy for that class of financial instrument.

If quoted or market values are not available then 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 principally consist of reverse repurchase agreements, are carried at fair value and are classified as financial assets held for trading. Gains, losses and related income are taken to net trading income as they arise.

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

The fair value of loans and advances to customers is measured at the commitment date and calculated by discounting anticipated cash flows, including interest, at a current market rate of interest. The fair value of floating rate loans and advances and overnight deposits is considered by the Group to be equal to the carrying value as these loans and advances are accounted for at current interest rates and credit risk is assessed in the impairment review. The fair value of fixed interest bearing accounts is based on cash flows discounted using current money market interest rates for debts with similar maturity and credit risk characteristics.

Loans and advances that are performing in accordance with the underlying contract are classified as neither past due nor impaired. If a customer fails to make a payment that is contractually due, or if the loan is in excess of facility limit, the loan is classified as past due.

If subsequently all contractually due payments are made or if the loan continues to operate within limit, the loan reverts to its neither past due nor impaired status.

The Group assesses whether objective evidence of impairment exists individually for financial assets that are individually significant and individually or collectively for assets that are not significant. The estimation involved in these impairment assessments is considered a critical accounting estimate.

Objective evidence that a financial asset is impaired includes significant difficulty of the customer, breach of contract such as interest or principal payments being missed, the loan being in excess of facility limit for a sustained period or the likelihood that the borrower will enter bankruptcy.

Objective evidence may also arise from wider economic and financial market indicators including factors that pertain to a particular industry sector or local economy.

The amount of any impairment is calculated by comparing the net present value of estimated future cash flows, discounted at the loan's original effective interest rate, with the carrying value of the loan. If impaired, the carrying value is adjusted via the provision and the additional provision is 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 income in the income statement and represents the unwinding of the discount.

A write-off is made when it is not possible or economically viable to collect all or part of a claim. Write-offs are offset against the release of a previously established impairment provision or directly through the income statement.

Loans with no identified evidence of individual impairment are subject to collective impairment assessment. This is to quantify impairment losses which exist at the balance sheet date, but which have not yet been individually identified. Collective assessment is carried out 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.

Terms and conditions for past due or impaired loans and advances may be renegotiated. When the renegotiated contract becomes effective, the loan is subsequently classified as past due, impaired or neither past due nor impaired according to its performance under the renegotiated terms.

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 are acquired by special purpose securitisation entities that fund their purchase primarily through the issue of debt securities in issue.

Syndications
Syndication activity is undertaken as part of the Group's risk management strategy specifically with the intention of transferring credit risk and obtaining financing as distinct from trading.

The Group considers that loan commitments and subsequent draw down form one contract and the loan is therefore recognised at the date of the draw down at the fair value as measured at the commitment date plus directly attributable and incremental transaction costs. Loans pending syndication are classified as loans and receivables and derecognised upon sell down when the risks and rewards are transferred to a third party.

Finance Leases 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. They are recorded at an amount equal to the net investment in the lease, less any provisions for impairment, within loans and advances to customers.

The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income. Lease income is recognised over the term of the lease using the pre-tax net investment method, which reflects a constant periodic rate of return on the net investment.

All other assets leased to customers that do not transfer substantially all the risks and rewards of ownership are classified as operating leases. These assets, less any provision for impairment, are separately disclosed in the balance sheet and are recorded at cost less accumulated depreciation, which is calculated on a straight-line basis over their estimated useful lives. Operating lease rentals are recognised in operating income on a straight-line basis over the lease term. Finance and operating lease assets are regularly reviewed for impairment.

Leases entered into by the Group as lessee are primarily operating leases. Operating lease rentals payable are recognised as an expense in the income statement on a straight-line basis over the term unless a more systematic basis is more appropriate.

Investment Securities
Investment securities held for trading are classified as financial assets held for trading and 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 other than those held for trading or designated at fair value and for which there is no active market at inception are classified as loans and receivables. They are initially recognised at fair value plus directly related incremental 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 incremental transaction costs and are subsequently carried on the balance sheet at fair value. Unrealised gains or losses arise from changes in the fair values and are recognised directly in equity in the available for sale reserve, except for impairment losses or foreign exchange 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 income 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.

Investment securities classified as available for sale are continually reviewed at the specific investment level for impairment. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Objective evidence of impairment might include a significant or prolonged decline in market value below the original cost of a financial asset and, in the case of debt securities, including those reclassified as loans and receivables, non-receipt of due interest or principal repayment, a breach of covenant within the security's terms and conditions or a measurable decrease in the estimated future cash flows since their initial recognition.

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 values of investment securities trading in active markets are based on market prices or broker/dealer valuations. Where quoted prices on instruments are not readily and regularly available from a recognised broker, dealer or pricing service, or available prices do not represent regular transactions in the market, the fair values are estimated using quoted market prices for securities with similar credit, maturity and yield characteristics or similar valuation models. Investment securities, principally asset backed securities (ABS), not traded in an active market are valued using valuation models that include non-market observable inputs. These models use observed issuance prices in related asset classes, market correlations, prepayment assumptions and external credit ratings. Additional assessments are then made on possible deterioration in credit risk for each individual security and on additional liquidity considerations for particular asset classes.

The Group uses trade date accounting when recording the purchase and sale of investment securities.

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

Associates 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.

The venture capital exemption is taken for investments where significant or joint control is present and the investing area operates as a venture capital business. These investments are designated at fair value through the income statement. Otherwise, the Group's share of results of associates 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.

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 a business is capitalised as goodwill. 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 represent the business acquired.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Cash-generating units to which goodwill is allocated are subject to a semi-annual impairment review at 31 March and 30 September and whenever there is an indication that the unit may be impaired. This compares the recoverable amount, being the higher of a cash-generating units' fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value of goodwill is not recoverable, it is irrevocably written down through the income statement by the amount of any impaired loss identified. Further details of the calculation are given in the critical accounting estimates and in Note 23.

Notes to the Financial Statements continued

IFRS 3 'Business Combinations' has not been applied retrospectively to business combinations that occurred before 1 January 2004.

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 and will generate future economic benefits to the Group either through sale or use.

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.

Purchased Value of In-Force Investment Contracts

The Group's contractual rights to benefits from providing investment management services in relation to investment contracts acquired in business combinations and portfolio transfers are measured at fair value at the time of acquisition. The resulting asset is referred to as purchased value of in-force investment contracts (PVIF) and is amortised over the estimated lives of the contracts on a systematic basis. At each reporting date an assessment is made to determine if there is any 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 is then adjusted to reflect the revised carrying amount.

Property, Plant and Equipment

Property, plant 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 comprise freehold and leasehold property that are held, either to earn rental income or for capital appreciation or both. They are initially recognised at cost and are fair valued annually. Rental income from investment properties is recognised on a straight-line basis over the term of the lease and 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 business.

Investments in Subsidiaries

Investments in subsidiaries are included in the Company's balance sheet. These comprise equity investments in, and capital contributions to subsidiary entities. These are carried at cost less impairment provisions. At each reporting date an assessment is undertaken to determine if there is any indication of impairment. This assessment can include reviewing factors such as the solvency, profitability and cash flows generated by the subsidiary. If there is an indication of impairment, an estimate of the recoverable amount is made. If the carrying value exceeds the recoverable amount then a provision for impairment is made to reduce the carrying value to the recoverable amount.

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. This applies where the assets and liabilities are available for sale in their present condition, subject only to the terms that are usual and customary for the sale of such assets and liabilities, and when a sale is highly probable and expected to complete within one year of being classified as a disposal group. Disposal groups are measured at the lower of carrying amount and fair value less costs to sell.

Deposits by Banks and Customer Accounts

Deposits by banks and customer accounts held for trading are classified as financial liabilities held for trading and are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. 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 maturities.

Repurchase Agreements

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, customer accounts or financial liabilities held for trading. Conversely, 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, loans and advances to customers, or financial assets held for trading. 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.

General Insurance Business
The Group underwrites general insurance products. For each general insurance policy underwritten, premiums (net of refunds) are credited to net earned premiums on insurance contracts over the period of risk coverage of the insurance policy.

The cost of claims notified but not settled and claims incurred but not reported at the balance sheet date are estimated and provided for. Claims incurred comprise the settlement and handling costs of paid and outstanding claims arising from events occurring during the financial year together with adjustments to prior year claims provisions. Estimates are based upon an assessment of the likely costs taking account of all known facts. Where the outcome of outstanding cases is unclear, statistical techniques are used which take into account the cost of recent similar claim settlements.

Costs related to the acquisition of new insurance contracts (including commissions paid to intermediaries and other related administration costs) are capitalised as deferred acquisition costs (DAC) and amortised on the same basis that premiums are recognised.

Where the expected value of claims and expenses attributable to unexpired risk periods exceed the value of unearned premiums less DAC, at the balance sheet date, additional provisions are made for the anticipated losses.

The accounting policies set out above in respect of the measurement of the insurance contract liabilities include liability adequacy testing that meets the requirements of IFRS 4 'Insurance Contracts'.

Insurance and Investment Product Classification
The Group has classified its long term insurance and investment business in accordance with IFRS 4 'Insurance Contracts' as follows:

- Insurance contracts are contracts containing significant insurance risk. Such contracts remain insurance contracts until all rights and obligations are extinguished or expired;
- Investment contracts with a discretionary participation feature (DPF) are contracts that do not contain significant insurance risk but that contain discretionary participation features, which for the Group are its with-profit contracts; and
- Investment contracts are contracts that have neither significant insurance risk nor a DPF.

General insurance business only issues insurance contracts.

Value of In-force Long Term Assurance Business (VIF)
The Group places a value on the long term insurance contracts and investment contracts with DPF, which represents the present value of future cash flows attributable to the Group with respect to these contracts. The change in VIF is accounted for as revenue.

In-force business is defined as all policies where the first premium has been paid. For traditional with-profit business, the surplus attributable to the Group equates to one ninth of the cost of the bonuses declared in any year. The level of assumed future bonuses is calculated by projecting the portfolio of with-profit business forward and applying reversionary and terminal bonus rates so as to exhaust the projected surplus of assets attributable to with-profit policyholders.

Insurance Contracts and Investment Contracts with DPF
Insurance contracts and investment contracts with DPF liabilities written within the with-profit fund, including both traditional and unitised with-profit contracts, are calculated with reference to the expected payout using realistic and, where applicable, market consistent assumptions in accordance with FRS 27 'Life Assurance'. Insurance contract liabilities within the non-profit funds are calculated in accordance with the Prudential Sourcebook for insurers (INSPRU) issued by the UK Financial Services Authority. For insurance contracts, premiums are recognised as revenue when due from the policyholder and claims payable are recorded when notified or due. For unitised with-profit contracts, where the policyholder has the choice to invest in a unit-linked investment fund, deposits and withdrawals are accounted for directly on the balance sheet. Similarly, for investment contracts with DPF, deposits and withdrawals are accounted for directly in the balance sheet.

At each reporting date an assessment is made of whether liabilities are adequate using current estimates of future cash flows and taking into account the value of any related VIF asset. Any deficiency is immediately charged to the income statement by establishing a provision on the balance sheet.

Costs related to the acquisition of new long-term insurance and investment with DPF contracts are expensed as incurred.

Investment Contracts
The Group's investment contracts, which include collective investment schemes, are primarily unit-linked. These contracts are managed and evaluated on a fair value basis in accordance with the terms of the contracts as benefits are linked to the fair value of the assets supporting the contracts. Accordingly, the investment contract liabilities have been designated at fair value through the income statement with fair value changes recognised through change in investment contract liabilities. The fair value of the liabilities is estimated using a valuation technique. In accordance with this technique the liability is established as the bid value of the assets held to match the liability, less an allowance in relation to deductions made to the liability for capital gains tax on the gains relating to the matching assets. Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability with other changes recognised in the income statement.

Revenue in relation to investment management services is recognised as the services are provided. Incremental costs directly attributable to securing the Group's contractual right to benefit from providing investment management services in relation to investment contracts, other than through a business combination or portfolio transfer (refer to the accounting policy for intangible assets), are recognised as an asset if it is probable that they will be recovered.

Incremental costs include commissions paid to intermediaries and other similar costs. This asset, referred to as deferred origination costs, is amortised as the related investment management revenue is recognised, and its recoverability assessed at each balance sheet date on a portfolio basis.

Notes to the Financial Statements continued

Unallocated Surplus

The unallocated surplus is accounted for as a liability as permitted by IFRS 4. The carrying value of the unallocated surplus is determined as the residual assets of the with-profit fund after providing for the with-profit liabilities in accordance with the policies described above.

Reinsurance

Contracts entered into with reinsurers under which the Group is compensated for losses on insurance contracts issued by the Group, and that meet the classification requirements for insurance contracts, are classified as reinsurance contracts held. The benefits to which the Group is entitled under these contracts are recognised as reinsurance assets. These assets consist of short term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related insurance contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts, in accordance with the terms of each reinsurance contract, and are regularly reviewed for impairment.

Post Retirement Schemes

The Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan. The net obligation represents the present value of the future benefits owed to employees in return for their service in the current and prior periods, after the deduction of the fair value of any plan assets.

The discount rate used is the market yield on high quality corporate bonds at the balance sheet date that have maturity dates approximating to the terms of the Group's obligation. The calculation is performed by a qualified actuary using the projected unit credit method. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised immediately through the statement of recognised income and expense.

The charge to the income statement for defined benefit schemes includes current service cost, past service cost, the interest cost of the scheme liabilities and the expected return on scheme assets.

The cost of contributions to defined contribution pension schemes are recognised as an expense in the income statement as incurred.

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 in full using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following 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 overseas earnings where both remittance is controlled by the Group and it is probable that the difference will 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, based on tax rates that are enacted or substantially enacted at the balance sheet date.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised.

The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Provisions

The Group recognises a provision if there is a present obligation as a consequence of either a legal or a constructive obligation resulting from a past event. To recognise this it should be 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 once a detailed restructuring plan has been formally approved and the plan has been announced publicly or work on the restructure has commenced.

Provision is made for undrawn loan commitments which have become onerous.

As explained under critical accounting judgements, if the Group assesses that a constructive obligation for a regulatory provision exists then a provision is established. Where the provisioning criteria are met, the Group makes provision for the estimated cost of making redress payments to customers in respect of past product sales where the sales processes have been deficient. To calculate the provision the Group estimates the number of cases requiring redress and the average cost per case. These are dependent upon, inter alia, the volume of claims, the actions of regulators and, as appropriate, the performance of investments. As progress is made in settling claims, if necessary, the Group revises its judgements and estimates based on the emerging trends.

Debt Securities in Issue

Debt securities in issue held for trading are classified as financial liabilities held for trading and are carried at fair value. Gains, losses and related expense 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 expense 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 incremental 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.

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, using the effective interest method.

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 expense.

Preferred securities are issued at or close to market values. These 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 expense.

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

Share Capital
Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction from the proceeds.

Netting
Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of offset and there is an intention and ability to settle on a net or simultaneous basis.

Where master netting agreements allow for offset only on default by one of the parties, the Group presents the disclosures on a gross basis.

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

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

Monetary assets and liabilities denominated in foreign currencies are translated at balance sheet date exchange rates. Exchange differences arising, including those from changes in the amortised cost of foreign currency monetary available for sale assets, are recognised in the income statement except for differences arising from hedges of net investments in foreign operations and derivatives related to cash flow hedges which are recognised directly in equity.

Non-monetary assets and liabilities carried at historical cost are translated using the historical exchange rate.

Non-monetary assets and liabilities carried at fair value are translated at exchange rates on the date the fair value is determined. Exchange differences arising are recognised in the income statement except those relating to available for sale financial assets (equity investments), which are recognised directly in reserves.

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 operation 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 exchange 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 exchange differences are recognised as a separate component of other reserves within equity.

On consolidation, exchange 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 exchange 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 will exclude translation differences that arose before 1 January 2004, but include later translation differences.

Cash and Cash Equivalents
Cash and cash equivalents consist of cash and balances at central banks that are freely available, and loans and advances to banks with an original maturity of three months or less excluding financial assets that are held for trading purposes.

Share-based Payments
The Group predominantly operates equity-settled share-based compensation schemes in exchange for employee services received. The fair values of options or shares granted are determined at the date of grant and expensed over the vesting period. The fair values 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. Market conditions are taken into account to set the fair value at grant and are not updated. Non-market vesting conditions, including non-market performance conditions, are not reflected in the grant date fair value but are reflected within estimates of the number of options or shares expected to vest. Any adjustments required as a result of updating these estimates are taken to the income statement over the remaining vesting period. Modifications are assessed at the date of modification and any incremental charges required are charged to the income statement over any remaining vesting period. For share based compensation schemes settled by the Company a recharge equal to the cost during the period is made to subsidiary companies.

Effective Interest Rate
Revenue on financial instruments classified as loans and receivables, available for sale and expense on financial liabilities at amortised cost, are recognised on an effective interest rate basis. This calculation takes into account interest received or paid and fees and commissions paid or received that are integral to the yield as well as incremental transaction costs and all other premiums and discounts. 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.

Notes to the Financial Statements continued

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 to estimate redemption profiles and derive the expected cash flows. A number of relevant considerations are taken into account to estimate the cash flows of individually significant corporate balances, including previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions at the date of acquisition. The impact of the assumption related to the expected life of the instruments is considered under critical accounting estimates.

Fees and Commission
Fees 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.

Fees and commission recognised in the income statement include service fees, agency and management fees, transaction fees, guarantee fees, letter of credit fees, asset management fees and non-utilisation fees.

Syndication and underwriting fees are spread over the expected term of the sell down. In the event of the loan not being sold down then no fees are recognised.

Fees and commission included in the effective interest calculation are those that are incremental and directly attributable to the origination of the product and which are integral to the yield of the product. These include arrangement fees, incentives such as cash backs, intermediary fees and commissions, high loan to value fees and procurement fees.

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.

Financial guarantees are initially recognised at fair value on the date the guarantee was given. Subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of the amount determined under the Group's accounting policy on provisions and the amount initially recognised less cumulative amortisation recognised to record any fee income earned in the period.

Intra-group financial guarantee contracts in the Company financial statements are accounted for as general insurance contracts. This practice also applies to any new intra-group financial guarantees written.

Critical Accounting Judgements and Estimates
The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based on amounts which differ from those estimates. Judgements, estimates and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

a) Critical Accounting Judgements
The preparation of the financial statements necessarily requires the exercise of judgement in the application of accounting policies which are set out above. These judgements are continually reviewed and evaluated based on historical experience and other factors. The principal critical accounting judgements made by the Group that have a material financial impact on the financial statements are as follows:

Designation of Financial Instruments
The Group has classified its financial instruments in accordance with IAS 39 'Financial Instruments: Recognition and Measurement'. In some instances the classification is prescribed whilst in others the Group is able to exercise judgement in determining the classification as follows:

- Non-derivative financial assets, other than those held for trading, where there is no active market and which have fixed or determinable payments are classified as 'loans and receivables';

- The Group's 'trading' portfolio is classified as 'held for trading'. The Group exercises judgement in determining which financial instruments form part of its trading book. This is determined at acquisition by the purpose for which the instrument is acquired;

- The Group exercised judgement when determining that the ongoing market dislocation and deterioration of the world's financial markets that occurred during the third quarter of 2008 was a sufficiently rare circumstance to warrant a reclassification of certain financial assets from 'held for trading' to 'available for sale' for which the Group has the intention and ability to hold these assets for the foreseeable future. The Group also subsequently reclassified certain financial assets from 'available for sale' to 'loans and receivables'. In both cases, the Group had the intention and ability to hold the financial assets for the foreseeable future and the financial assets transferred met the classification criteria of loans and receivables;

- Derivative instruments are automatically classified as 'at fair value through the income statement' unless they form part of an effective hedging relationship. The Group's accounting policy for hedge accounting is described under the policy for derivatives;

- Instruments that are deemed by the Group 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 on initial recognition as 'at fair value through the income statement'. In addition portfolios of assets, liabilities or both that are managed and the performance evaluated on a fair value basis in accordance with a documented risk or investment management strategy are designated on initial recognition 'at fair value through the income statement';

- In addition the venture capital exemption is taken for investments where significant influence or joint control is present and the investing area operates as a venture capital business. These investments are designated 'at fair value through the income statement'. This policy is applied consistently across the Group's portfolios. Judgement is applied when determining whether or not a business area operates as a venture capital business. The judgement is based on consideration of whether, in particular, the primary business activity is investing for current income, capital appreciation or both; whether the investment activities are clearly and objectively distinct from any other activities of the Group; and whether the investee operates as a separate business autonomous from the Group;

- Assets in support of the general insurance and long term assurance businesses are designated by the Group as 'at fair value through the income statement';
- Investment contracts within the long term assurance business are designated by the Group as 'at fair value through the income statement';
- The Group has chosen not to designate any financial assets as 'held to maturity';
- All other financial assets are classified as 'available for sale'; and
- All other financial liabilities are classified as 'at amortised cost'.

The accounting treatment of these financial instruments is set out in the relevant accounting policy.

Active Markets
Asset backed securities not traded in an active market are valued using models. An active market is one where prices are readily and regularly available from an exchange, broker, pricing service, industry group or regulator and these prices represent actual and regularly occurring transactions on an arm's length basis. Where there are no regular transactions occurring (significant liquid markets) the market is not described as active. A significant increase in the spread between the amount sellers are 'asking' and buyers are 'bidding' or the presence of a relatively small number of 'bidding' parties, are indicators that a market may be inactive. The determination of whether a market is inactive requires judgement.

More details of the models used to value the securities not traded in an active market are given in the 'fair values' section in critical accounting estimates below.

Impairment of Investment Securities
As explained in the accounting policy, investment securities are reviewed at the specific investment level for impairment. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Objective evidence of impairment might include a significant or prolonged decline in market value below the original cost of a financial asset and, in the case of debt securities, including those reclassified as loans and receivables, non-receipt of due interest or principal repayment, a breach of covenant within the security's terms and conditions or a measurable decrease in the estimated future cash flows since their initial recognition.

The disappearance of active markets, declines in market value and ratings downgrades do not in themselves constitute objective evidence of impairment and, unless a default has occurred on a debt security, the determination of whether or not objective evidence of impairment is present at the balance sheet date requires the exercise of management judgement.

Unarranged Overdraft Charges
The Group's accounting policy in respect of regulatory provisions is given in the section on provisions. In the absence of a legal obligation, judgement is necessary in determining the existence of a constructive obligation. In respect of the claims made for refunds of unarranged overdraft charges, the judgement of the Group is that there is no constructive obligation pending the outcome of the legal case.

Syndications
As explained in the accounting policy on syndications, the Group has elected to treat loans and advances pending syndication as loans and receivables rather than account for them as trading assets. Accordingly these are initially recognised at the draw down date at the fair value as at the commitment date plus directly attributable incremental transaction costs.

Investment in Subsidiaries
As explained in the accounting policies, investments in subsidiaries are included in the Company's balance sheet. These comprise equity investments in and capital contributions to subsidiary entities made by the Company. These are carried at cost less impairment provisions. At each reporting date, an assessment is undertaken to determine if there is an indication of impairment. This assessment can include reviewing factors such as the solvency, profitability and cash flows of the subsidiary.

If impairment indicators are evident, an estimate of recoverable amount is made which requires the exercise of management judgement.

More details of the methodology used to calculate recoverable amount are given in critical accounting estimates below.

Deferred Tax
Deferred tax assets and liabilities require management judgement in determining the amounts to be recognised. In particular, when assessing the extent to which deferred tax assets should be recognised with consideration given to the timing, nature and level of future taxable income. The recognition of deferred tax assets relating to tax losses carried forward relies on profit projections and taxable profit forecasts prepared by management, where a number of assumptions are required based on the levels of growth in profits and the reversal of deferred tax balances.

b) Critical Accounting Estimates
The preparation of the financial statements requires the Group to make estimations where uncertainty exists. The principal critical accounting estimates made by the Group are considered below. Disclosures about estimates and the related assumptions are also included in the appropriate Note to the Financial Statements.

Fair Values
The designation of financial instruments for measurement purposes is set out under the critical accounting judgements above and the valuation methodologies for financial instruments remain as disclosed in this accounting policy section.

Derivatives and other financial instruments classified as at fair value through the income statement or available for sale are recognised at fair value.

Debt securities measured at fair value and not traded in an active market, principally comprising asset back securities (ABS) in the Treasury division, are valued using valuation models that include non-market observable inputs. These models use observed issuance prices in related asset classes, market correlations, prepayment assumptions and external credit ratings. For each asset class within the ABS portfolio, the implied spread arrived at by using this methodology is applied to the securities within that asset class. Additional assessments are then made on possible deterioration in credit risk for each individual security and on additional liquidity considerations for particular asset classes.

Notes to the Financial Statements continued

Of the total debt securities carried at fair value on the balance sheet, the fair values of those calculated using models with inputs that are not observable in the market is £3,054m (2007 £17,790m).

For debt securities valuations using non-market observable inputs, the effect of a one hundred basis point move in credit spreads (which based upon experience is only key sensitivity) would result in a pre-tax movement of £163m (2007 £185m) for assets classified at fair value through the income statement and a post-tax movement of £nil (2007 £(351)m), recognised in equity reserves, on assets classified as available for sale.

On ABS that were valued using models with non-observable market inputs, a £1,056m (2007 £78m) pre-tax negative fair value adjustment was recognised in the income statement within net trading income and a post-tax negative fair value adjustment of £3,572m (2007 £158m) on ABS classified as available for sale was recognised in equity reserves.

Retirement Benefit Obligations
The expected cash flows used in the calculation of the defined benefit schemes' liabilities include a number of assumptions around mortality, inflation rates applicable to defined benefits and the average expected service lives of the employees. The selection of these assumptions and the selection of the discount rate have a material impact on the estimation of the pension liabilities. The discount rate used by the Group to calculate the defined benefit scheme liabilities is based upon a blended market yield at the balance sheet date of high quality bonds with a similar duration to that of the schemes' liabilities and is derived on a basis consistent with prior years. The sensitivity of the scheme liabilities to changes in the principal assumptions used are set out in Note 33.

Long Term Assurance Business
The estimation of the Group's insurance and investment contracts with discretionary participating features (DPF) liabilities and related value of in-force (VIF) assets relies on a number of assumptions in forecasting future experience. The selection of appropriate assumptions requires the application of material judgement and is made with reference to historic trends, taking into account the analysis of actual versus expected experience as well as industry data.

The accounting policy for insurance contracts and investment contracts with DPF and the description of long term assurance business in Note 30 describe the assumptions that are made when calculating the value of these contracts, which also impact on the value of the VIF and the unallocated surplus. The Group applies significant judgement when selecting the rates of persistency to be used in these calculations. The considerations given to lapse and surrender rate assumptions are detailed in Note 30. The sensitivity of the Group's results to changes in certain key variables on long term insurance and investment contracts and investment contracts with DPF are disclosed in Note 28.

Effective Interest Rate
As described in the accounting policy for effective interest rate, the Group uses statistical and mathematical models to calculate the effective yield for loans and advances. The Group applies judgement when determining the expected life of these loans. The underlying products usually allow the customer to make early repayment before the contractual maturity date. In estimating the expected life of the loan, the Group takes into account a number of relevant considerations when the asset is initially recognised to estimate the cash flows from early redemptions including the type of product, previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions. The cash flows are adjusted in the light of actual experience, however the effective interest rate is not reassessed. As a consequence of the reduced levels of principal repaid in 2008 and the resulting adjustments to estimated future cash flows a £200m credit (2007 £nil) has been taken to the income statement. If the estimated life of the Retail portfolio were to increase or decrease by one month then the carrying value of the Retail portfolio would increase or decrease by £6m (2007 £18m) respectively.

Impairment Losses on Loans and Advances
The Group regularly reviews its loan portfolios carried at amortised cost to assess for impairment. This review is conducted across all asset types and impairment provisions are established to recognise incurred impairment losses within the loan portfolios. As explained in the Group's accounting policy 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, historical loss experience for assets with similar credit risk characteristics and other factors including, inter alia, future prospects of the customers, value of collateral held and reliability of information. These calculations may be undertaken on either a portfolio basis or individually for individually significant exposures. In applying the portfolio basis the Group makes use of various statistical modelling techniques which are specific to different portfolio types.

The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment provisions given the range of asset types, number of customers and current economic conditions. This uncertainty is exacerbated in the current economic climate, where the timing of and value realisable from the collateral held in the form of property is particularly uncertain. Consequently these allowances can be subject to variation.

Goodwill
Goodwill arises on the acquisition of a business. As explained in the accounting policy for goodwill it is subject to a six monthly impairment review. This compares the recoverable amount, being the higher of a cash-generating units' fair value less costs to sell and its 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 as goodwill impairment.

The recoverable amount of goodwill carried at 31 December 2008 has been based upon value in use. This calculation uses cash flow projections based upon the five year business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows thereafter are extrapolated using a growth rate of 2.2% p.a, reflecting management's view of the expected future long term trend in growth rate of the respective economies concerned, predominantly being in the UK, and the long term performance of the businesses concerned. The pre-tax discount rate used in discounting the projected cash flows has, in view of current credit conditions, been increased to within a range of 14.4% - 15.3% p.a (2007: 10.0% - 12.2% p.a) reflecting, inter alia, the perceived risks within those businesses.

As at 31 December 2008 the carrying value of goodwill held on the balance sheet is £1,556m (2007 £1,940m) as shown in Note 23. Goodwill has been impaired by £158m during the year. The unprecedented levels of market turmoil and current economic conditions have adversely impacted the short-term profitability of the cash generating units. The Group has considered the impact upon the assumptions used and has conducted sensitivity analysis on the impairment tests. For example, an increase in the discount rate to 17% would result in an additional impairment to goodwill of £31m; alternatively if projected cash flows reduced by 20% an additional impairment of £118m would arise.

Investment in Subsidiaries

As explained in the accounting policies, investments in subsidiaries are included in the Company's balance sheet. These comprise equity investments in and capital contributions to subsidiary entities made by the Company and are carried at cost less impairment provisions. If impairment indicators are present, a comparison of the recoverable amount, being the higher of a subsidiary entity's value in use and fair value less costs to sell, is made with the carrying value. When this indicates that the carrying value is not recoverable it is written down by the impairment loss identified.

At 31 December 2008, the carrying value of the Company's investment in its principal subsidiary undertaking, Bank of Scotland plc, was £16,111m before write down.

The recoverable amount of this business is calculated based on value in use. This calculation uses five year projections which are extrapolated thereafter at a rate of 3.0% p.a with a discount rate of 14.6% p.a applied throughout.

As IAS 36 requires that, inter alia, estimates of future cash flows cannot include estimated future cash flows or related cost savings or benefits that are expected from future restructuring to which an entity is, under IAS 37, not yet committed, these projections exclude the effects of future synergies planned to arise from the Group's acquisition by Lloyds TSB Group plc.

This methodology results in a recoverable amount of £11,919m. Accordingly, a write-down of £4,192m was booked in the Company's Income Statement for the year ended 31 December 2008.

Notes to the Financial Statements continued

IFRS and IFRIC Not Yet Applied

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

IFRS 8 'Operating Segments' which is effective for periods commencing on or after 1 January 2009. This standard replaces IAS 14 'Segmental Reporting' and aligns the disclosure of operating segments in the financial statements with the internal reporting of segments to senior management. Following the acquisition of the Group by Lloyds TSB plc the Group will adopt the segmental structure and measurement basis for segments of the Lloyds Banking Group. These are currently being determined by the new organisation.

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

Amendment to IAS 23 'Borrowing Costs' which is applicable to borrowing costs related to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. The application of this revised standard in 2008 would not have had a material impact on the financial statements.

Amendment to IFRS 2 'Share-based Payment: Vesting Conditions and Cancellations' which is effective for periods commencing on or after 1 January 2009. This defines 'non-vesting' conditions and clarifies the accounting. The application of this amendment would not have an impact upon the financial statements as the Group accounting policy accords with the treatment prescribed by the amendment.

Amendments to IAS 32 and IAS 1 'Puttable Financial Instruments and Obligations Arising on Liquidation' which is effective for periods commencing on or after 1 January 2009. This amendment addresses the balance sheet classification of puttable financial instruments and obligations arising only on liquidation. Where these instruments represent a residual interest in the net assets of an entity and meet certain other conditions they should be classified as equity rather than liabilities. The Group has no items currently classified as liabilities that would need to be presented as equity as a result of this amendment because these instruments fail to meet the criteria for such a reclassification.

IFRIC 13 'Customer Loyalty Programmes' which is effective for periods commencing on or after 1 July 2008. The application of this interpretation in 2008 would not have had a material impact on the financial statements.

The following interpretation has not yet been adopted by the European Union but is effective for the year ended 31 December 2008. The Group has implemented the principles of this interpretation in preparing 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 would not have affected the financial statements as the Group accounting policy accords with the requirements.

The following standards and interpretations have not yet been adopted by the European Union, are not effective for the year ended 31 December 2008 and have not been applied in preparing the financial statements. Where appropriate disclosures will be revised in the financial statements in the year in which the standard or interpretation becomes applicable.

IFRS 1 'First-time adoption of IFRS' which is effective for periods commencing on or after 1 January 2009. As the Group and Company reports under IFRS, the application of this amendment in 2008 would not have any effect upon the financial statements.

Amendments to IAS 27 'Consolidated and Separate Financial Statements' which is effective for periods commencing on or after 1 January 2009. This amendment removes the definition of the cost method which requires dividends from pre-acquisition profits to be set off against the cost of an investment in a subsidiary. Application in 2008 would not have had an effect upon the financial statements.

IFRIC 15 'Agreements for the Construction of Real Estate' which is effective for periods commencing on or after 1 January 2009. The application of this interpretation would not have affected the financial statements as the Group accounting policy accords with the requirements.

IFRIC 16 'Hedges of a Net Investment in a Foreign Operation' which is effective for periods commencing on or after 1 October 2008. The application of this interpretation in 2008 would not have affected the financial statements as the Group accounting policy accords with the requirements.

IFRIC 17 'Distributions of Non Cash Assets to Owners' which is effective for periods commencing on or after 1 July 2009. the application of this interpretation would not have affected the financial statements as the Group accounting policy accords with the requirements.

IFRIC 18 'Transfer of assets from customers' which applies to transfers of assets from customers received on or after 1 July 2009. The application of this interpretation in 2008 would not have had a material impact on the financial statements.

Improvements to IFRS 2008 The majority of these improvements are effective for periods commencing on or after 1 January 2009 and their application would not have had a material effect upon the financial statements.

Amendments to IAS 39 'Financial Instruments: Recognition and Measurement: Eligible Hedged Items' which is effective for periods commencing on or after 1 July 2009. This amendment clarifies what can be designated as a hedged item in a hedge accounting relationship and application in 2008 would not have had a material impact upon the financial statements.

Amendments to IAS 39 'Reclassification of Financial Assets': Effective Date and Transition which is effective on or after 1 July 2008. This amendment clarifies the effective date and transition requirements for the change to the standard issued in October 2008 permitting entities to reclassify non derivative financial assets out of the fair value through the income statement category in particular circumstances. The application of this amendment would not have affected the financial statements as the Group accounting policy accords with the requirements.

Revised IFRS 3 'Business Combinations' and amended IAS 27 'Consolidated and Separate Financial Statements' These changes are effective for periods beginning on or after 1 July 2009 with the main effects being that the cost of investment will comprise the consideration paid to the vendors for equity with acquisition costs being expensed immediately; goodwill will be accounted for only upon the acquisition of a subsidiary as subsequent changes in interest will be recognised in equity and only upon the loss of control will any profit or loss be recognised in income. Further, any pre-existing stake held will, where control is subsequently gained, be revalued with any profit or loss arising being booked to income. These changes will affect the manner in which acquisitions and disposals made by the Group are accounted for after the implementation of the revised Business Combinations standard and related revisions to IAS 27.

Notes to the Financial Statements continued

1 Net Interest Income

	2008 £m	2007 £m
Interest receivable:		
Loans and advances to customers	**29,892**	26,354
Loans and advances to banks	**740**	2,295
Investment securities	**652**	115
Lease and hire purchase receivables	**299**	321
Interest receivable on loans and receivables	**31,583**	29,085
Available for sale financial assets	**2,108**	2,278
Interest receivable on derivatives	**3,515**	3,374
Other	**205**	275
Total interest receivable	**37,411**	35,012
Interest payable:		
Deposits by banks	**3,959**	2,568
Customer accounts	**9,538**	9,837
Debt securities in issue	**10,191**	10,482
Other borrowed funds	**1,450**	1,169
Interest payable on liabilities held at amortised cost	**25,138**	24,056
Interest payable on derivatives	**3,473**	3,399
Other	**629**	253
Total interest payable	**29,240**	27,708
Net interest income	**8,171**	7,304

2 Net Trading (Expense)/Income

	2008 £m	2007 £m
Equity and commodity instruments and related non hedging derivatives	**952**	92
Interest bearing securities and related non hedging derivatives	**(4,174)**	58
Foreign exchange and related non hedging derivatives	**(16)**	72
Net gains and losses from trading financial instruments and non hedging derivatives	**(3,238)**	222
Gains/(losses) on fair value hedges:		
On hedging instruments	**3,467**	1,184
On the hedged items attributable to the hedged risk	**(3,110)**	(1,227)
	357	(43)
Cash flow hedge ineffectiveness recognised	**3**	(1)
Total net trading (expense)/income	**(2,878)**	178

3 Net Operating Income

	2008 £m	2007 £m
Included within net operating income are the following:		
Cash flow hedges:		
Net (losses)/gains released from equity into income (Note 41)	**(2,561)**	417
Financial instruments at fair value through the income statement:		
Net (losses)/gains from trading financial instruments and non hedging derivatives (Note 2)	**(3,238)**	222
Net (losses)/gains from designated financial instruments	**(9,669)**	4,884
Available for sale financial instruments:		
Dividend income	**108**	291
Net realised gains on sale (Note 41)	**24**	281
Financial instruments designated as loans and receivables:		
Net realised gains on sale	**22**	3

4 (Loss)/Profit on Sale of Businesses

Non-operating income consists of the following:

	2008 £m	2007 £m
Loss on the sale of Bank of Western Australia Ltd and St. Andrews Australia Pty Ltd	**(845)**	
Profit on the part disposal of Rightmove plc (Note 21)	**56**	59
Distribution from Visa Inc shares listing	**26**	
Profit on the sale and leaseback of certain branch premises	**20**	28
Profit on the sale of Insight Investment Management (C.I.) Limited		4
	(743)	91

On 8 October 2008, the HBOS Group agreed the sale of part of its Australian operations, principally Bank of Western Australia Ltd and St. Andrews Australia Pty Ltd, to Commonwealth Bank of Australia Limited. The sale completed on 19 December 2008 and results in a pre-tax loss on disposal of £845m (including goodwill written-off of £240m) which is included as non-operating income within the (loss)/profit on sale of businesses for the year.

Under the share sale agreement HBOS plc has provided certain warranties to Commonwealth Bank of Australia, that all relevant, material circumstances and facts in relation to the sale have been disclosed and described in agreement. The share sale agreement provided for adjustments to the initial purchase price based on the risk weighted assets of Bank of Western Australia Limited and the net assets of St. Andrews Australia Pty Limited. As a result, the loss on sale of these businesses may be subject to adjustment for the contingent element of the commitment receivable.

Following the sale HBOS retains a presence in Australia through Bank of Scotland International (Australia) Limited and Capital Finance Australia Limited which are engaged in corporate banking and asset finance activities respectively, together with the Bank of Scotland plc Sydney branch and therefore this sale does not constitute a discontinued activity. As such, the performance of the businesses sold and the loss on disposal remains within the profit arising from continuing operations of the Group. These businesses are reported in International division for segmental reporting purposes.

5 Insurance Premiums and Claims

	2008 £m	2007 £m
Gross written premiums		
Long term insurance	**4,542**	4,739
General insurance	**887**	889
	5,429	5,628
Premiums ceded to reinsurers	**(178)**	(168)
Net change in provision for unearned premiums	**93**	156
Net earned premiums on insurance contracts	**5,344**	5,616

	2008 £m	2007 £m
Claims incurred		
Long term insurance	**(3,450)**	(2,599)
General insurance	**(334)**	(420)
	(3,784)	(3,019)
Claim recoveries from reinsurers	**81**	67
Net claims incurred on insurance contracts	**(3,703)**	(2,952)

6 Change in Investment Contract Liabilities

	2008 £m	2007 £m
Net change in investment contracts designated at fair value through the income statement	**12,863**	(2,451)
Net change in investment contracts with a discretionary participating feature	**(47)**	(87)
	12,816	(2,538)

Notes to the Financial Statements continued

7 Administrative Expenses

	2008 £m	2007 £m
Administrative expenses include:		
Regulatory provisions charge (Note 36):		
Financial Services Compensation Scheme (FSCS) management expenses levy	**200**	
Unauthorised overdraft charges		122
Colleague costs (Note 8)	**2,983**	2,911
Accommodation, repairs and maintenance	**493**	450
Technology	**261**	273
Marketing and communication	**432**	380

8 Colleagues

The Group refers to its employees as colleagues. Most UK based colleagues are contractually employed by the Company. The expense related to these colleagues is recharged to the subsidiary that gains the benefit of their employment and accordingly there are no residual staff costs held by the Company.

	Group 2008 Number	2007 Number	Company 2008 Number	2007 Number
The average number of colleagues employed during the year was:				
Full time	**58,101**	57,129	**53,680**	53,455
Part time	**16,575**	16,958	**15,882**	16,265
	74,676	74,087	**69,562**	69,720

	2008 £m	2007 £m
The aggregate remuneration payable in respect of Group colleagues is included within administrative expenses and comprises:		
Wages and salaries	**2,348**	2,340
Social security costs	**207**	226
Pension costs (Note 33)	**268**	201
Other post retirement benefits (Note 33)	**4**	5
Expense arising from share-based payments (Note 40)	**156**	139
	2,983	2,911

9 Directors' Remuneration

	2008 £'000	2007 £'000
Emoluments	**8,891**	11,834
Compensation for loss of office[a]		1,475
	8,891	13,309
Total potential pre-tax gains on share options exercised	**1**	715
Total potential pre-tax gains on share schemes vested	**1,306**	4,989
	10,198	19,013

(a) This includes non monetary benefits of £nil (2007 £nil).

Highest Paid Director

	2008 £'000	2007 £'000
Emoluments[b]	**1,452**	2,606
Total potential pre-tax gains on share options exercised		3
Total potential pre-tax gains on share schemes vested	**603**[c]	412
	2,055	3,021

(b) This includes the 2007 element of the 2007/2008 biennial cash incentive of £121,000 (2007 £172,000).

(c) As reported previously, a retention reward originally granted in January 2002 matured in 2005. At this time, this was converted into shares and was subsequently placed in the Sharekicker Scheme maturing in March 2008. The value on maturity was £466,000 and this is included in gains on share schemes vested.

9 Directors' Remuneration continued

The total emoluments (including taxable benefits and allowances) of Directors in the year are set out in the table below:

	Salary and fees £'000	Taxable benefits and allowances £'000	Total year ended 2008 £'000	Total year ended 2007 £'000	Total year ended 2008 excluding pension allowance £'000	Total year ended 2007 excluding pension allowance £'000
Chairman						
Dennis Stevenson	**795**	**20**	**815**	821	**815**	821
Executive Directors						
Peter Cummings	**675**	**193**	**868**	2,434	**699**	2,276
Jo Dawson	**615**	**164**	**779**	943	**625**	837
Mike Ellis	**650**	**173**	**823**	292(2)	**660**	250
Philip Gore-Randall	**552**	**174**	**726**	275(2)	**588**	235
Andy Hornby	**1,025**	**306**	**1,331**	1,672	**1,075**	1,437
Colin Matthew	**630**	**179**	**809**	1,055	**652**	905
Dan Watkins	**520**	**162**	**682**	287(2)	**552**	247
Non-executive Directors						
Richard Cousins	**99**		**99**	70	**99**	70
Sir Ron Garrick	**258**		**258**	235	**258**	235
Anthony Hobson	**230**		**230**	221	**230**	221
Karen Jones	**135**		**135**	100	**135**	100
John E Mack	**117**		**117**	66	**117**	66
Coline McConville	**192**		**192**	151	**192**	151
Kate Nealon	**138**		**138**	151	**138**	151
Former Directors	**244**	**58**	**302**	3,441	**248**	3,184
	6,875	**1,429**	**8,304**	12,214	**7,083**	11,186
Biennial cash incentive for 2007/2008(1)			**587**	1,095	**587**	1,095
Total			**8,891**	13,309	**7,670**	12,281

(1) The biennial cash incentive 2007/2008 comprises only the element earned in 2007 but deferred and includes Peter Cummings £79,000 (2007 £172,000), Jo Dawson £72,000 (2007 £156,000), Mike Ellis £20,000 (2007 £nil), Philip Gore-Randall £19,000 (2007 £nil), Andy Hornby £121,000 (2007 £254,000), Colin Matthew £73,000, (2007 £160,000), Dan Watkins £54,000 (2007 £42,000), Former Directors £149,000 (2007 £311,000). The Directors waived their rights to any payment in respect of the 2008 element of the scheme.
(2) Part year only

Emoluments

No bonuses were paid to any Directors with respect to 2008 following waiver by the Directors of their respective rights to receive these bonus payments. Remuneration in respect of Non-executive Directors consists solely of fees. No short or long term bonuses or benefits were paid to any of the Non-executive Directors in the year.

The Group did not make any payments to Directors' pensions during the year. The table above includes in "taxable benefits and allowances" the non-pensionable cash allowances payable to Executive Directors in lieu of any further service-related pension accrual. The cash allowance was equivalent to 25% of salary, payable monthly. The allowances paid in 2008 were; Peter Cummings £168,833; Jo Dawson £153,833; Mike Ellis £162,500; Philip Gore-Randall £138,000; Andy Hornby £256,000; Colin Matthew £157,416; Dan Watkins £130,000; Phil Hodkinson £53,750.

During the year the non-pensionable cash allowance for Andy Hornby was increased by the Remuneration Committee of the Company to 50% of salary with effect from April 2006. Andy Hornby waived his entitlement to receive this incremental backdated increase of £645,000. His allowance of £256,000 is equivalent to 25% of salary in 2008 as paid to all other Executive Directors.

Comparative year end totals of emoluments excluding the non-pensionable cash allowances are also shown in the table above.

Pension contributions paid, or treated as paid in the year, was nil (2007 £5,000) to defined benefit schemes and nil (2007 nil) to money purchase schemes and were attributed to nil Directors (2007 one). Nil contributions related to the highest paid Director (2007 nil) resulting in an accrued pension of £240,000 at the year end (2007 £344,000). Nil (2007 nil) was paid to past Directors in respect of retirement benefits in excess of their normal entitlements.

The fees paid to Dennis Stevenson comprises a payment made to him personally in respect of his service as Chairman of the Company of £795,000 (2007 £707,500).

Notes to the Financial Statements continued

9 Directors' Remuneration continued

From 1 May 2007 the basic Board membership fee payable to Non-executive Directors was at a rate of £66,000 p.a. and from 1 May 2008 this basic Board membership fee was increased to a rate of £70,000 p.a. The basic Board membership fee covers the full range of duties and responsibilities associated with Non-Executive Directorship, including attending Board meetings and the Company's Annual General Meeting.

The figures shown in the table above also include, in respect of Non-executive Directors, fees for service on Committees of the Board and, where relevant, fees for services as Directors of Subsidiaries and Joint Ventures and for service on other Committees.

The taxable benefits and allowances payment to Dennis Stevenson comprises a Distant Accommodation Allowance of £20,000 p.a..

Taxable benefits and allowances for the Executive Directors comprise, where relevant, the benefit in kind values of company cars, healthcare, life assurance, concessionary rate mortgages and, a contribution towards the cost of providing distant accommodation away from the Executive Director's primary residential area, as well as the non-pensionable cash allowance mentioned earlier.

Resignations and terminations

Phil Hodkinson retired as a main board Director on 30 April 2008. He received no termination payment and his pension benefits, based on service to 5 April 2006 (when further service based accrual ceased) and final pensionable salary at retirement, were reduced for early retirement based on the period between his retirement date and his 55th birthday in accordance with his contractual entitlements, having served 5 years as an Executive Director.

Charles Dunstone stood down as Non-executive Director from the Board immediately following the Company's Annual General Meeting on 29 April 2008. Termination payments are not made to Non-executive Directors and no such payment was made to Charles Dunstone.

On 16 January 2009, on the acquisition of the Company by Lloyds TSB Group plc (now Lloyds Banking Group plc (LBG)) becoming effective, the Chairman and all other Directors of the Company (other than Jo Dawson, Philip Gore-Randall and Dan Watkins) were required to resign from the Board of the Company. Jo Dawson, Philip Gore-Randall and Dan Watkins will resign from the Board of the Company during 2009. For departing Executive Directors, the total payments and pension arrangements put in place at the termination of their respective employments do not, or will not, (as the case may be) go beyond their legal entitlements. No severance payments will be made to Jo Dawson or Dan Watkins on their resignation from the Board of the Company, as they continue to be employed by LBG.

On termination of their contracts by the Company, Messrs Hornby and Stevenson waived their respective entitlements to receive their contractual severance payments under their service agreements. Andy Hornby received a statutory redundancy payment of £2,970.

It was agreed that, on termination of their contracts, the following Executive Directors would receive payments in lieu of notice (equivalent to 12 months' salary) in accordance with their contractual entitlements; for entering into certain post-termination restrictive covenants (approximately £10,000); and, in the case of Peter Cummings and Colin Matthew, statutory redundancy. In total, these payments are as follows: Peter Cummings £702,080; Mike Ellis £670,500; Philip Gore-Randall £568,000; Colin Matthew £656,405. No payments were made with respect to further service based pension accrual, or in lieu of pension. On termination of his contract, Peter Cummings waived his right to receive a contractual bonus entitlement of £1,320,000 which had been earned in 2007 but deferred pursuant to its terms.

Pensions

The pension entitlements of the Executive Directors who were active members of the HBOS Final Salary Pension Scheme ("the Scheme") as at 31 December 2008 are set out in the table below:

Executive Directors' pension entitlements

Name	Age at 31/12/08	Accrued pension at 31/12/08 £'000 pa	Increase in accrued pension over year £'000 pa	Increase in accrued pension over year (net of inflation) £'000 pa	Transfer value at 31/12/08 £'000	Increase in transfer value £'000	Transfer value of net increase to accrued pension (less Director's contributions at 31/12/08) £'000
P Cummings	53	369	25	7	**7,090**	1,120	141
J Dawson	46	100	11	6	**1,394**	210	85
A Hornby	41	240	20	9	**2,813**	406	103
C Matthew	58	416	18	(1)	**9,089**	1,290	(32)
D Watkins	46	218	56	47	**2,845**	873	619

The accrued pension at 31 December 2008 is the pension which the Director would have been entitled to receive based on his/her completed pensionable service, had he/she left on 31 December 2008 payable from normal retirement age (age 60) and subject to revaluation increases between leaving and retirement.

9 Directors' Remuneration continued

The transfer values are based on the accrued pensions at 31 December 2008 and are calculated as at 31 December 2008 respectively based on factors supplied by the actuaries, Watson Wyatt Limited. The transfer value basis was reviewed by the scheme Actuary, Watson Wyatt Limited, during 2008 to take account of changes in legislation for the calculation of such values and the change in financial markets. The resulting increase in the transfer values is predominantly as a result of applying the new basis to the accrued pensions at 31 December 2008. The transfer values are the notional lump sums which would have been paid to another pension scheme for the benefit of the Director had he or she left service at the respective dates. It is not possible for a transfer value to be paid directly to the Director personally.

The Director's contribution is the personal contribution required, if any, under the terms of the Scheme. Members of the Scheme have the option to pay additional voluntary contributions: neither the additional voluntary contributions nor the resulting benefits are included in the table.

For those Directors whose benefits were above the "Lifetime Allowance" at "A-day", there will be no further service accrual of benefits and no further Directors' contributions*. Those Directors receive the non-pensionable cash allowance referred to previously.

Philip Gore-Randall is not included in the Scheme and simply receives the cash allowance referred to previously. Mike Ellis is in receipt of a pension from his earlier employment with the Group which is unaffected by, and independent of, his current employment. In respect of his current employment he receives the cash allowance referred to previously.

Pension is generally based on retirement from service at normal retirement age (age 60) and is based on final salary. Pension and lump sum life assurance is provided from the Scheme and otherwise from separate arrangements with the Group.

On death after retirement or after leaving service, a spouse's or dependant's pension may be payable. Children's benefits may also be payable.

Executive Directors who have five years' service as an Executive Director have a contractual right to retire at age 55 or above with a non-reduced pension and at age 50 or above (but below age 55) with a reduced pension.

Pension increases after retirement are a mixture of guaranteed and discretionary. Scheme provisions vary by individual; the maximum extent of the Scheme guarantees is to increase pensions in line with the RPI, subject to a maximum of 5% p.a. and a minimum of 3% p.a. (no minimum for pensionable service after 31st March 2004). There is an established policy of reviewing pensions on a discretionary basis taking account of increases in the RPI. Allowance is made in transfer values on leaving in respect of the guaranteed and discretionary increases outlined above.

Peter Cummings and Colin Matthew retired on termination of their respective employments with the Company on 16 January 2009, as referred to in Resignations and Terminations above.

Pension benefits for Colin Matthew were provided without reduction for early payment, based on his service to 5 April 2006 (when further service based accrual ceased) and his final pensionable salary at retirement in line with his contractual right as set out above.

Pension benefits for Peter Cummings were provided in accordance with the Company's standard policy for Directors and senior managers retiring at age 50 and above. In such a case where a Director or senior manager retires by way of redundancy the Company does not reduce the pension payment to reflect retirement after the Director's or senior manager's 55th birthday. The notional additional capital cost of providing benefits for Peter Cummings in accordance with this policy was £0.7m. An actuarial reduction of 4.75% for early retirement based on the period between his retirement date and his 55th birthday was applied to his pension benefits based on service to 5 April 2006 (when further service based accrual ceased) and his final pensionable salary at retirement. As a result, and in waiving his entitlement to receive his contractual bonus of £1,320,000 referred to in 'Resignations and Terminations' above, Peter Cummings received in total less than his legal entitlements.

Potential pre-tax gains on share options exercised

During the year, two Directors exercised 2,045 options (2007 four Directors and 146,814 options) under share option schemes. The highest paid Director did not exercise any share options (2007 600 share options).

Shares vested under long term incentive schemes

During the year, one Director (Peter Cummings) had a share grant of 43,350 shares released (2007 eight Directors had share grants of 530,101 released) under long term incentive schemes, in accordance with his contractual entitlement under the rules of the schemes. This relates to the 2003-2006 long term incentive plan granted in January 2003. As explained in previous annual reports, all participants could choose to take any shares released after three years based on a 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 five year performance outcomes. Peter Cummings elected to continue to participate in the plan for the further two years to the end of 2007. HBOS's Total Shareholder Return over the five year performance period exceeded the weighted average of the comparator group by 1.57% consequently 183% of the original share grant was released under the terms of the long term incentive scheme on 27 February 2008. No share grant was released (2007 a share grant of 36,223 shares) under long term incentive plans in respect of the highest paid Director.

* Dan Watkins has an element of pre April 2006 pension accrual being released over the period to April 2011.

Notes to the Financial Statements continued

9 Directors' Remuneration continued

Shares vested under short term incentive schemes

During the year, seven Directors had share grants of 428,938 shares in total released (2007 seven Directors had share grants of 121,744 released) under short term incentive schemes, in accordance with contractual entitlements under the rules of the schemes. As explained in previous annual reports, Executive Directors could elect to take their annual and biennial incentives in HBOS shares. If they elected to do so, and held the shares in trust for three years, additional shares were awarded. The release of these 428,938 shares relates to the shares placed in trust using short term incentive plan awards in 2004 together with the additional shares awarded following the three year holding period. In respect of Andy Hornby, a share grant of 49,191 was released under short term incentive plans, and a special award originally granted in 2002 of 212,739 shares was also released. Both of these releases occurred before April 2008. None of these releases related to performance in 2008.

The value of additional shares is shown net of income tax and National Insurance liability although the value of the additional shares was grossed up to take account of the associated income tax and National Insurance payable by the participant.

Value of shares vested under free shares plan

During the year, 2,674 (2007 nil) free shares relating to six Directors (2007 no Directors) vested. In the year seven (2007 six) Directors were awarded shares under the free shares plan (see Note 40 for further detail). In respect of the highest paid Director, 333 (2007 nil, 2006 nil) free shares vested in the year.

The net value of assets other than money, shares and options received by all Directors was nil.

Change of control

All of the HBOS share plans contained a provision relating to change of control. The acquisition of HBOS by LBG resulted in awards and options vesting and becoming exercisable, in accordance with contractual entitlements under plan rules. Certain awards were exchanged for awards over LBG ordinary shares, but otherwise subject to the same terms as the original award. Certain options will also be exchanged to the extent they have not been exercised within the 6 month exercise period following the change of control.

Where the vesting of awards and options were subject to the satisfaction of performance conditions, in accordance with the plan rules and the terms of such conditions, the Remuneration Committee of the Company determined the extent to which such awards and options vested by taking into account the level of performance. In relation to the Directors, the Remuneration Committee exercised this discretion by reducing vesting to exclude any payments in relation to the 2008 financial year.

The total payments made to Directors of the Company on change of control were Peter Cummings, £129,000 and 2,051 share options; Jo Dawson £139,000 and 3,330 share options; Mike Ellis £83,000; Philip Gore-Randall £73,000; Andy Hornby £251,000 and 7,599 share options; Colin Matthew £151,000; and Dan Watkins £88,000 and 3,330 share options.

10 Auditors' Remuneration

During the year the Group (including overseas subsidiaries) obtained the following services from the company's auditor and its associates:

	2008 £m	2007 £m
Statutory Group audit of the parent Company and consolidated accounts	**0.3**	0.3
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	**6.7**	7.7
Other services pursuant to legislation	**7.1**	1.0
Total audit and audit related services	**14.1**	9.0
Tax services	**0.5**	0.8
Services relating to information technology		0.1
Services relating to corporate finance transactions	**0.1**	0.3
Other services	**1.0**	1.2
Total other services	**1.6**	2.4
Total[1]	**15.7**	11.4

(1) Excludes value added taxes.

Other services pursuant to legislation includes reporting accountant services in support of the listing rules and includes the review of the half yearly results.

In respect of the Company, fees in respect of the statutory audit were £31,000 (2007 £22,000) and other fees amounted to £0.2m (2007 £0.3m).

Notes to the Financial Statements continued

11 Segmental Analysis

Principal activities of the HBOS Group are the provision of banking and other financial services in the UK and overseas.

The Group's activities are organised on a divisional basis which reflect the business sector segments below. Information about the main divisions, including their key products and markets, is located in the Business Review. Group Items principally comprises the expenses of managing the Group, including technology so far as it is not devolved to divisions, accommodation and other shared services such as cheque clearing and mailing.

Business sector

	Retail £m	Corporate £m	Insurance & Investment £m	International £m	Treasury & Asset Management £m	Group Items £m	2008 Total £m
Net interest income – internal	(2,393)	300	(66)	(3,723)	5,882		
Net interest income – external	6,630	1,980	(31)	5,197	(5,605)		8,171
Net fees and commission income – internal	144	62	(490)	38	246		
Net fees and commission income – external	1,002	377	(292)	101	(61)		1,127
Net trading income – external	56	(643)		21	(2,312)		(2,878)
Other operating income – internal	66	3		37	(106)		
Other operating income – external	16	1,594	(4,728)	234	76		(2,808)
Net operating income/(expense)	5,521	3,673	(5,607)	1,905	(1,880)		3,612
Administrative expenses – internal	(635)	(246)	(118)		(233)	1,232	
Administrative expenses – external	(1,339)	(649)	(726)	(786)	(65)	(1,549)	(5,114)
Depreciation and amortisation	(55)	(1,215)	(51)	(67)	(7)	(213)	(1,608)
Goodwill impairment	(69)		(4)	(85)			(158)
Other operating expenses			6,167	25			6,192
Operating expenses	(2,098)	(2,110)	5,268	(913)	(305)	(530)	(688)
Impairment losses on loans and advances	(2,230)	(6,669)		(958)			(9,857)
Impairment losses on investment securities		(737)		(35)	(1,421)		(2,193)
Operating (loss)/profit	1,193	(5,843)	(339)	(1)	(3,606)	(530)	(9,126)
Share of (loss)/profit of jointly controlled entities and associates	3	(950)	2	10	(21)		(956)
(Loss)/profit on sale of businesses	102			(845)			(743)
(Loss)/profit before taxation	1,298	(6,793)	(337)	(836)	(3,627)	(530)	(10,825)
Total assets	266,197	127,705	77,588	67,865	147,148	3,414	689,917
Included in total assets:							
Interests in jointly controlled entities and associates	70	952	(38)	166	11		1,161
Loans and advances to customers	255,284	116,388		60,997	2,554		435,223
Total liabilities	192,233	54,470	68,580	24,212	336,244	679	676,418
Included in total liabilities: Customer accounts	143,703	38,500	87	6,507	33,454		222,251
Capital expenditure on property and equipment and software	91	1	144	111	12	357	716

11 Segmental Analysis continued

Business sector

In July 2008 the Group announced a divisional reorganisation under which the Group's Business Banking became part of Corporate division, moving from Retail division. In addition, there was a transfer of Trading Cash Management from Treasury to Corporate division. Accordingly the 2007 comparatives have been restated to reflect this new structure and certain other minor reorganisations. There is no impact on the 2007 Consolidated Balance Sheet and Income Statement as previously published.

	Retail £m	Corporate £m	Insurance & Investment £m	International £m	Treasury & Asset Management £m	Group Items £m	2007 Total £m
Net interest income – internal	(1,024)	393	(70)	(1,269)	1,970		
Net interest income – external	5,020	1,769	(28)	2,357	(1,814)		7,304
Net fees and commission income – internal	184	13	(168)	21	(50)		
Net fees and commission income – external	1,042	448	(521)	45	246		1,260
Net trading income – external	(7)	65	(7)	(3)	130		178
Other operating income – internal	19	15		45	(79)		
Other operating income – external	58	2,043	9,611	652	185		12,549
Net operating income	5,292	4,746	8,817	1,848	588		21,291
Administrative expenses – internal	(641)	(182)	(113)	(6)	(42)	984	
Administrative expenses – external	(1,452)	(773)	(680)	(665)	(283)	(1,126)	(4,979)
Depreciation and amortisation	(70)	(1,018)	(57)	(54)	(4)	(199)	(1,402)
Goodwill impairment			(5)				(5)
Other operating expenses			(7,406)	(278)			(7,684)
Operating expenses	(2,163)	(1,973)	(8,261)	(1,003)	(329)	(341)	(14,070)
Impairment losses on loans and advances	(1,277)	(619)		(116)			(2,012)
Impairment losses on investment securities	(22)	(37)		(1)			(60)
Operating profit/(loss)	1,830	2,117	556	728	259	(341)	5,149
Share of (loss)/profit of jointly controlled entities and associates	(9)	232	(2)	17	(4)		234
Profit on sale of businesses	87				4		91
Profit/(loss) before taxation	1,908	2,349	554	745	259	(341)	5,474
Total assets	259,255	122,642	88,454	76,087	119,806	773	667,017
Included in total assets:							
Interests in jointly controlled entities and associates	83	1,525	(41)	133	24		1,724
Loans and advances to customers	252,595	110,087		67,094	231		430,007
Total liabilities	218,614	59,624	81,905	35,580	245,758	3,302	644,783
Included in total liabilities:							
Customer accounts	154,034	48,334	101	23,585	17,167		243,221
Capital expenditure on property and equipment and software	6	43	11	83	16	397	556

Notes to the Financial Statements continued

11 Segmental Analysis continued

Geographical

The table below analyses the Group results and assets by geographical area based on the location of the customer.

	2008			2007		
	UK £m	Rest of world £m	Total £m	UK £m	Rest of world £m	Total £m
Net interest income	6,455	1,716	8,171	6,044	1,260	7,304
Net fees and commission income	950	177	1,127	1,110	150	1,260
Net trading income	(3,104)	226	(2,878)	144	34	178
Other operating income	28	(2,836)	(2,808)	11,135	1,414	12,549
Net operating income	4,329	(717)	3,612	18,433	2,858	21,291
Administrative expenses	(4,290)	(824)	(5,114)	(4,289)	(690)	(4,979)
Depreciation and amortisation	(1,535)	(73)	(1,608)	(1,341)	(61)	(1,402)
Goodwill impairment	(143)	(15)	(158)	(5)		(5)
Other operating expenses	6,690	(498)	6,192	(6,743)	(941)	(7,684)
Operating expenses	722	(1,410)	(688)	(12,378)	(1,692)	(14,070)
Impairment losses on loans and advances	(8,899)	(958)	(9,857)	(1,893)	(119)	(2,012)
Impairment on investment securities	(2,158)	(35)	(2,193)	(59)	(1)	(60)
Operating (loss)/profit	(6,006)	(3,120)	(9,126)	4,103	1,046	5,149
Share of (loss)/profit of jointly controlled entities and associates	(920)	(36)	(956)	51	183	234
(Loss)/profit on sale of businesses	102	(845)	(743)	91		91
(Loss)/profit before taxation	(6,824)	(4,001)	(10,825)	4,245	1,229	5,474
Total assets	550,500	139,417	689,917	532,572	134,445	667,017
Included in total assets:						
Interests in jointly controlled entities and associates	756	405	1,161	1,442	282	1,724
Total liabilities	524,991	151,427	676,418	498,417	146,366	644,783
Included in total liabilities:						
Capital expenditure on property and equipment and software	575	141	716	473	83	556

12 Impairment Provisions and Losses

a) Impairment provisions and losses on loans and advances to customers designated as loans and receivables

Impairment provisions	2008 £m	2007 £m
At 1 January	**3,373**	3,089
New impairment provisions less releases	**9,964**	2,111
Amounts written off	**(2,515)**	(1,726)
Disposal of subsidiary undertakings	**(115)**	
Discount unwind/interest income on impaired loans and advances to customers	**(149)**	(129)
Foreign exchange translation	**135**	28
At 31 December	**10,693**	3,373
Impairment provisions are held in respect of:		
Retail secured lending	**1,219**	330
Retail unsecured lending	**1,819**	1,889
Corporate	**6,563**	832
International	**1,092**	322
	10,693	3,373

Impairment losses	2008 £m	2007 £m
New impairment provisions less releases	**9,964**	2,111
Recoveries of amounts previously written off	**(107)**	(99)
Net charge to income statement	**9,857**	2,012

b) Impairment provisions and losses on investment securities

Total impairment losses on investment securities of £2,193m (2007 £60m) have been charged to the income statement, of which £1,270m (2007 £23m) relates to available for sale financial assets (Note 41) and £923m (2007 £37m) relates to loans and receivables, as shown below.

Impairment provisions	2008 £m	2007 £m
At 1 January		
New impairment provisions less releases	**923**	37
Amounts written off		(37)
At 31 December	**923**	
Impairment provisions are held in respect of:		
Treasury	**773**	
Corporate	**150**	
	923	

Impairment losses	2008 £m	2007 £m
New impairment provisions less releases	**923**	37
Net charge to income statement	**923**	37

Notes to the Financial Statements continued

13 Taxation

The tax credit for the year of £3,409m (2007 tax charge of £1,365m) includes a £893m tax credit (2007 £18m tax charge) in respect of the tax attributable to the policyholder earnings in the Group's UK life companies. The 2007 tax charge of £1,365m includes a credit of £178m in respect of the change in the rate of UK corporation tax. An overseas tax charge of £233m (2007 £293m) is within the tax credit of £3,409m.

	2008 £m	2007 £m
Current tax		
Corporation tax on profit for the year	**(286)**	1,156
Adjustments in respect of prior years	**(343)**	(32)
Overseas taxation on profit for the year	**219**	285
Adjustments in respect of prior years	**14**	8
Relief for overseas taxation	**(49)**	(73)
	(445)	1,344
Deferred tax		
Origination and reversal of temporary differences	**(2,939)**	189
Adjustments in respect of prior years	**(25)**	10
Deferred tax changes in rates of corporation tax (Note 34)		(178)
	(2,964)	21
Total income tax on (loss)/profit	**(3,409)**	1,365
The above tax expense is made up as follows:		
Tax on policyholder returns	**(893)**	18
Tax on shareholder returns	**(2,516)**	1,347

The main UK corporation tax rate reduced from 30% to 28% in April 2008. The average rate of UK corporation tax for the year to December 2008 is 28.5%. The effective tax rate for the year is 31.5% (2007 24.9%) which is higher (2007 lower) than the average rate of 28.5%. The differences are explained below.

	2008 £m	2007 £m
(Loss)/profit before taxation	**(10,825)**	5,474
Expected tax (credit)/charge at 28.5% (2007 30%)	**(3,085)**	1,642
Effects of:		
Changes in rates of corporation tax on deferred tax assets and liabilities	**11**	(178)
(Income)/expenses not deductible/(chargeable) for tax purposes	**358**	(48)
Net effect of differing tax rates overseas	**20**	29
Gains exempted or covered by losses	**(135)**	(90)
Policyholder tax for life assurance business	**(639)**	13
Impairment on investment securities	**56**	16
Adjustments in respect of previous periods	**(341)**	(14)
Tax losses where no deferred tax provided	**310**	
Other	**36**	(5)
Total income tax on (loss)/profit	**(3,409)**	1,365
Current tax credit recognised directly in equity		
Relating to share plans		(21)
Relating to available for sale investments	**(11)**	(117)
	(11)	(138)
Deferred tax (credit)/charge recognised directly in equity (Note 34)		
Relating to share plans	**2**	64
Relating to available for sale investments	**(1,917)**	(65)
Relating to cash flow hedges	**(376)**	(219)
Relating to employee benefits	**202**	130
Relating to long term assurance		5
Relating to other		(1)
	(2,089)	(86)

In addition there is £nil (2007 £1m) recognised in equity relating to changes in the rates of corporation tax (Note 34).

14 Earnings Per Share

Basic and diluted earnings per ordinary share are based upon Group (loss)/profit attributable to ordinary shareholders of £(7,580)m (2007 profit £3,965m) which is calculated as follows:

	2008 £m	2007 £m
(Loss)/profit attributable to parent company shareholders	**(7,499)**	4,045
Profit attributable to preference shareholders	**(81)**	(80)
(Loss)/profit attributable to ordinary shareholders for continuing operations	**(7,580)**	3,965

The average number of ordinary shares in issue in the prior year has been adjusted by the adjustment factor of 1.001 arising from the Rights Issue and by a factor of 1.026 arising from the Capitalisation Issue. The impact on previously published comparatives is as follows:

	2007
As published:	
Average number of ordinary shares in issue for basic EPS (millions)	3,735
- Earnings (basic)	106.2p
- Earnings (diluted)	105.5p
Restated:	
Average number of ordinary shares in issue for basic EPS (millions)	3,835
- Earnings (basic)	103.4p
- Earnings (diluted)	102.8p

To calculate basic earnings per ordinary share the weighted average number of 25p ordinary shares is used and for diluted earnings per ordinary share the weighted average number of actual and potential 25p ordinary shares is used. Details of these are given below:

	2008 Number million	2007 Number million (restated)
Actual weighted average number of shares in issue	**4,518**	3,835
Effect of dilutive share options and shares potentially to be issued or allotted	**17**	23
Potential weighted average number of shares in issue	**4,535**	3,858

The basic and diluted earnings per ordinary share are given below:

	2008 pence	2007 pence (restated)
Earnings per ordinary share (continuing operations)		
- Basic	**(167.8)**	103.4
- Diluted[1]	**(167.8)**	102.8

(1) The effect of dilutive share options and shares potentially to be issued or allotted has not been included in the calculation of diluted earnings per share for 2008 because doing so would have an anti-dilutive effect.

15 (Loss)/Profit Attributable to Equity Shareholders

By virtue of the exemption contained within Section 230 of the Companies Act 1985, the income statement of the Company is not presented. Of the loss attributable to equity shareholders a loss of £1,902m (2007 profit £1,731m) is dealt within the financial statements of the Company.

Notes to the Financial Statements continued

16 Financial Instruments Held for Trading

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

	2008 £m	2007 £m
Financial assets held for trading		
Debt securities	**13,538**	36,723
Loans and advances to banks	**3,344**	11,601
Loans and advances to customers	**5,689**	6,357
Total	**22,571**	54,681
Financial liabilities held for trading		
Debt securities in issue		469
Deposits by banks	**7,631**	8,989
Customer accounts	**11,220**	13,247
Total	**18,851**	22,705

Financial assets held for trading include £4,369m (2007 £4,711m) subject to repurchase (Note 54).

Following the International Accounting Standards Board's (IASB) decision in October 2008 to permit the reclassification of financial assets, the Group's Treasury division reclassified certain securities from assets held for trading into the available for sale (AFS) portfolio, and subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS to loans and receivables. Further details of these reclassifications are shown in Note 45.

17 Derivatives

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

The Group uses interest rate swaps, cross currency swaps 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 adopted by the Group is to utilise a combination of the macro cash flow, micro fair value and net investment hedge approaches.

	2008 Fair Value		2007 Fair Value	
	Asset £m	Liability £m	Asset £m	Liability £m
Total derivatives assets/liabilities:				
Held for trading	**29,728**	**29,608**	9,381	8,068
Held as qualifying hedges	**22,082**	**9,297**	4,760	4,243
Total recognised derivative assets/liabilities	**51,810**	**38,905**	14,141	12,311

17 Derivatives continued

Group	2008 Fair value		2007 Fair value	
	Asset £m	**Liability £m**	Asset £m	Liability £m
Derivatives held for trading				
Exchange rate related contracts:				
Forward foreign exchange	**2,209**	**3,690**	1,035	856
Cross currency swaps	**3,144**	**1,207**	667	297
Options			1	1
	5,353	**4,897**	1,703	1,154
Interest rate related contracts:				
Interest rate swaps	**19,417**	**21,267**	5,716	5,598
Forward rate agreements	**1,474**	**1,461**	119	111
Options	**1,031**	**760**	225	287
Futures	**99**	**199**	20	40
	22,021	**23,687**	6,080	6,036
Equity/index and commodity related contracts:				
Options and swaps	**1,606**	**991**	1,412	870
Credit related contracts:				
Credit default swaps	**748**	**33**	186	8
Total derivative assets/liabilities held for trading	**29,728**	**29,608**	9,381	8,068

The Group has entered into derivative contracts for qualifying hedges as noted below:

Group	2008 Fair value		2007 Fair value	
	Asset £m	**Liability £m**	Asset £m	Liability £m
Derivatives held as qualifying hedges				
Derivatives designated as fair value hedges:				
Interest rate swaps	**4,738**	**574**	732	575
Forward foreign exchange				27
Cross currency swaps	**8,863**	**183**	1,679	1,682
Options		**55**		
	13,601	**812**	2,411	2,284
Derivatives designated as cash flow hedges:				
Interest rate swaps	**7,218**	**8,337**	1,558	1,801
Forward rate agreements	**46**	**21**	10	4
Cross currency swaps	**1,037**	**123**	756	139
Options	**180**			
Futures		**4**	25	15
	8,481	**8,485**	2,349	1,959
Total derivative assets/liabilities held as qualifying hedges	**22,082**	**9,297**	4,760	4,243

The Company has derivatives designated as fair value hedges. These comprise cross currency swaps with an asset fair value of £2,495m (2007 £154m) and a liability fair value of £nil (2007 £49m), interest rate swaps with an asset fair value of £88m (2007 £8m) and a liability fair value of £nil (2007 £7m) and indexation swaps to hedge subordinated debt with an asset fair value of £55m (2007 £nil), and a liability fair value of £55m (2007 £nil).

Notes to the Financial Statements continued

18 Loans and Advances to Customers

	2008 £m	2007 £m
Retail secured lending	**239,758**	235,858
Retail unsecured lending	**18,592**	18,908
Corporate, International and Treasury	**187,566**	178,614
Gross loans and advances to customers	**445,916**	433,380
Impairment losses on loans and advances (Note 12)	**(10,693)**	(3,373)
Net loans and advances to customers	**435,223**	430,007

Included in loans and advances to customers is £56,858m (2007 £nil) subject to repurchase (Note 54).

Loans and advances to customers include advances securitised under the Group's securitisation and covered bonds programmes. Further details are given in Note 19.

The Group's gross lending exposure before impairment provisions and before taking account of collateral is analysed below:

	2008 £m	2007 £m
Agriculture, forestry and fishing	**574**	647
Energy	**1,318**	2,269
Manufacturing industry	**3,887**	4,332
Construction and property	**46,634**	41,099
Hotels, restaurants and wholesale and retail trade	**12,368**	12,620
Transport, storage and communication	**7,693**	6,834
Financial	**8,729**	6,312
Other services	**12,688**	14,749
Individuals		
Residential mortgages	**238,696**	235,771
Other personal lending	**22,604**	19,229
Non-UK residents	**90,725**	89,518
	445,916	433,380

	2008 £m	2007 £m
Loans and advances that are neither past due nor impaired (Note 48)	**403,484**	411,389
Loans and advances that are past due but not impaired (Note 48)	**16,401**	11,629
Impaired loans (Note 48)	**26,031**	10,362
	445,916	433,380

Included in loans and advances that are neither past due nor impaired are £478m (2007 £229m) of troubled debt restructured loans that would have been past due or impaired had their terms not been renegotiated.

Loans and advances to customers include finance leases analysed as follows:

	2008 £m	2007 £m
Gross investment in finance receivables:		
Within one year	**2,994**	3,206
Between one and five years	**4,904**	5,805
More than five years	**3,986**	4,221
	11,884	13,232
Less: unearned finance income	**(1,849)**	(3,234)
Present value of minimum lease payments	**10,035**	9,998
Analysed as:		
Within one year	**2,407**	2,669
Between one and five years	**3,796**	4,646
More than five years	**3,832**	2,683
Finance lease receivables	**10,035**	9,998

At 31 December 2008 total unguaranteed residual values accrued to the benefit of the Group amounted to £nil (2007 £20m) and total accumulated allowances for uncollectable minimum lease payments receivable amounted to £105m (2007 £67m).

19 Securitisation and Covered Bonds

a) Securitisation

Loans and advances to customers include advances securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby some of the risks and rewards of the portfolio are retained by the subsidiary, the SPEs are consolidated fully and all of these advances are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

b) Covered bonds

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security to issues of covered bonds by the Group. The Group retains substantially all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet, with the related covered bonds included within debt securities in issue.

The Group's principal securitisation and covered bonds programmes, together with the balances of the advances subject to notes in issue at 31 December, are listed below. The notes in issue are reported in Note 37.

Securitisation	Type of loan	**2008 Gross assets securitised £m**	**2008 Notes in issue £m**	2007 Gross assets securitised £m	2007 Notes in issue £m
Permanent	UK residential mortgages	**32,613**	**38,490**	31,577	31,540
Mound	UK residential mortgages	**8,063**	**8,238**	4,545	4,454
Swan	Australian residential mortgages			2,726	2,689
Candide	Dutch residential mortgages	**5,569**	**5,704**	2,705	2,759
Prominent	Commercial loans	**1,053**	**1,149**	1,107	1,108
Pendeford	UK residential mortgages	**9,888**	**9,870**	2,508	2,551
Melrose	Commercial loans			750	1,134
Balliol	UK residential mortgages	**12,701**	**12,549**		
Brae	UK residential mortgages	**9,213**	**9,955**		
Dakota	UK residential mortgages	**3,988**	**3,885**		
Deva	UK residential mortgages	**6,747**	**6,703**		
Penarth	Credit card receivables	**4,189**	**2,633**		
Tioba	UK residential mortgages	**2,647**	**2,568**		
Trinity	UK residential mortgages	**12,975**	**12,638**		
Wolfhound	Irish residential mortgages	**4,083**	**4,107**		
Other	UK residential mortgages	**68**	**179**	68	182
		113,797	**118,668**	45,986	46,417
Covered Bonds					
Covered Bonds	UK residential mortgages	**51,756**	**49,408**	34,711	38,315
Social Housing Covered Bonds	UK residential mortgages	**3,475**	**2,919**	2,354	1,519
		55,231	**52,327**	37,065	39,834
Total securitisations and covered bonds		**169,028**	**170,995**	83,051	86,251
Less held by the Group		**(97,363)**	**(94,265)**	(1,258)	(1,258)
Total		**71,665**	**76,730**	81,793	84,993

The balances reported for the Prominent securitisation above include £456m (2007 £459m) advances and £456m (2007 £459m) notes in issue that arise from a funded synthetic securitisation.

Cash deposits of £12,423m (2007 £5,144m) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs and other legal obligations.

In addition to the programmes noted above, the Group entered into synthetic securitisations, referencing an asset pool of £nil (2007 £14,089m), using credit default swaps of £nil (2007 £40m).

In total the Group has securitised £97,363m of mortgage assets under certain securitisation and covered bond programmes and purchased all of the loan notes in issue relating to those issuances for £94,265m. These transactions did not lead to any derecognition of the mortgage assets as the Group has retained all of the risks and rewards associated with the loan notes. See Note 54 for further details about the Group's repurchase transactions.

Notes to the Financial Statements continued

19 Securitisation and Covered Bonds continued

c) Other special purpose entities

In addition to the SPEs described above, the Group sponsors two conduit programmes, Grampian and Landale, which invest in asset-backed securities funded by commercial paper or through banking facilities. Details of the assets secured under these conduit programmes are given in Note 20.

The SPEs within these conduit programmes are consolidated fully, except for two of the four SPE's within Landale. One is the central funding company for the conduit that obtains external funding and lends it to the purchasing companies. The second is a purchasing company that has acquired floating rate notes issued under the Group's mortgage securitisation programmes and which is supported by liquidity lines that are provided by third party banks. These entities are not consolidated as there are insufficient indicators of control, in particular as the credit risk relating to the assets held by the entities and the liquidity risks are not borne by the Group. If these two entities were consolidated by the Group the financial impact would be minimal with the principal effects increasing deposits by banks by £1,126m (2007 £1,756m) and customer accounts by £51m (2007 £100m) and increasing debt securities in issue by £50m (2007 decrease by £1,856m). Group profit before tax would be increased by £2m (2007 £0.5m).

20 Investment Securities

Group					2008
	Policyholder assets at fair value through the income statement £m	**At fair value through the income statement £m**	**Available for sale £m**	**Loans and receivables £m**	**Total £m**
Listed					
Debt securities	**20,880**	**6,145**	**22,071**	**25,325**	**74,421**
Equity shares	**37,806**	**293**	**112**		**38,211**
Total listed	**58,686**	**6,438**	**22,183**	**25,325**	**112,632**
Unlisted					
Debt securities	**350**	**410**	**3,716**	**13,728**	**18,204**
Equity shares		**387**	**2,149**		**2,536**
Total unlisted	**350**	**797**	**5,865**	**13,728**	**20,740**
Total	**59,036**	**7,235**	**28,048**	**39,053**	**133,372**
Comprising:					
Debt securities	**21,230**	**6,555**	**25,787**	**39,053**	**92,625**
Equity shares	**37,806**	**680**	**2,261**		**40,747**

Group					2007
	Policyholder assets at fair value through the income statement £m	At fair value through the income statement £m	Available for sale £m	Loans and receivables £m	Total £m
Listed					
Debt securities	20,712	7,774	31,944		60,430
Equity shares	46,875	393	261		47,529
Total listed	67,587	8,167	32,205		107,959
Unlisted					
Debt securities	2	847	14,833	702[1]	16,384
Equity shares	94	274	2,948		3,316
Total unlisted	96	1,121	17,781	702	19,700
Total	67,683	9,288	49,986	702	127,659
Comprising:					
Debt securities	20,714	8,621	46,777	702	76,814
Equity shares	46,969	667	3,209		50,845

(1) Restated by £739m as explained in Note 21.

Included in investment securities is £37,263m (2007 £8,996m) subject to repurchase (Note 54).

Following the International Accounting Standards Board's (IASB) decision in October 2008 to permit the reclassification of financial assets, the Group's Treasury division reclassified certain securities from assets held for trading into the available for sale (AFS) portfolio, and subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS to loans and receivables. Further details of these reclassifications are shown in Note 45.

20 Investment Securities continued

The fair value movement during the year on investment securities held at fair value through the income statement is a loss of £13,415m (2007 gain of £1,014m) and the fair value movement during the year on investment securities classified as available for sale is a loss of £8,173m (2007 a loss of £429m).

Loans and receivables debt securities include ABS of £17,703m (end 2007 available for sale debt securities £18,563m) which are held in the Group's Grampian conduit. This is a series of bankruptcy remote special purpose entities (SPEs) that are funded by the issue of commercial paper and banking facilities. The commercial paper is included within debt securities in issue. As some of the rewards and risks of the portfolio are retained by the Group, including the provision of liquidity facilities by Bank of Scotland plc to the conduit, the assets and liabilities of the conduit are consolidated as part of the Group. The Group also has a smaller conduit, Landale, of which two of the four SPEs are consolidated. These hold available for sale debt securities of £681m (2007 £604m). Details of the Landale SPEs that are not consolidated by the Group are given in Note 19.

No investment securities held by the Company at 31 December 2008 (2007 £1m).

21 Interests in Jointly Controlled Entities and Associates

Interests in jointly controlled entities	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Carrying value £m
At 1 January 2008 (as restated)	**1,334**	**12**	**1,346**	**5**	**1,351**
Exchange translation	**1**		**1**		**1**
Acquisitions and subscriptions of capital	**329**		**329**		**329**
Disposals	**(59)**	**(3)**	**(62)**		**(62)**
Loss after tax		**(669)**	**(669)**		**(669)**
Dividends paid		**(12)**	**(12)**		**(12)**
At 31 December 2008	**1,605**	**(672)**	**933**	**5**	**938**

The Group's share of jointly controlled entities include the following:

	Income £m	Expenses £m	Tax £m	(Loss)/ profit after tax £m	Current assets £m	Non-current assets £m	Current liabilities £m	Non-current liabilities £m	Equity £m
2008	**(440)**	**(245)**	**16**	**(669)**	**2,388**	**5,470**	**(1,562)**	**(5,358)**	**938**
2007	529	(282)	(13)	234	5,802	5,768	(5,126)	(5,093)	1,351

The Group's unrecognised share of losses for the year is £164m (2007 £22m). 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 £211m (2007 £68m).

Interests in associates	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Carrying value £m
At 1 January 2008 (as restated)	**367**	**6**	**373**		**373**
Exchange translation	**(1)**		**(1)**		**(1)**
Acquisitions and subscriptions of capital	**160**		**160**		**160**
Disposals	**(14)**		**(14)**		**(14)**
Loss after tax		**(287)**	**(287)**		**(287)**
Dividends paid		**(8)**	**(8)**		**(8)**
At 31 December 2008	**512**	**(289)**	**223**		**223**

Notes to the Financial Statements continued

21 Interests in Jointly Controlled Entities and Associates continued

The Group's share of associates include the following:

	Revenue £m	Loss after tax £m	Assets £m	Liabilities £m	Equity £m
2008	**(277)**	**(287)**	**2,688**	**(2,465)**	**223**
2007	26		1,876	(1,503)	373

The Group's unrecognised share of losses for the year is £126m (2007 £5m). 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 £131m (2007 £4m).

The Group's main jointly controlled entities at 31 December 2008 are as follows:

	Nature of business		Issued share capital	Group's interest	Statutory accounts made up to	Principal area of operations
Jointly controlled entities						
AA Personal Finance Limited	Finance	ordinary	£3,000,002	50%	December 2008	UK
esure Holdings Ltd	Insurance	ordinary	£3,330,000	70%	December 2008	UK
		preference	£175,170,000	100%		
Green Property Investment Fund 1 plc	Investment	ordinary	41,198,100	50%	June 2008	Ireland
Sainsbury's Bank plc	Banking	ordinary	£170,000,000	50%	December 2008	UK

Except for the Green Property Investment Fund 1 plc which is incorporated in Ireland, all of the interests in jointly controlled entities above are incorporated in the UK. All interests in jointly controlled entities are held by subsidiaries. Where entities have accounts that are drawn up to a date other than 31 December management accounts are used when accounting for them by the Group. The Group's remaining holding of 13% in Rightmove plc was disposed of during the year (Note 4).

During the year, the Group reviewed the classification of its investments in jointly controlled entities and associates together with its long term investment loans to joint ventures, (collectively the Group's longer term interests in jointly controlled entities and associates) in light of the deteriorating economic environment. As a result of this review, certain longer term investment securities that in substance form part of the Group's overall net investment in jointly controlled entities and associates have been transferred from investment securities - debt securities classified as loans and receivables to interests in jointly controlled entities and associates. These longer term interests include loans for which settlement is neither planned nor likely to occur in the foreseeable future. Accordingly, the Group's interests in jointly controlled entities and associates have been restated in the 2007 consolidated balance sheet as shown below. There is no overall impact on the net assets at 31 December 2007 as a result of this restatement. Certain 2007 disclosures have been amended accordingly.

21 Interests in Jointly Controlled Entities and Associates continued

Interests in jointly controlled entities	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Carrying value £m
At 1 January 2007 (as published)	520	(105)	415	5	420
Transfer from investment securities	515		515		515
At 1 January 2007 (as restated)	1,035	(105)	930	5	935
At 31 December 2007 (as published)	819	12	831	5	836
At 31 December 2007 (as restated)	1,334	12	1,346	5	1,351

Interests in associates	Acquired book value £m	Equity adjustments £m	Share of net assets £m	Goodwill £m	Carrying value £m
At 1 January 2007 (as published)	133	48	181		181
Transfer from investment securities	224		224		224
At 31 January 2007 (as restated)	357	48	405		405
At 31 December 2007 (as published)	143	6	149		149
At 31 December 2007 (as restated)	367	6	373		373

22 Investments in Subsidiaries

Investments in subsidiaries comprise investments in ordinary shares and capital contributions carried at cost.

	Ordinary shares £m	Capital contributions £m	Total £m
At 1 January 2008	**13,442**	**1,033**	**14,475**
Subscriptions of capital	**5,500**		**5,500**
Impairment losses	**(4,192)**		**(4,192)**
At 31 December 2008	**14,750**	**1,033**	**15,783**

The impairment of £4,192m represents the write down of the company's investment in Bank of Scotland plc to a recoverable amount, based upon value in use, of £11,919m. The critical accounting estimate in respect of investment in subsidiaries explains the assumptions used and sensitivity of the impairment testing. The write-downs have been triggered principally by deteriorating economic conditions.

Amounts owed by Group entities of £50,157m (2007 £38,885m) include £12,499m (2007: £10,044m) of other borrowed funds loaned to subsidiaries.

The main subsidiaries at 31 December 2008 are as follows:

	Company's interest in ordinary share capital and voting rights	Principal business	Country of incorporation
Bank of Scotland plc	100%	Banking, financial and related services	UK
and subsidiaries, including			
Bank of Scotland (Ireland) Ltd	100%	Banking	Ireland
HBOS Australia Pty Ltd and subsidiaries	100%	Banking	Australia
HBOS Covered Bonds LLP	100%[a]	Residential mortgage funding	UK
Halifax Share Dealing Ltd	100%	Execution only stockbroking	UK
HBOS Insurance & Investment Group Ltd	100%	Investment holding	UK
and subsidiaries, including			
Halifax General Insurance Services Ltd	100%	General insurance brokerage	UK
St. Andrew's Insurance plc	100%	General insurance	UK
Clerical Medical Investment Group Ltd	100%	Life assurance	UK
Clerical Medical Managed Funds Ltd	100%	Life assurance	UK
Halifax Life Ltd	100%	Life assurance	UK
Halifax Investment Fund Managers Ltd	100%	OEIC management	UK
Insight Investment Management Ltd	100%	Investment management	UK
Invista Real Estate Investment Management Holdings plc	55%	Property investment management	UK
St. Andrews Life Assurance plc	100%	Pensions	UK
St. James's Place plc	60%	Financial services	UK

(a) HBOS Covered Bonds LLP does not have ordinary share capital. The Group consolidates a 100% interest in this entity.

Notes to the Financial Statements continued

22 Investments in Subsidiaries continued

The above information is provided in relation to the principal related undertakings and, in accordance with Section 231(5) of the Companies Act 1985, a full list of related undertakings, as at 31 December 2008, will be annexed to the Company's next Annual Return to be delivered to the Registrar of Companies for Scotland.

On 17 September 2007 in accordance with the provisions of the HBOS Group Reorganisation Act 2006 (the Act), the Governor and Company of the Bank of Scotland registered as a public limited company under the Companies Act and changed its name to Bank of Scotland plc. On the same day, under the Act, the business activities, assets (including investments in subsidiaries) and liabilities of CAPITAL BANK plc, Halifax plc and HBOS Treasury Services plc transferred to Bank of Scotland plc.

All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the relevant regulators; this may impact those subsidiaries' ability to make distributions.

23 Goodwill and Other Intangible Assets

Group	2008 £m	2007 £m
Goodwill	**1,556**	1,940
Other intangibles	**819**	850
	2,375	2,790

Goodwill	2008 £m	2007 £m
At 1 January	**1,940**	1,889
Exchange translation	**30**	38
Additions		33
Disposals	**(256)**	(15)
Impairment losses charged to the income statement	**(158)**	(5)
At 31 December	**1,556**	1,940

Goodwill is analysed on a divisional basis as follows:

	2008 £m	2007 £m
Retail	**376**	455
Corporate	**268**	277
Insurance & Investment	**850**	832
International	**23**	337
Treasury & Asset Management	**39**	39
Total	**1,556**	1,940

The primary component of goodwill disposed of comprises £240m in respect of the sale of Bank of Western Australia Ltd and St. Andrews Australia Pty Ltd to Commonwealth Bank of Australia (Note 4).

The Group carries out semi-annual and, if necessary, other impairment reviews of cash-generating units to which goodwill is allocated as described in the accounting policy on goodwill. The critical accounting estimate in respect of goodwill explains the assumptions used and sensitivity of the impairment testing.

The goodwill impairment of £158m principally comprises £72m being the full write-down of goodwill held in respect of the acquisition of the ICC business banking division in Ireland and £50m being the write-down of goodwill relating to a specialist area of the UK credit card business to a recoverable amount, based on a value in use, of £20m. The write-downs have been triggered principally by deteriorating economic conditions.

In 2007, the impairment loss of £5m related to a partial write-down of the goodwill held in respect of fund management business in Insurance & Investment division.

Cumulative impairment losses charged to the income statement total £218m (2007 £60m, 2006 £55m and 2005 £nil).

23 Goodwill and Other Intangible Assets continued

Other intangible assets	2008 Purchased value of in-force investment contracts £m	2008 Software and other intangible assets £m	2008 Total £m	2007 Purchased value of in-force investment contracts £m	2007 Software and other intangible assets £m	2007 Total £m
Cost						
At 1 January	**396**	**1,333**	**1,729**	396	1,069	1,465
Exchange translation		**39**	**39**		24	24
Acquired through business combination					7	7
Additions		**306**	**306**		249	249
Disposals		**(113)**	**(113)**		(16)	(16)
Disposal of subsidiary undertakings	**(3)**	**(94)**	**(97)**			
At 31 December	**393**	**1,471**	**1,864**	396	1,333	1,729
Amortisation						
At 1 January	**75**	**804**	**879**	45	620	665
Exchange translation		**12**	**12**		23	23
Amortisation charge for the year	**27**	**182**	**209**	30	163	193
Disposals		**(2)**	**(2)**		(2)	(2)
Disposal of subsidiary undertakings	**(1)**	**(52)**	**(53)**			
At 31 December	**101**	**944**	**1,045**	75	804	879
Carrying value						
At 1 January	**321**	**529**	**850**	351	449	800
At 31 December	**292**	**527**	**819**	321	529	850

The Company has other intangible assets relating to licenses at a cost of £10m (2007 £10m) less accumulated amortisation of £6m (2007 £4m), of which £2m (2007 £2m) is the amortisation charge for the year.

24 Property and Equipment

	2008 Property £m	2008 Equipment £m	2008 Total £m	2007 Property £m	2007 Equipment £m	2007 Total £m
Cost						
At 1 January	**1,733**	**1,622**	**3,355**	1,662	1,613	3,275
Exchange translation	**17**	**45**	**62**	5	11	16
Additions	**180**	**230**	**410**	123	185	308
Disposals	**(118)**	**(165)**	**(283)**	(38)	(187)	(225)
Disposal of subsidiary undertakings	**(53)**	**(108)**	**(161)**			
Transfer to investment property (Note 25)	**(84)**		**(84)**	(19)		(19)
At 31 December	**1,675**	**1,624**	**3,299**	1,733	1,622	3,355
Depreciation						
At 1 January	**628**	**1,233**	**1,861**	590	1,112	1,702
Exchange translation	**8**	**31**	**39**	5	7	12
Depreciation charge for the year	**63**	**158**	**221**	59	165	224
Impairment losses on property under construction	**10**		**10**			
Disposals	**(29)**	**(135)**	**(164)**	(26)	(51)	(77)
Disposal of subsidiary undertakings	**(16)**	**(85)**	**(101)**			
At 31 December	**664**	**1,202**	**1,866**	628	1,233	1,861
Carrying value						
At 1 January	**1,105**	**389**	**1,494**	1,072	501	1,573
At 31 December	**1,011**	**422**	**1,433**	1,105	389	1,494

Included within Group property and equipment are assets that are in the course of construction amounting to £89m (2007 £306m) which are not depreciated until the assets are brought into use. These are primarily properties that will be classified as investment properties upon completion.

Notes to the Financial Statements continued

25 Investment Properties

	2008 £m	2007 £m
At 1 January	**4,731**	5,010
Additions	**128**	
Disposals	**(398)**	(58)
Exchange translation	**1**	
Net movement in properties held by policyholder funds	**(143)**	351
Fair value movement	**(1,358)**	(591)
Transfer from property and equipment (Note 24)	**84**	19
At 31 December	**3,045**	4,731

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 and in accordance with guidance published by the Royal Institution of Chartered Surveyors. Valuations are performed at least annually.

Rental income and expenses in respect of the above properties amounted to £241m and £15m respectively (2007 £221m and £11m respectively). At 31 December 2008 investment properties of £3,001m (2007 £4,697m) are held in the Insurance & Investment business.

26 Operating Lease Assets

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

	Cost £m	Depreciation £m	2008 Carrying value £m	Cost £m	Depreciation £m	2007 Carrying value £m
At 1 January	**6,483**	**(1,840)**	**4,643**	6,164	(1,483)	4,681
Exchange translation	**96**	**(34)**	**62**	(28)	30	2
Additions	**1,488**		**1,488**	1,785		1,785
Disposals	**(1,733)**	**685**	**(1,048)**	(1,438)	598	(840)
Depreciation charge for the year		**(1,178)**	**(1,178)**		(985)	(985)
At 31 December	**6,334**	**(2,367)**	**3,967**	6,483	(1,840)	4,643

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

	2008 £m	2007 £m
Not later than one year	**849**	864
Later than one year and not later than five years	**2,245**	1,920
Later than five years	**52**	689
	3,146	3,473

Included in the depreciation charge for the year is £144m (2007 £1m) in relation to changes in the estimated residual values of certain operating lease assets.

Total future minimum sub-lease income of £18m at 31 December 2008 (£25m at 31 December 2007) is expected to be received under non-cancellable sub-leases of the Group's premises.

27 Deferred Costs

	2008 £m	2007 £m
Deferred acquisition costs	**423**	352
Deferred origination costs	**758**	749
	1,181	1,101

The change in deferred costs is analysed as follows:

	2008 £m	2007 £m
At 1 January	**1,101**	853
Acquisition costs deferred during the year	**418**	586
Amortisation	**(312)**	(340)
Transfers (Note 28)	**(27)**	
Disposal of subsidiary undertakings	**(3)**	
Exchange translation	**4**	2
At 31 December	**1,181**	1,101

28 Value of In-Force Long Term Assurance Business

	2008 £m	2007 £m
At 1 January	**3,184**	3,104
Unwind of discount rate	**255**	245
Expected return in the year	**(527)**	(415)
Effect of experience in the year	**(736)**	(201)
New business	**523**	567
Changes in assumptions	**(96)**	(180)
Transfers	**164**	
Exchange translation	**225**	64
At 31 December	**2,992**	3,184

Transfer from investment contracts to long term insurance contracts

During the year to 31 December 2008 changes have been made to certain investment bonds with additional life cover being added. In accordance with IFRS 4 'Insurance contracts' this results in these products transferring from being accounted for as investment contracts to insurance contracts. This has resulted in a £281m increase in the value of in-force long term assurance business. This is partly offset by a net £96m, principally arising from a reduction in deferred origination costs, which are charged to fees and commission expense. The overall impact of this change is an increase in profit before tax of £185m.

Also included within transfers is £117m that relates to a transfer from value of in-force long term assurance business to deferred costs.

Assumptions

The key assumptions used in the measurement of the value of in-force long term assurance business relating to insurance contracts and investment contracts with a discretionary participating feature (DPF) are determined by the Board of Directors.

The economic assumptions that have the greatest effect on the calculation of the value in-force long term assurance business are set out below.

The experience assumptions set out in Note 30 also have a significant effect on the cash flow projections. The selection of these assumptions requires the application of material judgement and is made with reference to historic trends, taking into account the analysis of actual versus expected experience as well as industry data.

Additional information on the long term assurance business risk is set out on pages 28 to 30 of the Risk Management report.

Discount rate

The discount rate is used to calculate the present value of the future projected cash flows.

In 2008 each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn the risk free rate and all cash flows are discounted at the risk free rate. The risk free rate assumed in valuing in-force business is equal to the 15 year gilt yield. This applies to all business with the exception of immediate annuity business.

Notes to the Financial Statements continued

28 Value of In-Force Long Term Assurance Business continued

The discount rate for annuity business is assumed to be higher than the risk free rate. Assets backing immediate annuity business are invested in a mix of government stocks and corporate bonds, which are generally held to maturity. The yield on corporate bonds typically exceeds the risk free rate, partly reflecting the risk of default, but also reflecting a premium required by investors as compensation for lower liquidity when compared with government stocks. The discount rate for annuity business is based on the risk free rate with an allowance for this 'liquidity premium'. It is assumed that the premium over the risk free rate is equal to 75% of the spread between the yield on HBOS's portfolio of corporate bonds and the yield on government stocks.

In 2007 the risk discount rate was increased to reflect the uncertainty associated with the projected cash flows. This increase can be broken down into two principal components, being the market risk component and the non-market risk component.

The market risk component represented an allowance for uncertainty as to the level of future margins that would actually be achieved by the Group's investments. The level of the market risk component was chosen so as to avoid capitalising any investment risk premiums over the long term view of the risk free rate of return. Following the move to the certainty equivalent approach in 2008, this adjustment is no longer required as it is assumed that all assets earn the risk free rate.

The non-market risk component represented an additional allowance in the risk discount rate to reflect the potential volatility of, and uncertainty around, the future level of non-market risk inherent in the contracts. In 2008 this has been replaced by an explicit allowance for non-market risk, as described below.

The breakdown of the discount rate is shown in the table below:

	2008 %	2007 %
Risk free rate of return	**3.74**	5.0
Market risk component	**n/a**	1.0
Non-market risk component	**n/a**	2.0
Total	**3.74**	8.0

Investment return

In 2008 it is assumed that all assets earn the risk free rate, in line with the certainty equivalent approach described above, with the exception of immediate annuity business. For annuity business the assumed return is equal to the risk free rate plus the allowance for the liquidity premium, calculated as described for the discount rate above.

In 2007 assumptions were set for each individual asset class based on the long term view of expected returns, and weighted to produce an investment return assumption for each particular class of business. The weighting was based on the long term asset allocation strategy for each class of business. In 2007 the long term view of expected returns was 5.0-5.5% for fixed interest securities and 7.5% for equities.

Expenses

Operating expense assumptions reflect the projected costs of maintaining and servicing in-force insurance contracts and investment contracts with DPF and associated overhead expenses. The current level of expenses is taken as an appropriate expense base. The current expenses are analysed having regard to the volume and type of business in force to derive per contract expense assumptions. These per policy expense assumptions are assumed to increase over the course of the projections in line with expected expenses over the plan period reverting to an assumed expense inflation rate of 3% (2007 3%) thereafter.

Non-market risk

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk and the with-profits fund there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

Changes in assumptions

During the year, the certainty equivalent approach described above was adopted, whereby it is assumed that all assets earn the risk free rate and all cash flows are discounted at the risk free rate. This applies to all business with the exception of immediate annuity business, for which the discount rate is based on the risk free rate plus an allowance for the liquidity premium. The certainty equivalent approach has the effect of increasing the value of in-force business assets by £143m in 2008, but has no effect on the valuation of the related insurance contract liabilities.

In addition to this, there were a number of changes to the underlying experience assumptions used to estimate the cashflows from the long term assurance business. The selection of these assumptions also requires the application of material judgement and is made with reference to historic trends, taking into account the analysis of actual versus expected experience as well as industry data.

28 Value of In-Force Long Term Assurance Business continued

Sensitivities

The tables below indicate the stand alone impact of changes to certain key variables on long term assurance business, this includes the impact on long term insurance contracts, investment contracts with DPF, value of in-force long term assurance business and related financial assets in support of the long term business but excluding those relating to investment contract liabilities.

	Change in variable	2008 Increase/ (decrease) in profit after tax £m
Interest rates increase into perpetuity	**25bps**	**(24)**
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	**-10%**	**(97)**
Maintenance expenses fall and thereafter increase by the estimated expense inflation rate	**-10%**	**46**
Mortality/morbidity rates decrease across all non annuity policy types and age groups	**-5%**	**33**
Mortality rates decrease across all annuity policy types and age groups	**-5%**	**(25)**
Lapse and surrender rates decrease across all policy types and cohorts over the duration of their lives (excluding paid-up policies)	**-10%**	**114**

	Change in variable	2007 Increase/ (decrease) in profit after tax £m
Interest rates increase into perpetuity	25bps	(23)
Equity/property market values fall and thereafter increase based onthe long term view of the risk free rate	-10%	(106)
Maintenance expenses fall and thereafter increase by the estimated expense inflation rate	-10%	43
Mortality/morbidity rates decrease across all non annuity policy types and age groups	-5%	30
Mortality rates decrease across all annuity policy types and age groups	-5%	(20)
Lapse and surrender rates decrease across all policy types and cohorts over the duration of their lives (excluding paid-up policies)	-10%	77

Although the tables above demonstrate the impact of individual variable changes, in practice due to the correlation between certain variables change in one variable would normally be expected to have an impact on other assumptions. It should also be noted that in some instances these sensitivities are non-linear.

29 Other Assets

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Reinsurance assets (Note 30)	**1,396**	963		
Group relief recoverable			**170**	380
Other assets	**3,455**	6,505	**15**	15
	4,851	7,468	**185**	395

Notes to the Financial Statements continued

30 Insurance Contract Liabilities

	2008 Gross liabilities £m	2008 Reinsurance assets (Note 29) £m	2008 Net of reinsurance £m	2007 Gross liabilities £m	2007 Reinsurance assets (Note 29) £m	2007 Net of reinsurance £m
Long term insurance contract liabilities						
Insurance contracts within the with-profit funds	**5,394**		**5,394**	5,640		5,640
Insurance contracts within the non-profit funds	**24,610**	**(1,387)**	**23,223**	20,274	(956)	19,318
	30,004	**(1,387)**	**28,617**	25,914	(956)	24,958
General insurance contract liabilities						
Provision for unearned premiums	**488**	**(5)**	**483**	652	(7)	645
Claims provisions including claims incurred but not reported (IBNR)	**220**	**(4)**	**216**	298		298
	708	**(9)**	**699**	950	(7)	943
Total insurance contract liabilities	**30,712**	**(1,396)**	**29,316**	26,864	(963)	25,901

The change in insurance contract liabilities (net of reinsurance) is analysed as follows:

	2008 £m	2007 £m
At 1 January	**25,901**	24,103
Disposal of subsidiary undertakings	**(27)**	
Transfer from investment contracts to long term insurance contracts (Note 28)	**6,203**	
Changes in assumptions	**61**	(279)
(Reduction in)/additions to insurance liabilities arising	**(3,279)**	1,895
Exchange translation	**457**	182
At 31 December	**29,316**	25,901

Long term insurance contract liabilities

The Group principally writes the following long term contracts which contain insurance risk. The contracts also contain financial risk. The principal risks associated with each type of contract are described below.

Life assurance – The policyholder is insured against death or permanent disability usually for predetermined amounts (principally mortality and disability risk).

Annuity products – The policyholder is entitled to payments for the duration of their life and is therefore insured for living longer than expected (principally longevity and market risk).

With-profit business – The primary purpose of these products is to provide a long term smoothed investment vehicle to the policyholder, protecting them against short term market fluctuations. The policyholder is also usually insured against death and the policy may carry an annuity option at maturity (principally market risk).

Unit-linked business – The primary purpose of these products is to provide an investment vehicle but where the policyholder is also insured against death (principally market risk).

Additional information on the risk associated with the long term assurance business is set out on pages 28 to 30 of the Risk Management report.

The table below sets out the extent of the above exposures based on the carrying value of the liabilities:

	2008 Insurance contract liabilities £m	2008 Reinsurers' share of contract liabilities £m	2008 Net insurance contract liabilities £m	2007 Insurance contract liabilities £m	2007 Reinsurers' share of contract liabilities £m	2007 Net insurance contract liabilities £m
Life assurance	**636**	**(65)**	**571**	327	(28)	299
Annuity products	**2,198**		**2,198**	2,041		2,041
With-profit	**5,394**		**5,394**	5,640		5,640
Unit-linked	**21,759**	**(1,314)**	**20,445**	17,893	(921)	16,972
Other	**17**	**(8)**	**9**	13	(7)	6
Total	**30,004**	**(1,387)**	**28,617**	25,914	(956)	24,958

30 Insurance Contract Liabilities continued

Guarantees and options

The products with the most significant guarantees and options are certain with-profit bonds which allow surrenders at specified dates without market value adjustments being applied and withdrawals to be taken without penalty; certain contracts which provide guaranteed minimum levels of return on policyholder contributions made to the contract; and certain pension contracts containing an option that allows the policyholder to take an annuity benefit at any time between their 60th and 75th birthday on annuity rates that were guaranteed at the outset of the contract. There are no other material guarantees and options within the long term assurance business other than those discussed above.

For contracts where there are guarantees and options the most significant factor in determining the cost of the guarantees and options (other than economic conditions in which the option or guarantee has value) is the actual take up rate of options. The most significant factor in determining take up rates is customer behaviour which is influenced by a number of factors including the value of the contract, and the financial circumstances of the individuals. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

In order to measure the risk of these guarantees, the Group makes use of statistical modelling techniques where appropriate to determine the possible and most likely range of outcomes. To help mitigate the risks, the Group makes use of matching techniques in order to hedge part of the expected cash flows arising under the guarantees in these contracts with financial instruments.

Experience and valuation rates of interest assumptions

The assumptions used in the measurement of insurance liabilities are determined by the board of directors. Material judgement is required in the choice of assumptions relating to insurance contracts.

The assumptions that have the greatest effect on the measurement of the insurance contract liabilities are set out by type of business below.

Mortality and longevity rates

The process used to determine the Group's mortality and longevity assumptions starts with an internal investigation of the Group's actual mortality experience over the last five years. This investigation is updated regularly.

The results of this investigation are considered in the context of a number of factors including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period being considered, any known or expected trends in underlying data and relevant published market data.

The rates derived from the Group's experience are adjusted in the light of the factors mentioned above to derive a set of 'best estimate' rates. No deliberate margins for prudence are introduced as part of this process. These 'best estimate' assumptions will be used in the projection of 'best estimate' cash flows, such as the measurement of the value of in-force long term assurance business.

For insurance contracts within the non-profit funds, the liabilities are assessed on a prudent basis and hence the rates used need to include a margin for adverse deviation that will increase liabilities and provide some protection from the risk that actual experience is worse than the 'best estimate' assumptions.

For insurance contracts within the with-profit fund, the liabilities are required to be determined using the realistic or 'best estimate' assumptions.

The mortality tables used to determine insurance contract liabilities are as follows:

	2008	2007
Non-profit policies		
Pension annuities		
Males	**90% PMA92 mc (1.5% minimum improvement)**	98% PMA92 mc (1.5% minimum improvement)
Females	**87% PMA92 mc (1% minimum improvement)**	80% PFA92 75%mc (1% minimum improvement)
Term assurances		
Males	**33% - 138% TM92**	24% – 79% TM92
Females	**33% - 94% TF92**	26% – 95% TF92
Unit-linked policies		
Life assurance and pensions	**49.5% - 88% AM92/AF92**	58% – 143% AM92/AF92
With-profit policies		
Life assurance and pensions	**60.5% -88% AM92/AF92**	49% – 132% AM92/AF92

For life assurance policies, increased mortality rates would lead to a larger number of claims and claims occurring sooner than anticipated, increasing the expenditure and reducing profits. For annuity contracts, the opposite is true.

Notes to the Financial Statements continued

30 Insurance Contract Liabilities continued

Lapse and surrender rates (persistency)

A lapse occurs when the termination of a contract results from the non-payment of premiums due under that contract. A surrender occurs when a policyholder decides to voluntarily terminate their contract. Paid-up and partial surrender are additional forms of lapse and surrender.

The process used to determine contract lapse and surrender rates is similar to that used to determine mortality and longevity rates. The previous experience of the Group from 2005 to 2007 is analysed using statistical techniques. As the experience can vary considerably between different product types and for contracts which have been in force for different periods, the internal analysis breaks the data down into broadly homogeneous groups for the purposes of this analysis. This analysis is updated regularly.

The most recent experience is considered along with the results of previous analyses in order to determine a 'best estimate' view of what persistency experience will be in the future. In determining this 'best estimate' view, a number of factors are considered including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period being considered, any known or expected trends in underlying data and relevant published market data.

These 'best estimate' assumptions will be used in the projection of 'best estimate' cash flows, such as the measurement of the value of in-force long term assurance business. For insurance contracts within the non-profit funds, the liabilities are calculated assuming a prudent scenario. For insurance contracts within the with-profit fund, the liabilities are required to be determined using the realistic or 'best estimate' assumptions.

Lapse and surrender rates vary according to both contract type and the length of time a contract has been in force. No lapse and surrender rates have been presented because it is impractical to summarise the information in a meaningful manner.

The impact of an increase in lapse and surrender rates on contracts without guarantees and options would most likely result in a decrease in profits, as the contracts would no longer be in force to generate cash flows in the future. However, for certain policies with valuable guarantees and options (principally within the with-profit fund), increased lapse and surrender rates may be beneficial to the Group as the policyholder loses the ability to exercise the potentially valuable guarantee or option when their policy terminates.

Valuation rate of interest

The valuation rate of interest is the rate used to discount the projected cash flows on the contracts in order to determine the value of the liabilities as at the reporting date.

For insurance contracts within the non-profit funds, the liabilities are calculated using an estimate of the prudent valuation rate of interest determined according to specific rules set out by the Financial Services Authority.

For insurance contracts within the with-profit fund, the liabilities are calculated using a realistic or market consistent valuation rate of interest based on the prevailing economic conditions at the time of the liability assessment without further adjustment.

The valuation rates of interest used are as follows:

	2008	2007
Non-profit policies		
Pension annuities	**2.2% - 4.9%**	4.1% – 5.3%
Term assurances	**2.5% - 3.7%**	3.5% – 4.4%
Unit-linked policies		
Life assurance	**3.1% - 3.4%**	3.3% – 4.0%
Pensions	**2.4% - 3.4%**	4.1% – 4.9%

In isolation, an increase in the valuation rate of interest decreases liabilities leading to an increase in profits or vice versa.

Discretionary participating bonus rates

The distributions to policyholders with insurance and investment contracts with DPF are determined by the board of directors of subsidiaries based on local regulations and in line with arrangements in individual policy contracts. For insurance and investment contracts with DPF in the with-profit fund, the distributions to policyholders are governed by the fund's Principles and Practices of Financial Management. No material changes were made to the distribution policies for insurance and investment contracts with DPF during the year under review.

Changes in experience and valuation rate of interest assumptions

The only significant changes to the assumptions used to calculate the value of policyholder liabilities at the year ended 31 December 2008 from those used at the year end 31 December 2007 were due to the change in valuation rates of interest which were updated to reflect prevailing economic conditions at the balance sheet date. The valuation rate of interest assumptions were broadly matched by changes in the valuation of investment securities.

30 Insurance Contract Liabilities continued

General insurance contract liabilities

The insurance business's general insurance claim provisions including IBNR by policy type are set out in the table below:

	2008			2007		
	Gross claims provisions £m	**Reinsurers' share of claims provisions £m**	**Net claims provisions £m**	Gross claims provisions £m	Reinsurers' share of claims provisions £m	Net claims provisions £m
Repayment insurance	**113**	**(4)**	**109**	94		94
Household insurance	**104**		**104**	192		192
Other insurance	**3**		**3**	12		12
Total	**220**	**(4)**	**216**	298		298

Assumptions

For general insurance contracts, claims provisions (comprising provisions for claims reported by policyholder and IBNR claims) are established to cover the ultimate costs of settling the liabilities in respect of claims that have occurred and are estimated based on known facts and anticipated experience at the balance sheet date. The provisions are refined as part of a regular ongoing process as claims experience develops, certain claims are settled and further claims are reported. Outstanding claims provisions are not discounted for the time value of money.

The measurement process primarily includes projection of future claims costs through a combination of actuarial and statistical projection techniques. In certain cases, where there is a lack of reliable historical data on which to estimate claims development, relevant benchmarks of similar business are used in developing claims estimates.

The principal assumption underlying the estimates is the general insurance business's past claims development experience. This includes assumptions in respect of average claims costs, claims handling costs, claims inflation factors, and claim numbers for each accident year. Judgement is used to assess the extent to which external factors such as judicial decisions and government legislation affect the estimates.

Additional information on the Group's general insurance risk is given on pages 28 to 30 of the Risk Management report.

General insurance claims development table

The development of general insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the net liability appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

Accident year	2001 £m	2002 £m	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	**Total £m**
Estimate of ultimate claims costs:									
At end of accident year	62	77	85	177	328	363	482	324	
One year later	50	56	62	158	278	316	391		
Two years later	48	55	66	154	277	313			
Three years later	48	55	66	155	274				
Four years later	48	55	65	155					
Five years later	48	55	65						
Six years later	48	55							
Seven years later	48								
Current estimate of cumulative claims	48	55	65	155	274	313	391	324	**1,625**
Cumulative payments to date	(48)	(55)	(65)	(153)	(272)	(305)	(365)	(146)	**(1,409)**
Total net liability included in the balance sheet				**2**	**2**	**8**	**26**	**178**	**216**

Notes to the Financial Statements continued

31 Investment Contract Liabilities

	2008 £m	2007 £m
Investment contract liabilities	**29,057**	40,387
Investment contract liabilities with a discretionary participating feature	**6,161**	7,192
	35,218	47,579
Investment contracts related to collective investment schemes	**4,264**	5,249
Total investment contract liabilities	**39,482**	52,828

32 Unallocated Surplus

	2008 £m	2007 £m
At 1 January	**1,493**	1,543
Change in the year	**(942)**	(50)
At 31 December	**551**	1,493

The nature of certain insurance and investment contracts with DPF within the with-profit fund is such that the allocation of the surplus assets between the policyholder and the Group has not been determined at the end of the accounting period. The unallocated surplus comprises these surplus assets and is deemed to be a liability until allocation to the appropriate party has been determined. In accordance with the requirements of FRS 27, the 'best estimate' of the Group's share of future bonuses has been recognised as part of the unallocated surplus.

Sensitivities

The table below indicates the stand alone impact of changes to certain key variables that have the greatest impact on the Group's with-profit fund. These are shown with reference to the unallocated surplus and the underlying with-profit liabilities:

	Change in variable	Increase/ (decrease) in liabilities £m	2008 Impact on unallocated surplus £m
Interest rates increase into perpetuity	**25 bps**	**(117)**	
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	**-10%**	**(312)**	**(96)**
Lapse and surrender rates decrease across all policy types and cohorts (excluding paid-up policies)	**-10%**	**36**	**(36)**

	Change in variable	Increase/ (decrease) in liabilities £m	2007 Impact on unallocated surplus £m
Interest rates increase into perpetuity	25bps	(94)	29
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	-10%	(652)	(257)
Lapse and surrender rates decrease across all policy types and cohorts (excluding paid-up policies)	-10%	16	(16)

Although the tables above demonstrate the impact of individual variable changes, in practice due to the correlation between certain variables a change in one variable would normally be expected to have an impact on other assumptions. It should also be noted that in some instances these sensitivities are non-linear.

33 Retirement Benefit Obligations

The Group operates defined benefit and defined contribution pension schemes, as well as defined benefit post retirement medical and concessionary mortgage plans. The charge for the year in respect of the pension schemes is £272m (2007 £206m) comprising £167m (2007 £141m) for defined benefit schemes, £101m (2007 £60m) for defined contribution schemes and £4m (2007 £5m) for other post retirement benefits. The Group's IAS 19 pension surplus across all defined benefit post employment plans as at 31 December 2008 comprises an asset of £629m and a deficit of £152m (gross of deferred tax) giving a net surplus of £477m. As at 31 December 2007, the IAS 19 position was a deficit of £347m (gross of deferred tax).

Defined contribution post employment benefit plans

The principal Group defined contribution plan is the HBOS Group Money Purchase Scheme. It is funded by contributions from colleagues and the Group. New colleagues are automatically enrolled in the scheme unless they opt out.

The level of Group contributions for the majority of members who contribute at the core rate of 4% is 6%. In addition, if members wish to pay more, then the Group will also make further contributions in respect of the members first 4% of additional contributions. For the majority of members, stepping their contribution rate to 8% will result in the Group stepping up its rate to 12%. Higher levels of Group contributions are available to more senior colleagues. Alternatively, members may elect to pay a lower contribution of 2% and receive Group contributions at 3%. These were the levels of contributions for colleagues and Group for the majority of the existing members at April 2006 and other colleagues who were automatically enrolled into the plan. The respective default rates for colleague and Group contributions have been increased to 3% and 4.5% in 2007 and was increased to 4% and 6% in 2008.

The expense of all the Group defined contribution plans for the year ended 31 December 2008 was £101m (2007 £60m).

Defined benefit post employment benefit plans

The Group provides several defined benefit plans. The main scheme is the HBOS Final Salary Pension Scheme (HBOS FSPS) which is a closed funded scheme. It was formed in July 2006 through the merger of the Group's four main UK defined benefit schemes. Accordingly disclosures prior to the date of the merger have been re-analysed to show pro forma comparatives for the HBOS FSPS based on the comparative disclosures of the four legacy schemes.

Separate disclosures for all other defined benefit pension plans within the Group are made under the heading 'Other Schemes'. These contain a mixture of funded and unfunded schemes and arrangements.

Separate disclosures are also made on a combined basis for the unfunded post retirement medical plans and concessionary mortgage plans under the heading 'Other Post Retirement Benefits'.

The Company sponsors the HBOS FSPS Equitable Life Assurance Scheme (closed fund scheme), the unfunded scheme as included within Other Schemes and the post retirement medical and mortgage schemes as included within Other Post Retirement Benefits. The net assets of these schemes are £576m, £53m, £(49)m and £(55)m respectively totalling £525m (2007 £(263)m, £(44)m and £(53)m respectively totalling £(360)m). Accordingly the disclosures relating to the HBOS FSPS and Other Post Retirement Benefits are also those of the Company.

The unfunded scheme in the Company had a liability of £44m at the start of the year (2007 £44m) and £49m at the year end (2007 £44m). The pension expense relating to the unfunded scheme in the Company is £3m (2007 £2m) and is comprised of an interest cost and current service cost of £3m and £nil respectively (2007 £2m and £nil). In addition benefits paid by the Company in respect of the unfunded scheme during the year amounted to £2m (2007 £2m). The unfunded pension liabilities have been secured by assets held by the Group. These assets, comprising listed investment securities held at a value of £51m at 31 December 2008 (2007 £56m), are included in the Group's investment securities and would only be available to members in the event of certain contingencies, such as the failure to pay benefits.

The assets of the Group's funded schemes are held in separate trustee-administered funds, which are independent of the Group's own assets, to meet the long term pension liabilities of past and present employees. The trustees of the schemes are required to act with regard to the best interests of the schemes' beneficiaries and a number of trustees are nominated or elected by the members of the schemes. The trustees, in consultation with the Group, set the schemes' investment strategies and, with the agreement of the Group, set the level of contributions to be made to the schemes.

The liabilities of the defined benefit schemes are measured by discounting the estimated future cash flows to be paid out by the schemes using the projected unit method. This method is an accrued benefit valuation technique that makes allowances for projected earnings. The Group estimates the average duration of the liabilities of the defined benefit scheme to be 23 years.

Following its formation in 2006, the first funding valuation and the most recent published valuation of the HBOS FSPS was carried out as at 31 December 2006 by an independent actuary. The financial assumptions adopted within this valuation were based upon the economic conditions prevailing at the date of valuation. This resulted in the Group adjusting the rate of regular contributions to around 23% of pensionable salaries with effect from July 2007. From 1 June 2008 a salary sacrifice was introduced. Under this arrangement all member contributions are instead paid by the Company, with a corresponding adjustment made to members' net salaries. (This similarly applies to the defined contribution schemes noted above). In the light of the deficit of £95m under the assumptions agreed for the valuation, the Company also agreed to make annual deficit contributions of £50m per annum for each of the years 2007 to 2010 inclusive. The Company has paid £100m in respect of the first two years contribution during 2007. As such no deficit contributions were paid in 2008. The level of contributions payable to the scheme is expected to be reviewed again following completion of the next scheduled funding valuation, due as at 31 December 2009.

The Company operates a post retirement medical plan for certain former employees and provides post retirement mortgage benefits to both current and retired employees.

Notes to the Financial Statements continued

33 Retirement Benefit Obligations continued

On 1 January 2008, the Clerical Medical International Pension Scheme, which is a funded defined benefit plan, included within Other Schemes was merged with the HBOS FSPS. In anticipation of this, the Company paid a deficit reduction contribution of £5m during 2007 as part of the merger agreement.

The Group's net post retirement benefit liabilities in respect of its defined benefit plans are analysed as follows:

				2008				2007
	HBOS FSPS £m	Other Schemes £m	Other Post Retirement Benefits £m	Total £m	HBOS FSPS £m	Other Schemes £m	Other Post Retirement Benefits £m	Total £m
Defined benefit obligations	**(6,195)**	**(514)**	**(55)**	**(6,764)**	(7,072)	(551)	(53)	(7,676)
Fair value of assets	**6,771**	**470**		**7,241**	6,809	520		7,329
Net asset/(liabilities)	**576**	**(44)**	**(55)**	**477[1]**	(263)	(31)	(53)	(347)
Movements in the net post retirement benefit liabilities were as follows:								
At 1 January	**(263)**	**(31)**	**(53)**	**(347)**	(778)	(79)	(55)	(912)
Pension expense	**(157)**	**(10)**	**(4)**	**(171)**	(131)	(10)	(5)	(146)
Group contributions	**191**	**30**		**221**	250	42		292
Benefits paid directly by the Group		**2**	**2**	**4**		1	2	3
Actuarial gains/(losses)	**805**	**(35)**		**770**	396	15	5	416
At 31 December	**576**	**(44)**	**(55)**	**477**	(263)	(31)	(53)	(347)
Movements in the defined benefit obligations were as follows:								
At 1 January	**7,072**	**551**	**53**	**7,676**	6,952	549	55	7,556
Effect of scheme merger	**26**	**(26)**						
Current service cost	**198**	**13**	**1**	**212**	210	12	2	224
Plan participant contributions	**11**	**1**		**12**	23	1		24
Interest cost	**404**	**31**	**3**	**438**	358	28	3	389
Benefits paid	**(208)**	**(15)**		**(223)**	(165)	(19)		(184)
Benefits paid directly by the Group		**(2)**	**(2)**	**(4)**		(1)	(2)	(3)
Net actuarial (gains)/losses	**(1,320)**	**(67)**		**(1,387)**	(311)	(24)	(5)	(340)
Past service cost	**12**	**2**		**14**	5	1		6
Settlement/curtailment		**(9)**		**(9)**		(4)		(4)
Foreign exchange translation		**35**		**35**		8		8
At 31 December	**6,195**	**514**	**55**	**6,764**	7,072	551	53	7,676
Movements in the fair value of plan assets were as follows:								
At 1 January	**6,809**	**520**		**7,329**	6,174	470		6,644
Effect of scheme merger	**21**	**(21)**						
Actual return on plan assets	**(53)**	**(65)**		**(118)**	527	24		551
Group contributions	**191**	**30**		**221**	250	42		292
Plan participant contributions	**11**	**1**		**12**	23	1		24
Benefits paid	**(208)**	**(15)**		**(223)**	(165)	(19)		(184)
Settlement/curtailment		**(13)**		**(13)**		(6)		(6)
Foreign exchange translation		**33**		**33**		8		8
At 31 December	**6,771**	**470**		**7,241**	6,809	520		7,329
The fair value of plan assets at 31 December comprise the following:								
Equity instruments	**2,814**	**234**		**3,048**	3,940	260		4,200
Bonds	**3,779**	**137**		**3,916**	2,478	129		2,607
With-profit investments		**15**		**15**		50		50
Property	**178**	**7**		**185**	298	8		306
Other assets		**77**		**77**	93	73		166
Total value of assets	**6,771**	**470**		**7,241**	6,809	520		7,329

33 Retirement Benefit Obligations continued

The expense recognised in the income statement for the year ending 31 December comprises:

	2008				2007			
	HBOS FSPS £m	Other Schemes £m	Other Post Retirement Benefits £m	Total £m	HBOS FSPS £m	Other Schemes £m	Other Post Retirement Benefits £m	Total £m
Current service cost	198	13	1	212	210	12	2	224
Interest cost	404	31	3	438	358	28	3	389
Expected return on assets	(462)	(35)		(497)	(442)	(33)		(475)
Settlement/curtailment		4		4		2		2
Past service cost	12	2		14	5	1		6
Effect of scheme merger	5	(5)						
Total expense	157	10	4	171	131	10	5	146

The actuarial gains/(losses) recognised in the statement of recognised income and expense for the year ending 31 December comprises:

	2008				2007			
	HBOS FSPS £m	Other Schemes £m	Other Post Retirement Benefits £m	Total £m	HBOS FSPS £m	Other Schemes £m	Other Post Retirement Benefits £m	Total £m
Actuarial gain/(loss) on plan assets	(515)	(100)		(615)	85	(9)		76
Experience (loss)/gain on plan liabilities		(22)	(3)	(25)	(91)	(4)	1	(94)
Gain/(loss) from change in assumptions	1,320	87	3	1,410	402	28	4	434
Total actuarial gains/(losses)	805	(35)		770	396	15	5	416

The Group's policy for recognising actuarial gains and losses is to take them directly to reserves in the period in which they arise. A gain of £568m (2007 gain of £312m) (net of tax) was recognised in the consolidated statement of recognised income and expense in the year. Cumulative actuarial gains and losses recognised in the consolidated statement of recognised income and expense at 31 December 2008 amounts to a gain of £744m (2007 a gain of £176m) (net of tax).

The expected and actual returns on plan assets for the HBOS FSPS and other schemes is as follows:

	2008			2007		
	HBOS FSPS £m	Other Schemes £m	Total £m	HBOS FSPS £m	Other Schemes £m	Total £m
Expected return on plan assets	462	35	497	442	33	475
Actuarial gain/(loss) on plan assets	(515)	(100)	(615)	85	(9)	76
Actual return on plan assets	(53)	(65)	(118)	527	24	551

Notes to the Financial Statements continued

33 Retirement Benefit Obligations continued

The history of experience adjustments for the HBOS FSPS and other schemes is as follows:

			2008			2007
	HBOS FSPS £m	**Other Schemes £m**	**Total £m**	HBOS FSPS £m	Other Schemes £m	Total £m
Defined benefit obligations	**(6,195)**	**(514)**	**(6,709)**	(7,072)	(551)	(7,623)
Fair value of plan assets	**6,771**	**470**	**7,241**	6,809	520	7,329
Net assets/(liabilities)	**576**	**(44)**	**532**	(263)	(31)	(294)
Experience adjustments on plan liabilities: (Loss)/gain (£m)		**(22)**	**(22)**	(91)	(4)	(95)
Percentage of plan liabilities (%)		**5**	**1**	1	1	1
Experience adjustments on plan assets: Gain/(loss) (£m)	**(515)**	**(100)**	**(615)**	85	(9)	76
Percentage of plan assets (%)	**8**	**21**	**8**	1	(2)	1

			2006			2005
	HBOS FSPS £m	Other Schemes £m	Total £m	HBOS FSPS £m	Other Schemes £m	Total £m
Defined benefit obligations	(6,952)	(549)	(7,501)	(6,635)	(500)	(7,135)
Fair value of plan assets	6,174	470	6,644	4,934	409	5,343
Net liabilities	(778)	(79)	(857)	(1,701)	(91)	(1,792)
Experience adjustments on plan liabilities: (Loss)/Gain (£m)	136	7	143	(83)	(7)	(90)
Percentage of plan liabilities (%)	(2)	(1)	(2)	1	1	1
Experience adjustments on plan assets: Gain (£m)	149	25	174	581	10	591
Percentage of plan assets (%)	2	5	3	12	2	11

The mortality assumptions used in 2008 are unchanged from those adopted following the 31 December 2006 valuation of the FSPS. For current and deferred pensioners table PNA00 projected to 2006 using the base level of improvements from the '92' series, with subsequent future improvements in line with the '92' series 'medium cohort' projections have been used with a 10% loading to the female table reducing life expectancy. This is to align it with actual experience for the schemes' pensioners. For active members table A92ULT multiplied by 70% has been used.

Summary of assumptions and membership data

The following assumptions and data have been used in respect of the defined benefit pension schemes:

				HBOS FSPS				**Other Schemes**
	2009	2008	2007	2006	**2009**	2008	2007	2006
Actuarial assumptions at beginning of the year								
Discount rate (%)	**6.25**	5.70	5.15	4.85	**5.7**	5.70	5.15	4.85
RPI inflation rate	**3.0**	3.4	3.0	2.8	**3.4**	3.4	3.0	2.8
Expected return on plan assets[(a)] (%)	**5.53**	6.78	7.18	7.15	**6.66**	6.66	6.86	6.29
Salary increases[(b)] (%)	**3.5**	3.9	3.5	3.3	**3.9**	3.9	3.5	3.3
Pension increases[(c)] (%)	**3.0**	3.3	3.0	2.8	**3.3**	3.3	3.0	2.8
Life expectancy at age 60 (years)								
Retired members								
Males	**26**	26	26	23	**26**	26	26	23
Females	**27**	27	27	26	**27**	27	27	26
Non-retired members								
Males	**27**	27	27	24	**27**	27	27	24
Females	**29**	29	29	27	**29**	29	29	27

(a) The expected rate of return on plan assets shown above is a weighted average based on the current investment strategy. Return seeking assets (eg equities) are assumed to return 7.55% pa, low risk matching assets (predominantly gilts) are assumed to return 3.85% pa, corporate bonds are assumed to return 6.25% pa, with profits funds are assumed to return 6.25% and property is assumed to return 6.5% pa.

(b) In addition to the general assumed rate of salary increases, there is a separate assumed salary scale of increases due to promotions and increasing seniority worth about 0.5% in overall terms.

(c) The pension increase is on the excess over the Guaranteed Minimum Pension. Pensions which are guaranteed to increase at a rate of at least 3% per annum have been assumed to increase at 3.25% per annum for the end of year calculations (3.60% per annum for 2007 and 3.40% per annum for 2006).

The expected company contributions for the year commencing 1 January 2009 total £274.5m (2008 £215.9m).

33 Retirement Benefit Obligations continued

A summary of the membership data at the end of each year is as follows:

	HBOS FSPS				Other Schemes			
	2008	2007	2006	2005	**2008**	2007	2006	2005
Active members								
Number	**26,061**	27,893	30,044	32,504	**1,149**	2,581	2,113	2,289
Covered annual payroll (£m)	**729**	745	747	764	**67**	106	82	78
Average age	**41**	42	41	41	**45**	43	44	43
Average length of service	**15**	15	14	13	**12**	11	11	12
Deferred members								
Number	**37,037**	35,869	35,167	32,844	**1,996**	2,557	2,019	1,969
Average age	**45**	42	42	44	**45**	44	47	44
Retired members								
Number	**15,909**	14,460	13,866	12,932	**684**	675	677	644
Total annual pensions (£m)	**144**	129	120	112	**13**	18	10	9
Average age	**65**	64	63	64	**64**	63	64	65

The membership data above reflects the transfer of Clerical Medical International Scheme into the HBOS FSPS.

The principal assumptions used in the calculation of the other post retirement benefits are the discount rate, which is the same as that used for the pension schemes and the medical cost trend rate which has been assumed to be the same as the discount rate.

Sensitivity analysis for each of the principal assumptions used to measure the scheme liabilities, showing the increase in defined benefit obligations at 31 December 2008, is set out below:

Factor		HBOS FSPS		Other Schemes	
	Change in assumption	**Increase 2008**	Increase 2007	**Increase 2008**	Increase 2007
Discount rate	decrease 0.1%	**2.3%**	2.3%	**2.2%**	2.2%
Rate of inflation	increase 0.1%	**2.3%**	2.3%	**2.2%**	2.2%
Rate of salary growth	increase 0.1%	**0.4%**	0.5%	**0.4%**	0.4%
Life expectancy at age 60	increase by 1 year	**2.7%**	2.7%	**2.5%**	2.5%

34 Deferred Tax

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities tie to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

Statutory Position	**2008 £m**	2007 £m
Deferred tax liabilities	**227**	2,600
Deferred tax asset	**(2,556)**	(70)
Net deferred tax (asset)/liability	**(2,329)**	2,530

Tax Disclosure	**2008 £m**	2007 £m
Deferred tax liabilities	**1,608**	2,945
Deferred tax asset	**(3,937)**	(415)
Net deferred tax (asset)/liability	**(2,329)**	2,530

At 31 December 2008 a deferred tax liability of £255m (2007 £251m) relating to investments in subsidiaries has not been recognised because the Company controls whether or not the liability will be incurred and it is satisfied that it will not be incurred in the foreseeable future.

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable.

Deferred tax assets of £92m (2007 £nil) have not been recognised in respect of unrealised capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition deferred tax assets of £69m (2007 £62m) have not been recognised in respect of Eligible Unrelieved Foreign tax (EUFT) carried forward as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. EUFT can be carried forward indefinitely.

Notes to the Financial Statements continued

34 Deferred Tax continued

As a result of the Finance Act 2007, the main UK corporation tax rate reduced from 30% to 28% in April 2008. UK deferred tax balances that are not expected to have been realised by April 2008 have been restated at the rate of 28%. In addition, the German corporation tax rate reduced from 25% to 15% in January 2008.

The movement in the net position is as follows:

	2008 £m	2007 £m
At 1 January	**2,530**	2,591
(Credit)/charge to income for the year (Note 13)	**(2,964)**	199
Credit to equity for the year (Note 13)	**(2,089)**	(86)
Disposals	**41**	
Changes in rates of corporation tax recognised in income (Note 13)		(178)
Changes in rates of corporation tax recognised in equity (Note 13)		1
Other movements	**153**	3
At 31 December	**(2,329)**	2,530

Analysed as follows:

Deferred tax liabilities	Capital allowances £m	Available for sale investments £m	Employee benefits £m	Long term assurance business £m	Effective interest rate £m	Other £m	2008 Total £m
At 1 January 2008	**1,060**	**15**		**1,610**	**98**	**162**	**2,945**
Credit to income for the year	**(518)**		**(78)**	**(1,012)**	**(12)**	**(62)**	**(1,682)**
(Credit)/charge to equity for the year		**(15)**	**202**			**2**	**189**
Disposals	**(3)**					**(3)**	**(6)**
Other movements	**72**		**20**	**70**			**162**
At 31 December 2008	**611**		**144**	**668**	**86**	**99**	**1,608**

Deferred tax assets	Available for sale investments £m	Cash flow hedges £m	Employee benefits £m	Provisions £m	Other £m	Trading losses c/fwd £m	2008 Total £m
At 1 January 2008		**(34)**	**(98)**	**(168)**	**(115)**		**(415)**
Charge/(credit) to income for the year	**975**		**98**	**(348)**	**(494)**	**(1,513)**	**(1,282)**
Credit to equity for the year	**(1,902)**	**(376)**					**(2,278)**
Disposals				**47**			**47**
Other movements	**3**			**(9)**	**(2)**	**(1)**	**(9)**
At 31 December 2008	**(924)**	**(410)**		**(478)**	**(611)**	**(1,514)**	**(3,937)**

Deferred tax assets in respect of employee benefits primarily relate to retirement benefit plans. Deferred tax assets relating to share based compensation are included in other.

In the Company there is a deferred tax liability of £161m (2007 asset £85m). The liability is primarily in respect of the post retirement asset of the Company.

34 Deferred Tax continued

Deferred tax liabilities	Capital allowances £m	Available for sale investments £m	Cash flow hedges £m	Long term assurance business £m	Effective interest rate £m	Other £m	2007 Total £m
At 1 January 2007	1,112	96	182	1,738	131	90	3,349
Charge/(credit) to income for the year	31	(9)		(44)	(29)	88	37
(Credit)/charge to equity for the year		(65)	(182)	5		(1)	(243)
Changes in rates of corporation tax recognised in income	(76)			(101)	(7)	(12)	(196)
Changes in rates of corporation tax recognised in equity		(7)					(7)
Other movements	(7)			12	3	(3)	5
At 31 December 2007	1,060	15		1,610	98	162	2,945

Deferred tax assets	Cash flow hedges £m	Employee benefits £m	Provisions £m	Other £m	2007 Total £m
At 1 January 2007		(284)	(213)	(261)	(758)
Charge to income for the year		46	36	80	162
(Credit)/charge to equity for the year	(37)	130		64	157
Changes in rates of corporation tax recognised in income		1	9	8	18
Changes in rates of corporation tax recognised in equity	3	5			8
Other movements		4		(6)	(2)
At 31 December 2007	(34)	(98)	(168)	(115)	(415)

35 Other Liabilities

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Unclaimed shares	**150**	151	**150**	151
Other liabilities	**4,959**	4,921	**146**	53
	5,109	5,072	**296**	204

Unclaimed shares comprise the net sale proceeds of certain Halifax Group Limited (formerly Halifax Group plc) ordinary shares which, following the Halifax Group restructuring which took effect on 1 June 1999, represented Halifax plc ordinary shares. These shares were issued to meet claims for Halifax plc ordinary shares from qualifying members of Halifax Building Society and others following the transfer of business from Halifax Building Society to Halifax plc in 1997. This liability also includes the related unclaimed dividends up to the date of sale and the unclaimed capital payments arising from the Halifax Group restructuring in 1999. These amounts are being held on behalf of the persons who would have been entitled to claim the shares before they were sold. Amounts representing the sale proceeds, together with the unclaimed capital payments, can be claimed during a period of nine years from the date of sale (30 August 2001) after which time they will be forfeited. Amounts representing the related unclaimed dividends can be claimed during the period of twelve years from the date of the resolution for payment of each dividend, after which time they will be forfeited. Following an internal reorganisation on 1 July 2002, responsibility for these balances was assumed by the Company.

36 Provisions

	Regulatory provisions £m	Other provisions £m	Total £m
At 1 January 2008	**106**	**69**	**175**
Exchange translation		**3**	**3**
Charge to administrative expenses	**200**	**31**	**231**
Utilised in year	**(10)**	**(52)**	**(62)**
At 31 December 2008	**296**	**51**	**347**

The Group is an authorised institution and operates in the UK or overseas within the regulatory framework established in the UK by the Financial Services Authority or overseas by local regulatory bodies. As a result of this, regulatory provisions are established when a legal or constructive obligation exists as a result of a past event where it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate can be made. Regulatory provisions include the following:

Notes to the Financial Statements continued

36 Provisions continued

i. the estimated cost of making redress payments to customers in respect of past product sales where sales processes have been deficient or where fees and premiums have been overcharged; and

ii. the costs estimated by management for the Financial Services Compensation Scheme management expense levy against deposit taking firms to fund the UK compensation scheme for customers of authorised financial services firms that are unable to pay claims made against them. Further details are given below.

In addition, other provisions include property-related costs in respect of surplus leased space that amounted to £39m (2007 £27m) at the year end, provisions for long term and annual leave, provisions in respect of legal liabilities and for obligations under reward programmes.

The timing of cash outflows for regulatory and other provisions can be uncertain and depend on a number of variables outwith the control of the Group. It is estimated that £191m (2007 £35m) of the outstanding provisions will be settled within the next year.

Financial Services Compensation Scheme (FSCS)
The Financial Services Compensation Scheme (FSCS) is the UK's statutory compensation scheme for customers of authorised financial services firms that are unable to pay claims made against them. Bank of Scotland plc, as an authorised firm, is obliged to pay levies to the FSCS as part of its funding arrangements, as explained below.

The FSCS raises levies against firms authorised by the Financial Services Authority (FSA) in respect of its management expenses and compensation costs. Under a new funding system introduced on 1 April 2008, the levies are split into five broad classes, one of which is protected deposits. Each deposit-taking firm contributes an amount in respect of these costs, which is proportionate to their share of the protected deposits for the relevant year. The levies are subject to the maximum thresholds determined by the FSA.

Since October 2008, the FSCS has contributed to the costs of transferring, and/or paid compensation to, the customers of certain failed firms (including Bradford & Bingley plc, Kaupthing Singer & Friedlander Limited, Heritable Bank plc, Landsbanki's Icesave and London Scottish Bank plc). As a result, the FSCS is now a creditor of these firms.

To fund these activities, the FSCS has obtained interest-only finance from HM Treasury of £19.7 billion (as at 16 December 2008), which is due to be refinanced in 2011. The FSCS expects the amounts owed to it by failed firms to be reduced as assets are realised or other payments are made to creditors. In turn, this will enable the FSCS to reduce its borrowings from HM Treasury. In the meantime, the FSCS will need to meet its anticipated obligations in respect of interest payments on its borrowings through management expenses levies on authorised firms.

The FSA, on behalf of the FSCS, has issued guidance regarding the levies to be made by the FSCS in 2009. This guidance indicates that the FSCS is expected to raise the next levy before 31 March 2009 and that the annual limit on the FSCS management expenses levy for 2008/09 has been set at £1 billion. HBOS has accrued a charge of £200m in respect of forecast management expenses levies for the levy years 2008/09 and 2009/10 that are based upon its share of protected deposits as at 31st December 2007 and 2008 respectively.

When the existing borrowing with HM Treasury is refinanced in 2011, a repayment schedule for the outstanding principal will be agreed between HM Treasury and the FSCS, after which the FSCS will raise compensation costs levies against firms in respect of these amounts. These levies could be significant. However, no provision has been made for these costs to date as their amount is unknown and is not expected to be quantifiable until 2011 at the earliest.

37 Debt Securities in Issue

	2008			2007		
	At fair value through the income statement £m	**At amortised cost £m**	**Total £m**	At fair value through the income statement £m	At amortised cost £m	Total £m
Certificates of deposit		**50,956**	**50,956**		63,680	63,680
MTNs issued		**48,630**	**48,630**		29,199	29,199
Covered bonds		**34,022**	**34,022**		39,184	39,184
Commercial paper		**12,132**	**12,132**		28,648	28,648
Securitisation		**42,708**	**42,708**	1,842	43,967	45,809
		188,448	**188,448**	1,842	204,678	206,520

Included within commercial paper above is £2,979m (2007 £11,954m) issued by the Grampian conduit and £nil (2007 £137m) issued by the Landale conduit.

The additional amount contractually payable on maturity of the debt securities held at fair value through the income statement at 31 December 2007 was £294m. During 2007, £0.1m movement in the fair value of these liabilities was attributable to changes in credit spread risk.

38 Other Borrowed Funds

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Preferred securities	**3,969**	4,973		
Preference shares	**2,614**	1,571	**2,614**	1,571
Subordinated liabilities				
Dated	**15,078**	10,964	**10,927**	7,253
Undated	**8,458**	6,745	**8,694**	6,679
	30,119	24,253	**22,235**	15,503

Preferred securities	Group 2008 £m	Group 2007 £m
US$750m 6.071% Non-cumulative Perpetual Preferred Securities of US$1,000 each	**513**	374
US$1,000m 6.85% Non-cumulative Perpetual Preferred Securities of US$1,000 each	**684**	499
£600m 6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A of £1,000 each	**600**	600
£250m 8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class A)	**250**	250
£150m 7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B)	**150**	150
£245m 7.881% Guaranteed Non-voting Non-cumulative Preferred Securities	**245**	245
415m Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities	**396**	305
750m 4.939% Non-voting Non-cumulative Perpetual Preferred Securities	**716**	551
£2bn 6.0064/6.0895% Fixed Rate Perpetual Securities		2,000
Other Preferred Securities		4
Unamortised issue costs	**(22)**	(24)
Accrued interest	**32**	36
Fair value hedge adjustments	**405**	(17)
	3,969	4,973

During 2007 Fortrose Investments Ltd, a subsidiary, issued £2,000m of Fixed Rate Perpetual Securities and other subsidiaries issued Preferred Securities totalling £4m, all of which were redeemed during 2008.

Preference shares	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
£300m 9 1/4% Non-cumulative Irredeemable £1 preference shares	**300**	300	**300**	300
£100m 9 3/4% Non-cumulative Irredeemable £1 preference shares	**100**	100	**100**	100
US$750m 6.413% Fixed-to-Floating Rate US$1 series A preference shares	**513**	374	**513**	374
US$750m 5.92% Fixed-to-Floating Rate US$1 series B preference shares	**513**	374	**513**	374
US$750m 6.657% Fixed-to-Floating rate US$1 preference shares	**513**	374	**513**	374
Unamortised issue costs	**(11)**	(9)	**(11)**	(9)
Accrued interest	**32**	27	**32**	27
Fair value hedge adjustments	**654**	31	**654**	31
	2,614	1,571	**2,614**	1,571

The US$750m 6.413% Fixed-to-Floating Rate series A preference shares, the US$750m 5.92% Fixed-to-Floating Rate series B preference shares and the US$750m 6.657% Fixed-to-Floating Rate preference shares have been issued in the form of American Depository Receipts.

On 21 May 2007 HBOS plc issued 7,500 American Depository Receipts representing US$750m 6.657% Fixed-to-Floating Rate US$1 preference shares. These are Tier I non-innovative non-equity preference shares that were issued at $1,000 per share. Dividends are payable semi-annually in arrears until 21 May 2037 at which date the Company has the option to redeem them. Thereafter, dividends are payable at a rate of three month LIBOR plus 1.27% per annum payable quarterly in arrears and can be redeemed by the Company on any dividend payment date.

There have been no new issues during 2008. On 15 January 2009 HBOS plc issued £3,000m HMT preference shares (Note 57).

Notes to the Financial Statements continued

38 Other Borrowed Funds continued

Dated subordinated liabilities	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
€650m 4.75% Subordinated Bonds 2009	**621**	477		
€500m 5.50% Instruments 2009	**478**	367		
US$500m Notes 2010	**342**	249		
US$150m Notes 2011	**103**	75		
€750m Subordinated Fixed Rate Notes 2012	**716**	551		
€12.8m 6.25% Instruments 2012	**12**	9		
€1,000m Subordinated Callable Fixed/Floating Rate Instruments 2013		734		
€325m 6.125% Notes 2013	**310**	239		
US$1,000m 4.25% Subordinated Guaranteed Notes 2013	**684**	499	**684**	499
JPY 60bn 0.55% Subordinated Callable Notes 2013		267		267
US$500m Subordinated Callable Notes 2014	**342**	249	**342**	249
£250m 11% Subordinated Bonds 2014	**250**	250		
€1,000m 4.875% Subordinated Notes 2015	**955**	734	**955**	734
€500m Callable Floating Rate Subordinated Notes 2016	**478**	367	**478**	367
€500m Subordinated Notes 2016	**478**	367	**478**	367
US$750m Notes 2016	**513**	374	**513**	374
€1,000m Subordinated Lower Tier II Notes 2017	**955**	734	**955**	734
US$1,000m Subordinated Callable Notes 2017	**684**	499	**684**	499
Aus$400m Subordinated Callable Floating Rate Instruments 2017	**189**	175	**189**	175
Aus$200m Subordinated Callable Fixed/Floating Rate Instruments 2017	**95**	88	**95**	88
Can$500m Callable Fixed to Floating Rate Notes 2017	**279**	254	**279**	254
£500m Lower Tier II Subordinated Notes 2017	**500**	500	**500**	500
£150m 10.5% Subordinated Bonds 2018	**150**	150		
US$2,000m 6.75% Subordinated Fixed Rate Notes 2018	**1,368**		**1,368**	
£250m 6.375% Instruments 2019	**250**	250		
€750m Callable Fixed to Floating Rate Subordinated Notes 2019	**716**	551	**716**	551
£500m 9.375% Subordinated Bonds 2021	**500**	500		
€160m Subordinated Fixed Rate Notes 2021	**153**	117	**153**	117
€400m 6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023	**382**	294		
€175m 6.5% Subordinated Fixed Rate Notes 2023	**167**		**167**	
€750m Fixed Rate Step-up Subordinated Notes due 2030	**716**	551	**716**	551
US$750m 6.00% Subordinated Notes 2033	**513**	374	**513**	374
£245m 7.881% Subordinated Extendable Maturity Notes 2048			**245**	245
€415m Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048			**396**	305
Unamortised premiums, discounts and issue costs	**(29)**	(32)	**(25)**	(25)
Accrued interest	**261**	221	**108**	79
Fair value hedge adjustments	**947**	(70)	**418**	(51)
	15,078	10,964	**10,927**	7,253

During the year the following dated subordinated liabilities have been issued:

On 8 April 2008 HBOS plc issued €175m Subordinated Lower Tier 2 Notes at par. The notes pay interest at a rate of 6.5% plus Indexation (HICP excluding tobacco for Eurozone) annually in arrears until maturity on 8 April 2023.

On 21 May 2008 HBOS plc issued US$2bn Subordinated Lower Tier 2 Notes at an issue price of 99.334% of the principal amount. The notes pay interest at a rate of 6.75% per annum, payable semi-annually in arrears until maturity on 21 May 2018.

During 2007 the following dated subordinated liabilities were issued:

On 20 March 2007 HBOS plc issued €1bn Subordinated Lower Tier 2 Notes at an issue price of 99.954% of the principal amount. The notes pay interest at a rate of three month Euribor plus 0.2% per annum payable quarterly in arrears until 21 March 2012 at which time the interest rate will become three month Euribor plus 0.7% per annum payable quarterly in arrears until maturity in March 2017. The Company has the option to redeem these notes on 21 March 2012 and quarterly thereafter.

On 27 April 2007 HBOS plc issued Aus$400m Subordinated Callable Floating Rate and Aus$200m Subordinated Callable Fixed/Floating Rate Australian Domestic Instruments at issue prices of 100% and 99.423% of the principal amount respectively. The fixed rate notes pay interest at a rate of 6.75% and the floating rate notes at three month AUD-BBR-BSW plus 0.26% per annum payable quarterly in arrears until 1 May 2012 at which time both interest rates will become three month AUD-BBR-BSW plus 0.76% per annum payable quarterly in arrears until maturity in May 2017. The Company has the option to redeem these notes on 1 May 2012 and quarterly thereafter.

38 Other Borrowed Funds continued

On 6 June 2007 HBOS plc issued US$1bn Subordinated Callable Notes at par. The notes pay interest at a rate of three month US$ LIBOR plus 0.2% per annum payable quarterly in arrears until 6 September 2012 at which time the interest rate will become three month US$ LIBOR plus 0.7% per annum payable quarterly in arrears until maturity in September 2017. The Company has the option to redeem these notes on 6 September 2012 and quarterly thereafter.

On 20 June 2007 HBOS plc issued Can$500m Callable Fixed to Floating Rate Notes at par. The notes are subordinated and pay interest at a rate of 5.109% per annum payable quarterly in arrears until 20 June 2012 at which time the interest rate will become three month CAD-BA-CDOR plus 0.65% per annum payable quarterly in arrears until maturity in June 2017. The Company has the option to redeem these notes on 20 June 2012 and quarterly thereafter.

On 15 October 2007 HBOS plc issued 160m Subordinated Fixed Rate Notes at par. The notes pay interest at a rate of 5.374% per annum payable annually and mature on 30 June 2021.

On 17 October 2007 HBOS plc issued £500m Lower Tier 2 Subordinated Notes at an issue price of 99.9% of the principal amount. The notes pay interest at a rate of 6.305% per annum payable semi-annually until 18 October 2012 at which time the interest rate will become three month LIBOR plus 1.2% per annum payable quarterly in arrears until maturity in October 2017. The Company has the option to redeem these notes on 18 October 2012 and quarterly thereafter.

No repayment, for whatever reason, of dated subordinated liabilities prior to their stated maturity and no purchase by the relevant entity of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary, 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 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 dated loan capital.

Notes to the Financial Statements continued

38 Other Borrowed Funds continued

Undated subordinated liabilities	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
£500m Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes	**500**	500	**500**	500
US$750m 6.071% Undated Subordinated Fixed to Floating Rate Instruments			**513**	374
€750m 4.875% Undated Fixed to Floating Rate Subordinated Notes	**716**	551	**716**	551
€500m Floating Rate Undated Subordinated Notes	**478**	367	**478**	367
US$1,000m 5.375% Undated Fixed to Floating Rate Subordinated Notes	**684**	499	**684**	499
€750m Undated Subordinated Fixed to Floating Notes	**716**	551	**716**	551
£600m 5.75% Undated Subordinated Step-up Notes	**600**	600	**600**	600
US$1,000m 6.85% Undated Subordinated Notes			**684**	499
£600m Fixed to Floating Rate Undated Subordinated Notes			**600**	600
€500m Fixed to Floating Rate Undated Subordinated Notes	**478**	367	**478**	367
£300m Perpetual Regulatory Tier One Securities	**300**	300		
£300m 7.5% Undated Subordinated Step-up Notes	**300**	300	**300**	300
JPY 42.5bn 3.50% Undated Subordinated Yen Step-up Notes	**321**	189	**321**	189
US$300m Reset Notes				
£200m Perpetual Notes	**200**	200		
£200m 7.375% Undated Subordinated Guaranteed Bonds	**200**	200		
€300m Floating Rate Undated Subordinated Step-up Notes	**287**	220	**287**	220
US$250m Floating Rate Primary Capital Notes	**171**	125		
£150m Instruments	**150**	150		
JPY 17bn Instruments	**128**	76		
£100m Instruments	**100**	100		
£100m 12% Perpetual Subordinated Bonds	**100**	100		
£100m 8.75% Perpetual Subordinated Bonds	**100**	100		
£75m 13.625% Perpetual Subordinated Bonds	**75**	75		
JPY 9bn Instruments		40		
£50m 9.375% Perpetual Subordinated Bonds	**50**	50		
£500m 5.75% Undated Subordinated Step-up Notes	**500**	500	**500**	500
€750m 4.25% Perpetual Fixed/Floating Rate Reset Subordinated Guaranteed Notes	**716**	551		
€750m 4.939% Undated Fixed to Floating Rate Subordinated Notes			**716**	551
£750m Undated Perpetual Preferred Securities			**750**	
Unamortised premiums, discounts and issue costs	**(46)**	(71)	**(44)**	(48)
Accrued interest	**145**	146	**144**	104
Fair value hedge adjustments	**489**	(41)	**(249)**	(45)
	8,458	6,745	**8,694**	6,679

On 19 March 2008 HBOS plc issued £750m Undated Fixed to Floating Rate Subordinated Notes at an issue price of 99.25% of the principal amount to HBOS Capital Funding No. 4 L.P., a subsidiary undertaking. The notes pay interest at a rate of 9.54% per annum, payable semi-annually in arrears until 19 March 2018 at which time the interest rate will become 3 month LIBOR plus 6.75% per annum payable quarterly in arrears. The company has the option to redeem these notes on 19 March 2018 and quarterly thereafter. Upon consolidation this is eliminated and minority interest arises, as disclosed in Note 41.

No exercise of any redemption option or purchase by the relevant entity of any of the undated subordinated liabilities may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary, 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 Company or subsidiary 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.

39 Share Capital

Allotted, called up and fully paid	Ordinary shares £m	Preference shares £m	Total £m
At 1 January 2007	941	198	1,139
Issued under employee share schemes	5		5
Ordinary share buyback	(13)		(13)
At 31 December 2007 and 1 January 2008	**933**	**198**	**1,131**
Issued under employee share schemes	**10**		**10**
Rights Issue	**375**		**375**
Capitalisation Issue	**34**		**34**
At 31 December 2008	**1,352**	**198**	**1,550**

Authorised share capital

On 29 April 2008 HBOS announced that it would make a rights issue of two new ordinary shares for every five ordinary shares held at a price of 275p per share. On 26 June 2008 a General Meeting increased the authorised share capital of HBOS plc by 2,900m ordinary shares to 7,640m ordinary shares and approved the rights issue. The rights issue was completed in July and raised £3,987m net of expenses of £137m. On 12 December 2008 an Extraordinary General Meeting increased the authorised share capital of HBOS plc by a further 7,500m to 15,140m.

At 31 December 2008 the authorised share capital comprised:

Ordinary shares

15,140m ordinary shares of 25 pence each (2007 4,740m)

Preference shares

198,065,600 6.475% non-cumulative preference shares of £1 each (2007 198,065,600)
350,002 6.3673% fixed to floating non-cumulative preference shares of £1 each (2007 350,000),
750,000 6.0884% non-cumulative preference shares of £1 each (2007 750,000),

The terms of the following preference shares when issued are such that these shares are classified as other borrowed funds rather than as issued share capital .

2,597 million preference shares of £1 each (2007 2,597 million),
200 million 6 1/8% non-cumulative redeemable preference shares of £1 each (2007 200 million),
375 million 9 1/4% non-cumulative irredeemable preference shares of £1 each (2007 375 million),
125 million 9 3/4% non cumulative irredeemable preference shares of £1 each (2007 125 million),
250,000 8.117% non-cumulative perpetual preference shares class 'A' of £10 each (2007 250,000),
150,000 7.754% non-cumulative perpetual preference shares class 'B' of £10 each (2007 150,000),
3,000 million preference shares of 1 each (2007 3,000 million),
4,998 million preference shares of US$1 each (2007 4,998 million),
750,000 6.413% non-cumulative callable fixed to floating rate preference shares series 'A' of US$1 each (2007 750,000),
750,000 5.92% non-cumulative callable fixed to floating rate preference shares series 'B' of US$1 each (2007 750,000),
750,000 6.657% non-cumulative callable preference shares of US$1 each (2007 750,000),
1,000 million preference shares of Aus$1 each (2007 1,000 million),
1,000 million preference shares of Can$1 each (2007 1,000 million),
400 million preference shares of JPY 250 each (2007 nil),
3,000,000 12% fixed to floating callable non-cumulative preference shares of £1 each (2007 nil).

Note 38 details the preference shares that have been issued and classified as other borrowed funds.

Issued share capital

At 31 December 2008 the Company's issued ordinary share capital, excluding shares held in Treasury, amounted to 5,406,574,275 shares (2007 3,730,415,166). The Company's issued preference share capital amounted to 199,165,602 (2007 199,165,600).

HBOS plc completed the rights issue in July 2008 issuing 1,500m ordinary shares of 25p each and raising £3,987m net of expenses of £137m.

During the year HBOS plc used 2,589,000 shares previously purchased under the 2007 share buyback programme to satisfy employee share scheme demands. During the year HBOS plc has bought no further ordinary shares (2007 50m) at a total consideration of nil (2007 £500m). At 31 December 2008 no shares (2007 2,589,000) bought back remained in Treasury.

The Group operates a number of share option plans and savings related option plans for colleagues. Details of these, including the impact of the rights issue, is given in Note 40.

On 15 January 2009 HBOS plc issued 7,482m ordinary shares under a placing with HM Treasury (Note 57).

Notes to the Financial Statements continued

40 Share-based Payments

As a result of the acquisition of the Group by Lloyds TSB on 16 January 2009, some of the share schemes vested in the period between 12 January 2009, and 16 January 2009. For further details, see Note 57. This note therefore reflects the position of the share schemes as at 31 December 2008. Details of the accelerated vesting, together with the financial effects will be disclosed in the financial statements for 2009.

During the year ended 31 December 2008, the Group operated the following share-based payment arrangements, which were predominantly equity-settled:

Sharesave plan	Colleagues may enter into contracts through the sharesave schemes to save up to £250 per month for a fixed term of 3, 5 or 7 years. At the end of the savings period a tax-free bonus is added to the savings and colleagues have the option to acquire shares in the Group at a price equal to 80% of the share price agreed.
Share option plans	The final award under the HBOS plan was made in 2004. Under this plan options over shares at market value, with a face value equal to 20% of salary, were awarded to all colleagues with the exception of those of level 8 and above. A separate option plan exists for St. James's Place, which awards options in respect of HBOS shares, and which continues to operate.
Free shares	This was introduced in 2005 under the share incentive plan legislation as a replacement for the share option plan (not including the St. James's Place plan). In broad terms, it covers all colleagues and free shares up to a limit of £3,000 annually are awarded to each colleague.
Sharekicker plan	This provides colleagues with the opportunity to purchase shares with a proportion of their annual net bonus. For every two shares purchased a matching share is awarded after three years.
Performance sharekicker plan	With effect from September 2008, the EPS sharekicker plan was renamed the Performance Sharekicker Plan. The plan is open to colleagues of level 7 and above (in relation to annual net bonuses) and colleagues of level 8 and above (in relation to net bonuses payable under the two-year incentive scheme). This provides colleagues with the opportunity to purchase shares with a proportion of their annual net bonus. For every two shares purchased a matching share is awarded after three years. For the 2006 and 2007 awards, matching shares awarded under this plan depends on EPS performance over the three year vesting period. For the 2008 award, matching shares awarded under this plan depends on EPS performance in excess of the RPI and on operating cost performance over the three year vesting period.
Long term incentive plan	For most senior colleagues, share grants of varying percentages of salaries are made and colleagues may receive up to 200% of the grant depending on the Group's annualised TSR compared to the annualised weighted average TSR of a basket of comparator companies, over a three year period. See below for further detail.
Executive stock option plan	The final award under this plan was in 2000. Under this plan, options were granted at market value to certain colleagues. The options vested upon satisfaction of a performance measure over a three year period. Options are exercisable from the date the measure is satisfied until the tenth anniversary of the date of grant.
St. James's Place plans	Various St. James's Place plc option and share plans are offered to some of its colleagues.
Insight Investment plan	In 2007 Insight Investment Management Ltd converted an existing incentive scheme into a share-based payment arrangement, offering options and/or shares to some of its colleagues.
Invista Real Estate plans	Various share-based plans are offered to certain colleagues in Invista Real Estate Investment Management Holdings plc.

40 Share-based Payments continued

The table below summarises the share-based payment awards granted in 2008 and 2007:

	Sharesave interim	Sharesave plan	Share option plan[b]	Free shares	Sharekicker plan	Performance Sharekicker plan	Long term incentive plan	Long term Incentive Plan Insight[d]
Awards in 2008								
Date of grant	**2 October**	**28 March**	**27 February**	**5 September**	**20 March**	**20 March**	**6 March**	**14 March**
Number granted (pre rights issue)	**78,625,974**	**27,762,345**	**1,220,709**	**21,048,159**	**8,572,591[c]**	**1,366,451[c]**	**3,360,653**	**18,152,934**
Number granted (post rights issue)[e]	**78,625,974**	**27,960,647**	**1,229,428**	**21,048,159**	**8,707,637**	**1,387,977**	**3,413,594**	**18,438,902**
Awards in 2007								
Date of grant		30 March	1 March	7 August	23 March	23 March	15 March	18 December
Number granted		4,614,933	620,957	8,372,685	4,535,816[c]	722,340[c]	2,163,888	7,082,532
Contractual life	3.5, 5.5 and 7.5 years	3.5, 5.5 and 7.5 years	7 years	3 years	3 years	3 years	3 years	5 years
Vesting conditions	3.25, 5.25 and 7.25 years vesting period[a]	3.17, 5.17 and 7.17 years vesting period[a]	3 years service	3 years service	3 years service	3 years service and achievement of target	3 years service and achievement of TSR target	3 years service

(a) Although the savings periods are three, five and seven years the vesting periods are slightly longer since savings commence after the grant date.
(b) The awards relate to the St. James's Place plan.
(c) These are the number of deferred shares purchased.
(d) Award of options include nil-priced options and options with an exercise price equal to the price of the Company's B ordinary shares based on the most recently approved annual valuation of the Insight business at the date of the grant. If all options and shares outstanding under the Insight Investment Plan at 31 December 2008 vested on that date, 46.6 million HBOS shares would be required to meet this.
(e) The rights issue in July 2008 assumed a cashless takeup of the rights at a nil-paid rights price of 11.274p.

Movements in options

Movements in options granted under the various equity participation plans mentioned above are as follows:

Sharesave plan	2008 Number of options	2008 Weighted average exercise price (£)	2007 Number of options	2007 Weighted average exercise price (£)
Outstanding at 1 January	**40,293,627**	**6.65**	48,560,991	6.29
Granted during the year	**106,388,319**	**2.95**	4,614,933	8.44
Rights issue	**264,059**			
Exercised during the year	**(5,903,580)**	**5.52**	(9,626,924)	5.52
Forfeited during the year	**(2,763,722)**	**5.38**	(2,949,595)	7.11
Expired during the year	**(2,536,600)**	**5.88**	(305,778)	6.08
Cancelled during the year	**(60,319,267)**	**5.12**		
Outstanding at 31 December	**75,422,836**	**2.80**	40,293,627	6.65
Exercisable at 31 December	**25,638**	**5.54**	585,472	4.52

Share option plans	2008 Number of options	2008 Weighted average exercise price (£)	2007 Number of options	2007 Weighted average exercise price (£)
Outstanding at 1 January	**20,782,033**	**7.26**	35,860,579	7.13
Granted during the year	**1,220,709**	**6.57**	620,957	10.71
Rights issue	**128,630**			
Exercised during the year	**(55,211)**	**6.68**	(15,123,252)	7.10
Forfeited during the year	**(2,688,778)**	**7.28**	(576,251)	7.20
Outstanding at 31 December	**19,387,383**	**7.16**	20,782,033	7.26
Exercisable at 31 December	**17,079,383**	**7.01**	19,211,979	7.05

Notes to the Financial Statements continued

40 Share-based Payments continued

Executive stock option plan	2008 Number of options	2008 Weighted average exercise price (£)	2007 Number of options	2007 Weighted average exercise price (£)
Outstanding at 1 January	**813,927**	**6.28**	1,251,907	6.11
Rights issue	**5,267**			
Exercised during the year	**(2,000)**	**5.91**	(395,980)	5.79
Forfeited during the year	**(202,731)**	**5.94**	(42,000)	5.87
Outstanding and exercisable at 31 December	**614,463**	**6.34**	813,927	6.28

For the sharesave plan, the weighted average share price at the date of exercise for share options exercised during the year was £6.77. The options outstanding at 31 December 2008 had exercise prices in the range of £2.20 to £8.38 and a weighted average remaining contractual life of 4.6 years.

For the share option plans, the weighted average share price at the date of exercise for share options exercised during the year was £6.66. The options outstanding at 31 December 2008 had exercise prices in the range of £6.49 to £10.64 and a weighted average remaining contractual life of 1.5 years.

For the executive stock option plan, the weighted average share price at the date of exercise for share options exercised in the year was £6.42. The options outstanding at 31 December 2008 had exercise prices in the range of £5.35 to £7.07 and a weighted average remaining contractual life of 1.5 years.

Financial assumptions underlying the calculation of fair value

The fair value expense has been based on the fair value of the instruments granted, as calculated using appropriate pricing models. The tables below shows the assumptions and models used to calculate the grant date fair value of awards in 2008 and 2007:

	Sharesave interim	Sharesave plan	Share option plan[b]	Free shares	Sharekicker plan
Awards in 2008					
Fair value (pence)	**84**	**76**	**152**	**282**	**163[d]**
Share price (pence)	**170**	**540**	**657**	**282**	**446**
Exercise price (pence)	**220**	**508**	**657**		
Expected volatility (% p.a.)[a]	**40**	**40**	**40**	**N/A**	**N/A**
Expected dividends (% p.a.)	**5**	**9.1**	**6.8**	**N/A**	**11.0[e]**
Risk-free interest rate (% p.a.)	**4.1**	**4.2**	**4.5**	**N/A**	**N/A**
Awards in 2007					
Fair value (pence)		260	182	945	474[d]
Share price (pence)		1,047	1,071	945	1,062
Exercise price (pence)		844	1,071		
Expected volatility (% p.a.)[a]		20	20	N/A	N/A
Expected dividends (% p.a.)		4.0	3.5	N/A	3.9[e]
Risk-free interest rate (% p.a.)		5.3	5.3	N/A	N/A
Pricing model	Black-Scholes	Black-Scholes	Binomial Lattice	[c]	Black-Scholes

(a) Expected volatility is based on an analysis of both the Group's historical volatility over the twelve months preceding the date of each award and the volatility implied by the price of traded options as at the date of each award.
(b) The awards relate to the St. James's Place plan.
(c) As no performance conditions attach to these awards and dividends are reinvested, the fair value is the same as the face value of the awards.
(d) The fair value of Sharekicker awards reflects that a share is automatically awarded for every two held after three years.
(e) Dividends payable on the matching shares during the vesting period are not awarded to the recipient.
(f) Dividends payable on the shares during the vesting period are reinvested and so no dividend yield assumption is required.

40 Share-based Payments continued

	Performance sharekicker plan	Long term incentive plan	Long term Incentive Plan Insight (Nil - priced options)	Long term Incentive Plan Insight (Market value options)
Awards in 2008				
Fair value (pence)	**326**	**397**	**234**	**47**
Share price (pence)	**446**	**574**	**249**	**249**
Exercise price (pence)			**Nil**	**249**
Expected volatility (% p.a.)[(a)]	**N/A**	**N/A**	**25**	**25**
Expected dividends (% p.a.)	**11.0[(e)]**	**N/A[(f)]**	**2**	**2**
Risk-free interest rate (% p.a.)	**N/A**	**N/A**	**4.3**	**4.3**
Awards in 2007				
Fair value (pence)	947	756	233	72
Share price (pence)	1,062	1,017	214	214
Exercise price (pence)			Nil	214
Expected volatility (% p.a.)[(a)]	N/A	N/A	25	25
Expected dividends (% p.a.)	3.9[(e)]	N/A[(f)]	2	2
Risk-free interest rate (% p.a.)	N/A	N/A	4.4	4.4
Pricing model	Black-Scholes	Monte Carlo Simulation	Black-Scholes	Black-Scholes

(a) Expected volatility is based on an analysis of both the Group's historical volatility over the twelve months preceding the date of each award and the volatility implied by the price of traded options as at the date of each award.
(b) The awards relate to the St. James's Place plan.
(c) As no performance conditions attach to these awards and dividends are reinvested, the fair value is the same as the face value of the awards.
(d) The fair value of Sharekicker awards reflects that a share is automatically awarded for every two held after three years.
(e) Dividends payable on the matching shares during the vesting period are not awarded to the recipient.
(f) Dividends payable on the shares during the vesting period are reinvested and so no dividend yield assumption is required.

Early exercise assumptions

The following allowance has been made for the impact of early exercise once options have vested:

Sharesave plan As the length of the exercise window is only six months all option holders are assumed to exercise halfway through the exercise window.

St. James's Place plan It is assumed that half of the option holders will exercise their options each year if the share price is at least 15% above the exercise price.

Allowance for performance conditions

The long term incentive plan includes a market based performance condition based on the Group's total shareholder return relative to an index of comparator companies. The impact of this performance condition has been modelled using Monte Carlo Simulation techniques, which involves running several thousands of simulations of future share price movements for both the Group and the comparator index. For the purpose of these simulations it is assumed that the share price of the Group and the comparator index are 80% correlated (2007 award 60%) and that the comparator index has volatility of 30% p.a. for the 2008 award (2007 award 20% p.a.).

The performance condition is based on the Group's performance relative to the comparator index over a three year period commencing on 1 January each year. The fair value calculations for the awards that were made in 2008 and 2007 therefore include an allowance for the actual performance of the Group's share price relative to the index over the period between 1 January and the award date.

In 2008 the weightings attached to certain comparators were amended with effect from 1 January 2008 and apply, from that date to 2005, 2006 and 2007 awards. To better match the business profile of the Group, the committee decided to amend the comparator companies and Northern Rock has dropped out of the comparator group due to government involvement. Alliance and Leicester and Bradford & Bingley remain within the comparator group at their delisted prices. This amendment also applies to all future awards. The modifications do not alter the fair values of any of the awards, nor make additional changes necessary.

Modifications

Changes to the Performance Sharekicker plan as described above had no material effect on the fair value costs of the plans.

The Rights Issue carried out by HBOS plc in July 2008 created a modification to all share plans. This resulted in an adjustment to the awards made to colleagues but had no material effect on the fair value of the awards.

A new sharesave award was made in October 2008 which commenced on 1 January 2009. On the making of the award, a significant number of monthly savings contracts held by employees in respect of previous sharesave awards were cancelled and new savings contracts commenced under the new sharesave award. The new sharesave award has been identified as a replacement for previous sharesave awards in respect of the cancelled monthly savings contracts. A modification approach has been taken, which has had no material effect on the fair value cost of the plans. Charges have been made for employees commencing new contracts or increasing levels of savings.

Notes to the Financial Statements continued

40 Share-based Payments continued

The period allowable for colleagues to exercise their share options for the 2003 and 2004 share option plans was extended from 3 years to 7 years in October 2008. This resulted in an increase in fair value, chargeable directly to the income statement, of £0.6m.

Charge to the income statement

	2008 £m	2007 £m
Expense arising from share-based payment transactions (Note 8)		
Equity settled	**155**	138
Cash settled	**1**	1
	156	139

Included within the charge for the year is £16m (2007 £13m) in respect of share-based arrangements within St. James's Place, £15m in respect of the Insight Investment plan (2007 £4m) and £3m in respect of Invista Real Estate plans (2007 £3m). In relation to the Group's share schemes, National Insurance and income tax costs are accrued by the Group. The credit of £9m (2007 £14m - debit) are not included in the above table.

The liability for cash settled share-based payment plans at 31 December 2008 is £2m (2007 £5m) and is included in accruals and deferred income.

The Group uses trusts to purchase and hold its own shares as part of the share-based payment arrangements. Details of these trusts and the shares held are given below.

No.1 and No.2 Employee Share Ownership Trusts
The No.1 Employee Share Ownership Trust (ESOT 1) administers shares conditionally granted to Executive Directors and other executives under the HBOS Long Term Executive Bonus Plan. The Trust also administers shares which have been conditionally granted to Executive Directors, other executives and employees under the HBOS plc Annual Bonus Plan and overseas operations of the HBOS plc Share Incentive Plan (Free Shares). The No.2 Employee Share Ownership Trust (ESOT 2) administers shares to be awarded to Executive Directors, other executives and employees under the Group's Sharesave and share option plans, where options are not satisfied by the new issue of shares or from shares held by the HBOS QUEST. Interest free loans have been provided by the Company to the Trusts to allow shares to be purchased in the market to satisfy these share grants.

At 31 December 2008 1.3 million HBOS plc ordinary shares (2007 0.5 million) with a market value of £1m (2007 £4m) were held in ESOT 1 and 4.3 million HBOS plc ordinary shares (2007 7.5 million) with a market value of £3m (2007 £55m) were held in ESOT 2. The shares in the Trusts are included in the balance sheet of the Group at a net book value of £nil (2007 £nil). Under the terms of the Trusts, dividends on these shares require to be waived.

HBOS plc Qualifying Employee Share Ownership Trust (the HBOS QUEST)
The HBOS QUEST operates in conjunction with the HBOS Sharesave scheme and the former savings-related share schemes operated by Bank of Scotland and Halifax Group plc.

At 31 December 2008, the HBOS QUEST held no HBOS plc ordinary shares (2007 0.1 million - market value £1m). In the prior year these shares are included in the balance sheet at nil value. Under the terms of the Trust Deed, dividends on these shares require to be waived.

Free shares plan
A number of trusts operate in conjunction with the Free Shares Plan which commenced in 2005.

(a) The Share Incentive Plan trust operates in conjunction with free share awards made to employees throughout the Group, except to the extent noted below. At 31 December 2008 this trust held 58.2 million HBOS plc ordinary shares (2007 19.6 million), with a market value of £40m (2007 £144m). These shares are included in the balance sheet at nil value.

(b) The Irish Profit Share Trust holds free shares awarded to colleagues employed in Ireland. At 31 December 2008 this trust held 1.2 million HBOS plc ordinary shares (2007 0.5 million), with a market value of £0.8m (2007 £3m). These shares are included in the balance sheet at nil value.

(c) The HBOS Australia Employee Share Trust holds free shares awarded to colleagues employed in Australia. At 31 December 2008 this trust held 3.8 million shares (2007 1.7 million) with a market value of £3m (2007 £13m). These ordinary shares are included in the balance sheet at nil value.

(d) ESOT 1 administers free shares awarded to colleagues based overseas.

41 Shareholders' Equity

Group	Share capital £m	Share premium £m	Other reserves[3] Cash flow hedge reserve £m	Other reserves[3] Available for sale reserve[1] £m	Other reserves[3] Other reserves[2] £m	Retained earnings £m	Minority interests £m	Total £m
At 1 January 2008	1,131	2,997	(85)	(313)	552	17,567	385	22,234
Foreign exchange translation				(23)	210			187
Net actuarial gains from defined benefit plans						770		770
Tax thereon						(202)		(202)
Available for sale investments:								
Net change in fair value				(8,173)				(8,173)
Tax thereon				2,276				2,276
Realised gain on sale transferred to the income statement (Note 3)				(24)				(24)
Tax thereon				7				7
Impairment recognised in income statement (Note 12b)				1,270				1,270
Tax thereon				(355)				(355)
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			(3,895)					(3,895)
Tax thereon			1,093					1,093
Losses transferred to income statement (Note 3)			2,561					2,561
Tax thereon			(717)					(717)
(Loss)/profit for the year						(7,499)	83	(7,416)
Total recognised income and expense			(958)	(5,022)	210	(6,931)	83	(12,618)
Dividends paid (Note 42)						(1,286)	(55)	(1,341)
Issue of new shares (Note 39)	419	3,712					750	4,881
MI acquisitions							242	242
MI disposals							(110)	(110)
Movement in own shares						88		88
Movements in share-based compensation reserve						118		118
Other							5	5
At 31 December 2008	1,550	6,709	(1,043)	(5,335)	762	9,556	1,300	13,499

(1) The available for sale reserve is comprised of £(5,285)m (2007 £(450)m) in respect of treasury assets and £(50)m (2007 £137m) in respect of corporate and other investments.
(2) Other reserves principally include the merger reserve of £494m arising from the combination of Halifax and Bank of Scotland in 2001.
(3) The cumulative balance for exchange translation at 31 December 2008 is £159m (2007 £(28)m).

On 19 March 2008 HBOS Capital Funding No. 4 L.P. issued £750m Fixed-to-Floating Rate Perpetual Preferred Securities at par, as included in Minority Interest above. Discretionary distributions at a rate of 9.54% per annum payable semi-annually in arrears until 19 March 2018 at which time the interest rate will become three month LIBOR plus 6.75% per annum payable quarterly in arrears. The Group has the option to redeem these securities on 19 March 2018 and quarterly thereafter.

Notes to the Financial Statements continued

41 Shareholders' Equity continued

Group	Share capital £m	Share premium £m	Other reserves: Cash flow hedge reserve £m	Other reserves: Available for sale reserve(1) £m	Other reserves(2) £m	Retained earnings £m	Minority interests £m	Total £m
At 1 January 2007	1,139	2,856	423	203	535	15,529	486	21,171
Foreign exchange translation				1	1			2
Net actuarial gains from defined benefit plans						416		416
Tax thereon						(104)		(104)
Available for sale investments:								
Net change in fair value				(429)				(429)
Tax thereon				96				96
Realised gains on sale transferred to the income statement (Note 3)				(281)				(281)
Tax thereon				80				80
Impairment recognised in income statement (Note 12b)				23				23
Tax thereon				(6)				(6)
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			(313)					(313)
Tax thereon			97					97
Gains transferred to income statement (Note 3)			(417)					(417)
Tax thereon			125					125
Profit for the year						4,045	68	4,113
Total recognised income and expense			(508)	(516)	1	4,357	68	3,402
Dividends paid (Note 42)						(1,747)	(39)	(1,786)
Issue of new shares (Note 39)	5	141						146
Ordinary share buyback	(13)				13	(500)		(500)
Sale of disposal group							(130)	(130)
Other movements (net of tax £11m)					3	(15)		(12)
Movement in own shares						(177)		(177)
Movements in share-based compensation reserve						120		120
At 31 December 2007 and 1 January 2008	**1,131**	**2,997**	**(85)**	**(313)**	**552**	**17,567**	**385**	**22,234**

(1) The available for sale reserve is comprised of £(5,285)m (2007 £(450)m) in respect of treasury assets and £(50)m (2007 £137m) in respect of corporate and other investments.
(2) Other reserves principally include the merger reserve of £494m arising from the combination of Halifax and Bank of Scotland in 2001.

41 Shareholders' Equity continued

Company	Share capital £m	Share premium £m	Other reserves £m	Cash flow hedge reserve £m	Retained earnings £m	Total £m
At 1 January 2007	1,139	2,856	53		4,537	8,585
Net actuarial gains from defined benefit plans (net of tax)					261	261
Profit after tax					1,731	1,731
Total recognised income and expense					1,992	1,992
Dividends paid					(1,747)	(1,747)
Issue of new shares	5	141				146
Ordinary share buyback	(13)		13		(500)	(500)
Acquisition of own shares					(62)	(62)
Movements in respect of share-based compensation			3		134	137
At 31 December 2007 and 1 January 2008	**1,131**	**2,997**	**69**		**4,354**	**8,551**
Net actuarial gain from defined benefit plans					**808**	**808**
Tax thereon					**(215)**	**(215)**
Loss after tax					**(1,902)**	**(1,902)**
Total recognised income and expense					**(1,309)**	**(1,309)**
Dividends paid					**(1,286)**	**(1,286)**
Issue of new shares	**419**	**3,712**				**4,131**
Movement in cash flow hedge				**(2)**		**(2)**
Movement in own shares					**(53)**	**(53)**
Movements in respect of share-based compensation					**134**	**134**
At 31 December 2008	**1,550**	**6,709**	**69**	**(2)**	**1,840**	**10,166**

Movements in own shares are included within retained earnings. These shares are held for the purposes of satisfying obligations arising from certain share-based compensation schemes as detailed in Note 40.

42 Dividends

A Capitalisation Issue took place on 6 October 2008 in lieu of an interim cash dividend to shareholders. The Capitalisation amount was £320m. Qualifying shareholders received new fully paid ordinary shares based on the capitalisation amount per ordinary share as at 3 October 2008 (6.07p), multiplied by the number of ordinary shares held at close of business on 3 October, divided by the Capitalisation Issue price of 232p, being the value per ordinary share agreed under the terms of the acquisition by Lloyds TSB Group plc (Note 57).

Ordinary dividends are charged direct to reserves only when the Company has a contractual obligation to pay.

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

	2008 £m	2007 £m
Ordinary share dividends		
2006 final dividend of 27.9p per share		1,048
2007 interim dividend of 16.6p per share		619
2007 final dividend of 32.3p per share	**1,205**	
	1,205	1,667
Preference share dividends		
Equity dividends paid	**81**	80
	1,286	1,747

Notes to the Financial Statements continued

43 Contingent Liabilities and Commitments

Group	2008 £m	2007 £m
Contingent liabilities		
Acceptances and endorsements		43
Guarantees and irrevocable letters of credit	**4,898**	6,891
	4,898	6,934

	2008 £m	2007 £m
Commitments		
Short term trade related transactions	**137**	115
Undrawn formal standby facilities, credit lines and other commitments to lend with maturity:		
Up to and including one year	**50,211**	68,253
Over one year	**33,109**	31,416
	83,457	99,784

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £56,319m (2007 £71,970m) was irrevocable.

Company	2008 £m	2007 £m
Contingent liabilities		
Guarantees provided to subsidiaries	**3,949**	2,608
	3,949	2,608

The contractual amounts above indicate the volume of business outstanding at the year end and do not reflect the underlying credit and other risks, which are significantly lower as some facilities will not be drawn down and some facilities that are drawn will be supported by collateral. It should be noted that the Group's liquidity lines to the Group's Grampian and Landale conduits do not appear in the table above as these are internal to the Group and are eliminated on consolidation.

Where the Group is a lessee the future minimum lease payments under non-cancellable operating leases are due to be paid in the following periods:

Group	2008 £m	2007 £m
Not later than one year	**177**	185
Later than one year and not later than five years	**645**	674
Later than five years	**1,230**	1,320
	2,052	2,179

Where the Group is a lessee the future obligations payable under finance leases are as follows:

Group	2008 £m	2007 £m
Not later than one year		1
Later than one year and not later than five years		
		1

Commitments in respect of capital expenditure on property and equipment that is authorised but not provided for in the accounts, for contracts which have been entered into amount to £18m (2007 £21m). Commitments for contracts which have been placed in relation to operating lease assets amount to £10m (2007 £11m).

Legal and regulatory matters:

a) Unarranged overdraft charges

On 27 July 2007 it was announced that members of the Group, along with seven other major UK current account providers, had reached agreement with the OFT to commence legal proceedings in the High Court of England and Wales for a declaration (or declarations) to resolve legal uncertainties concerning the fairness and lawfulness of unarranged overdraft charges (the Test Case). It was also announced that HBOS and those other providers will seek a stay of all current and potential future court proceedings which are brought against them in the UK concerning these charges and have obtained the consent of the Financial Ombudsman Service (FOS) not to proceed with consideration of the merits of any complaints concerning these charges that are referred to them prior to the resolution of the Test Case. By virtue of a waiver granted by the FSA of its complaints handling rules, HBOS (and other banks, including the banks party to the Test Case) will not be dealing with or resolving customer complaints about unarranged overdraft charges while the waiver is in force. On 22 January 2009, the FSA confirmed that it is extending its waiver regarding unarranged overdraft charges complaints until 26 July 2009.

43 Contingent Liabilities and Commitments continued

The first step in the Test Case was a trial of certain preliminary issues concerning the legal status and enforceability of contractual terms relating to unarranged overdraft charges. This preliminary trial concluded on 8 February 2008 and the judgment was handed down on 24 April 2008. The judgment held that the contractual terms relating to unarranged overdraft charges currently used by the Group (i) are not capable of being penalties, but (ii) are not exempt from assessment for fairness under the Unfair Terms in Consumer Contract Regulations 1999 (UTCCRs).

At a court hearing on 22 and 23 May 2008, the Judge granted HBOS and the other Test Case banks permission to appeal his decision that current unarranged overdraft charges are assessable for fairness under the UTCCRs. This appeal concluded on 5 November 2008. On 26 February 2009 the Court of Appeal dismissed the banks' appeal and held that the charges are assessable for fairness. The banks will now be applying to the House of Lords for permission to appeal this judgement.

A further hearing took place in early July 2008, at which the Court was asked to consider whether terms and conditions previously used by the Test Case banks are capable of being penalties and whether the Judge's decision in April 2008 (that the banks' current contractual terms are capable of being assessed for fairness under the UTCCRs) can be applied to historic terms.

The Court handed down its judgment on 8 October 2008 on this second stage of the test case process. The Court ruled that charges applied under Halifax and Bank of Scotland's previously used terms and conditions cannot be penalties. However, the Court also ruled that the historic terms and conditions are not exempt from assessment for fairness under the UTCCRs. The banks intend to appeal this latter decision.

Further Court hearings will be required before the test case process is concluded.

A definitive outcome of the Test Case is unlikely to be known for at least twelve months.

Given the early stage of these proceedings and the uncertainty as to their outcome, it is not practicable at this time to estimate any potential financial effect.

b) Payments Protection Insurance (PPI)
The final report from the Competition Commission (CC) into Payment Protection Insurance (PPI) was received on 29 January 2009. The remedies published were broadly similar to those outlined in the CC's Provisional Decision with some changes to the sales process.

Whilst the Group believes many of the remedies could improve customer searching and enable switching, the inability to sell appropriate insurance products at a point when customers take on increased financial commitment, will likely result in lower levels of protection for UK consumers.

The Group is actively reviewing its customer propositions, in the light of the CC's Final Report, to ensure that the Group continue to offer a valuable protection product to the Group's customers.

The Group took the decision to launch a regular premium protection product. This was launched in early February 2009.

The FOS has been receiving a large number of complaints in relation to PPI sold by a number of providers and has written to the FSA suggesting an industry wide review of PPI sales standards. In response, the industry is working on a Statement of Principles to define a consistent way of handling sales complaints. The FSA is considering FOS' suggestions and a statement from the FSA in relation to its most recent thematic work in relation to PPI is expected in the first quarter of 2009.

c) Other legal and regulatory matters
HBOS is engaged in other litigation in the UK and overseas arising out of its normal business activities. HBOS considers that none of these actions are material and has not disclosed any contingent liability in respect of these actions because it is not practical to do so.

Notes to the Financial Statements continued

44 Measurement Basis of Financial Assets and Liabilities

The accounting policies describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading. Investment contracts with DPF valued under IFRS 4 are excluded from this table.

		At fair value through the income statement					
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition[1] £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost	Total Group
As at 31 December 2008							
Financial assets							
Cash and balances with central banks					2,502		2,502
Items in course of collection					445		445
Financial assets held for trading		22,571					22,571
Derivative assets	22,082	29,728					51,810
Loans and advances to banks			4,854		12,791		17,645
Loans and advances to customers					435,223		435,223
Investment securities			66,271	28,048	39,053		133,372
Other financial assets			491		2,478		2,969
Total financial assets	22,082	52,299	71,616	28,048	492,492		666,537
Financial liabilities							
Deposits by banks						97,150	97,150
Customer accounts						222,251	222,251
Financial liabilities held for trading		18,851					18,851
Derivative liabilities	9,297	29,608					38,905
Debt securities in issue						188,448	188,448
Investment contract liabilities			33,321				33,321
Other borrowed funds						30,119	30,119
Other financial liabilities			210			2,419	2,629
Total financial liabilities	9,297	48,459	33,531			540,387	631,674

(1) Financial instruments designated at fair value through the income statement upon initial recognition include £63,631m financial assets and £33,362m financial liabilities that are policyholder funds.

44 Measurement Basis of Financial Assets and Liabilities continued

Group	Derivatives designated as hedging instruments £m	At fair value through the income statement: Held for trading £m	At fair value through the income statement: Designated upon initial recognition[1] £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost £m	Total £m
As at 31 December 2007							
Financial assets							
Cash and balances with central banks					2,945		2,945
Items in course of collection					945		945
Financial assets held for trading		54,681					54,681
Derivative assets	4,760	9,381					14,141
Loans and advances to banks			3,118		4,565		7,683
Loans and advances to customers					430,007		430,007
Investment securities			76,971	49,986	702		127,659
Other financial assets			887		893		1,780
Total financial assets	4,760	64,062	80,976	49,986	440,057		639,841
Financial liabilities							
Deposits by banks						41,513	41,513
Customer accounts						243,221	243,221
Financial liabilities held for trading		22,705					22,705
Derivative liabilities	4,243	8,068					12,311
Investment contract liabilities			45,636				45,636
Debt securities in issue			1,842			204,678	206,520
Other borrowed funds			50			24,203	24,253
Other financial liabilities			502			665	1,167
Total financial liabilities	4,243	30,773	48,030			514,280	597,326

(1) Financial instruments designated at fair value through the income statement upon initial recognition include £70,546m financial assets and £44,025m financial liabilities that are policyholder funds.

Company	Derivatives designated as hedging instruments £m	At fair value through the income statement: Held for trading £m	At fair value through the income statement: Designated upon initial recognition £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost £m	Total £m
As at 31 December 2008							
Financial assets							
Amounts owed by Group entities					**50,157**		**50,157**
Derivative assets	**2,638**						**2,638**
Other financial assets					**58**		**58**
Total financial assets	**2,638**				**50,215**		**52,853**
Financial liabilities							
Amounts owed to Group entities						**36,450**	**36,450**
Derivative liabilities	**55**						**55**
Other borrowed funds						**22,235**	**22,235**
Other financial liabilities						**296**	**296**
Total financial liabilities	**55**					**58,981**	**59,036**

Notes to the Financial Statements continued

44 Measurement Basis of Financial Assets and Liabilities continued

Company	Derivatives designated as hedging instruments £m	At fair value through the income statement: Held for trading £m	At fair value through the income statement: Designated upon initial recognition £m	Available for sale £m	Loans and receivables £m	Financial liabilities at amortised cost £m	Total £m
As at 31 December 2007							
Financial assets							
Amounts owed by Group entities					38,885		38,885
Derivative assets	162						162
Investment securities				1			1
Other financial assets					15		15
Total financial assets	162			1	38,900		39,063
Financial liabilities							
Amounts owed to Group entities						29,267	29,267
Derivative liabilities	56						56
Other borrowed funds						15,503	15,503
Other financial liabilities						151	151
Total financial liabilities	56					44,921	44,977

45 Financial Asset Reclassifications

Following the publication by the International Accounting Standards Board (IASB) and subsequent endorsement by the European Union in October 2008 of the amendments to International Accounting Standard 39 'Financial Instruments: Recognition and Measurement' (IAS 39) and IFRS 7 'Financial Instruments: Disclosures', the Group has reviewed the classification of its trading portfolio.

The Group has noted that the ongoing market dislocation and the deterioration of the world's financial markets that has occurred during the third quarter of 2008 is a sufficiently rare circumstance to warrant a review of the classification of financial assets held for trading.

With effect from 1 July 2008, the Group transferred from the held for trading classification certain asset backed securities (ABS) and floating rate notes (FRNs) with fair values at that time of £9,112m and £3,098m respectively, to the available for sale (AFS) classification within investment securities. The carrying values as at 31 December 2008 are £10,132m and £3,410m respectively and the fair values as at 31 December 2008 are £10,047m and £3,410m respectively.

Subsequent to the transfers performed on 1 July 2008, the Group determined in light of increasing illiquidity in the markets for ABS to change the classification of certain ABS assets from AFS to loans and receivables. A portfolio of ABS was reclassified to loans and receivables with effect from 1 November 2008 with fair values at that time of £35,446m. The carrying values and fair values as at 31 December 2008 are £37,173m and £36,191m respectively.

The financial impact of the reclassifications described above is set out below.

a) Debt securities reclassified from held for trading to AFS, with effect from 1 July 2008
Negative fair value adjustments of £730m were taken through the income statement relating to these assets for the period from 1 January 2008 to 30 June 2008 (full year 2007 £212m). If these assets had not been reclassified during the year additional negative fair value adjustments of £981m, net of accretion of discount of £96m, would have been recognised in the income statement and the AFS reserve movement would have been reduced by £776m (post tax) for the period from 1 July 2008 to 31 December 2008.

At 1 July 2008 the effective interest rates on the reclassified debt securities ranged from 3% to 12% with expected recoverable cash flows of £13,359m.

b) ABS reclassified from available for sale to loans and receivables, with effect from 1 November 2008
Negative fair value adjustments of £3,301m (post tax) were taken through AFS reserves for the period from 1 January 2008 to 31 October 2008 (full year 2007 £319m post tax). If these assets had not been reclassified during the year additional negative fair value adjustments of £708m (post tax) would have been recognised in the AFS reserves for the period from 1 November 2008 to 31 December 2008.

Following this change in classification, these securities are no longer subject to measurement at fair value, although they will continue to be subject to regular impairment testing.

At 1 November 2008 the effective interest rates on the ABS reclassified, ranged from 3% to 12% with expected recoverable principal flows of £40,968m.

The reclassifications of trading assets and AFS investment securities during the year had the effect of increasing both basic and diluted earnings per share by 15.6p.

46 Fair Value of Financial Instruments

The following table summarises the carrying amounts and fair values of financial assets and liabilities not carried on the Group's balance sheet at fair value. This note provides additional information in respect of financial instruments carried as loans and receivables or held at amortised cost (Note 44).

Group	Carrying amount 2008 £m	Carrying amount 2007 £m	Fair value 2008 £m	Fair value 2007 £m
Financial assets				
Loans and advances to banks	**12,791**	4,565	**12,824**	4,948
Loans and advances to customers	**435,223**	430,007	**422,019**	431,639
Investment securities	**39,053**	0702	**38,231**	702
Other financial assets	**2,478**	893	**2,480**	893
Financial liabilities				
Deposits by banks	**97,150**	41,513	**97,184**	41,528
Customer accounts	**222,251**	243,221	**222,992**	244,072
Debt securities in issue	**188,448**	204,678	**182,470**	203,579
Other borrowed funds	**30,119**	24,203	**20,895**	23,981
Other financial liabilities	**2,419**	665	**2,424**	665

Company	Carrying amount 2008 £m	Carrying amount 2007 £m	Fair value 2008 £m	Fair value 2007 £m
Financial assets				
Amounts owed by Group entities	**50,157**	38,885	**44,793**	38,536
Other financial assets	**58**	15	**58**	15
Financial liabilities				
Amounts owed to Group entities	**36,450**	29,267	**36,552**	29,334
Other borrowed funds	**22,235**	15,503	**15,229**	15,253
Other financial liabilities	**296**	151	**296**	151

The valuation methodologies for calculating the fair value of financial instruments carried as loans and receivables and at amortised cost are set out below.

Fair value is the amount for which the Group could exchange an asset, or could settle a liability, with other knowledgeable, willing parties in an arm's length transaction. The objective of the valuation techniques applied is to determine what the values would have been at year end in an arm's length transaction motivated by normal business considerations.

Loans and advances to banks, loans and advances to customers, deposits by banks and customer accounts are not regularly traded and so market prices are not available. In this instance, valuation techniques are applied to determine the fair value of these instruments.

For loans and deposits with variable interest rates, the fair value is represented by the carrying value as these products are at an administered rate that can be immediately repriced. The portfolios are stratified into various sub-groups, and also distinguish between performing loans and non-performing loans. For performing loans, counterparty credit risk is taken into account in determining the fair value with reference to current spreads at which similar products are currently priced, as appropriate. For non-performing loans, fair value is determined taking into account expected cash flows and discounting them over the period when they are expected to be recovered.

For other loans fair value is estimated by discounting anticipated contractual cash flows at current market interest rates. The portfolios are stratified into various sub-groups, and also distinguish between performing loans and non-performing loans. For performing loans, current market interest rates are derived by reference to the rates at which similar products are currently priced and after taking into account significant changes in credit spreads. Credit spreads are determined with reference to new originations for similar products, and take into account the type of product, the maturity profile of the portfolio and collateral held. For non-performing loans, fair value is determined taking into account expected cash flows and discounting it over the period when they are expected to be recovered.

For other customer deposits, fair value is estimated by discounting anticipated contractual cash flows at current market interest rates.

For investment securities held as loans and receivables and debt securities in issue and other borrowed funds carried at amortised cost, the fair values have been derived using quoted prices where available, broker valuations and where these are not available, cash flow models, adjusted for credit spreads where appropriate. Cash flow models take into account expected cash flows and the expected maturity of the instrument.

The fair values have been calculated on a product basis and as such do not necessarily represent the value that could have been obtained for a portfolio if it were sold at 31 December 2008.

Notes to the Financial Statements continued

47 Expected Maturity

The table below sets out the expected maturity of financial assets and liabilities.

Group	Less than 12 months 2008	12 months or more 2008	Total 2008	Less than 12 months 2007	12 months or more 2007	Total 2007
Financial assets						
Cash and balances at central banks	**2,502**		**2,502**	2,945		2,945
Financial assets held for trading	**18,324**	**4,247**	**22,571**	36,921	17,760	54,681
Loans and advances to banks	**14,961**	**2,684**	**17,645**	6,619	1,064	7,683
Loans and advances to customers	**119,073**	**316,150**	**435,223**	137,337	292,670	430,007
Investment securities	**41,514**	**91,858**	**133,372**	29,379	98,280	127,659
Derivative assets	**9,543**	**42,267**	**51,810**	3,608	10,533	14,141
Financial liabilities						
Deposits by banks	**94,863**	**2,287**	**97,150**	40,192	1,321	41,513
Customer accounts	**211,096**	**11,155**	**222,251**	223,349	19,872	243,221
Financial liabilities held for trading	**18,851**		**18,851**	22,503	202	22,705
Derivative liabilities	**8,960**	**29,945**	**38,905**	3,439	8,872	12,311
Investment contract liabilities	**2,782**	**36,700**	**39,482**	10,396	42,432	52,828
Debt securities in issue	**91,107**	**97,341**	**188,448**	116,918	89,602	206,520
Other borrowed funds	**2,948**	**27,171**	**30,119**	2,431	21,822	24,253

Company	Less than 12 months 2008	12 months or more 2008	Total 2008	Less than 12 months 2007	12 months or more 2007	Total 2007
Financial assets						
Derivative assets		**2,638**	**2,638**		162	162
Investment securities				1		1
Financial liabilities						
Derivative liabilities		**55**	**55**		56	56
Other borrowed funds	**572**	**21,663**	**22,235**	475	15,028	15,503

48 Credit Risk

The Group's approach to managing credit risk is set out on pages 16 to 21 of the Risk Management report. The table below sets out the Group's exposure to credit risk relating to financial instruments and insurance assets before taking account of collateral and other security. Policyholder assets are excluded from the Group's exposure in the table as the underlying credit risks are for the account of policyholders.

	2008 Total £m	2008 Policyholder funds £m	2008 Group exposure £m	2007 Total £m	2007 Policyholder funds £m	2007 Group exposure £m
Assets						
Cash and balances at central banks	**2,502**		**2,502**	2,945		2,945
Items in the course of collection	**445**		**445**	945		945
Financial assets held for trading	**22,571**		**22,571**	54,681		54,681
Derivative assets	**51,810**	**1,237**	**50,573**	14,141	416	13,725
Loans and advances to banks	**17,645**	**4,487**	**13,158**	7,683	2,437	5,246
Loans and advances to customers	**435,223**		**435,223**	430,007		430,007
Debt securities	**92,625**	**21,230**	**71,395**	76,814	20,714	56,100
Reinsurance assets	**44**		**44**	41		41
Other financial assets (excluding equity shares)	**2,969**	**299**	**2,670**	1,780	426	1,354
	625,834	**27,253**	**598,581**	589,037	23,993	565,044
Irrevocable loan commitments and other credit related contingencies	**61,217**		**61,217**	78,904		78,904
Total	**687,051**	**27,253**	**659,798**	667,941	23,993	643,948

The table below sets out the Company's exposure to credit risk relating to financial instruments before taking account of collateral and other security.

	2008 £m	2007 £m
Derivative assets	**2,638**	162
Amounts owed by Group entities	**50,157**	38,885
Debt securities		1
	52,795	39,048
Contingent liabilities and commitments	**3,949**	2,608
	56,744	41,656

Loans and advances to customers

Loans and advances to customers are managed on a divisional basis as shown in Note 11. Further analysis of loans and advances to customers is given in Note 18.

	Retail £m	Treasury £m	Corporate £m	International £m	2008 Total £m
Loans and advances to customers*:					
Neither past due nor impaired	**240,618**	**2,545**	**104,519**	**55,802**	**403,484**
Past due but not impaired	**8,609**		**4,570**	**3,222**	**16,401**
Impaired	**9,123**		**13,848**	**3,060**	**26,031**
Total	**258,350**	**2,545**	**122,937**	**62,084**	**445,916**

* Before impairment provisions

Included in loans neither past due nor impaired are the following troubled debt restructured loans which would have been past due or impaired had their terms not been renegotiated:

	Retail £m	Corporate £m	International £m	2008 Total £m
Renegotiated loans	**368**	**98**	**12**	**478**

Notes to the Financial Statements continued

48 Credit Risk continued

	Retail £m	Treasury £m	Corporate £m	International £m	2007 Total £m
Loans and advances to customers*					
Neither past due nor impaired	240,921	299	104,983	65,186	411,389
Past due but not impaired	7,342		2,720	1,567	11,629
Impaired	6,503		3,218	641	10,362
Total	254,766	299	110,921	67,394	433,380

* Before impairment provisions

Included in loans neither past due nor impaired are the following troubled debt restructured loans which would have been past due or impaired had their terms not been renegotiated:

	Retail £m	Corporate £m	International £m	2007 Total £m
Renegotiated loans	227	2		229

Retail - residential mortgage lending

i) Loan to value analysis of residential mortgage lending

	2008 %	2007 %
Less than 60% (averaging 25%, 2007 28%)	**28**	47
60% to 70%	**10**	18
70% to 80%	**13**	18
80% to 90%	**16**	13
90% to 100%	**16**	4
Greater than 100%	**17**	
Total	**100**	100

ii) Average loan to value of residential mortgage lending

	2008 %	2007 %
Stock of residential mortgages	**56**	44
New residential lending	**67**	65
Impaired mortgages	**76**	57

Note: LTV analysis is based on indexed valuation for stock and valuation at inception of new loans. The stock of residential mortgages includes past due loans.

Corporate, International and Treasury

The Group's Corporate, International and Treasury neither past due nor impaired lending exposures are analysed by internal credit rating below:

	Treasury %	**Corporate %**	**International %**	**2008 Total %**	Treasury %	Corporate %	International %	2007 Total %
Better than satisfactory risk	**100**	**29**	**36**	**33**	100	34	41	37
Satisfactory risk		**51**	**49**	**50**		52	47	50
Viable but monitoring		**17**	**12**	**15**		12	12	12
High risk		**3**	**3**	**2**		2		1
	100	**100**	**100**	**100**	100	100	100	100

48 Credit Risk continued

Past due but not impaired

The ageing of the Group's lending exposure that is past due but not impaired (before impairment provisions) is analysed below:

	Retail[a] £m	Corporate £m	International £m	2008 Total £m	Retail[a] £m	Corporate £m	International £m	2007 Total £m
0 to 3 months	**8,609**	**4,153**	**2,511**	**15,273**	7,342	2,690	1,375	11,407
3 to 6 months		**417**	**505**	**922**		7	145	152
More than 6 months			**206**	**206**		23	47	70
Total	**8,609**	**4,570**	**3,222**	**16,401**	7,342	2,720	1,567	11,629

(a) Secured £7,993m (2007 £6,756m) and unsecured £616m (2007 £586m).

Impaired loans

The Group's impaired gross lending exposure (before impairment provisions) is analysed below:

	2008 £m	2007 £m
Retail secured lending	**6,914**	4,234
Retail unsecured lending	**2,209**	2,269
Corporate – no loss	**1,242**	1,648
Corporate – with loss	**12,606**	1,570
International	**3,060**	641
	26,031	10,362

Loans categorised as impaired with no loss represent loans that have been individually assessed as having impairment characteristics but where the Group expect, after taking into consideration collateral and other credit enhancements, full recovery of both interest and capital.

The ageing of the Group's gross lending exposure that is impaired (before impairment provisions) is analysed below:

	Retail £m	Corporate[(1)] £m	International £m	2008 Total £m	Retail £m	Corporate[(1)] £m	International £m	2007 Total £m
0 to 3 months	**89**	**8,585**	**1,299**	**9,973**	165	1,052	211	1,428
3 to 6 months	**3,580**	**1,704**	**578**	**5,862**	2,298	534	170	3,002
6 to 12 months	**2,204**	**1,927**	**629**	**4,760**	1,380	655	104	2,139
Over 12 months	**913**	**1,632**	**333**	**2,878**	533	977	89	1,599
Recoveries	**1,784**			**1,784**	1,795			1,795
Possession	**553**		**221**	**774**	332		67	399
Total	**9,123**	**13,848**	**3,060**	**26,031**	6,503	3,218	641	10,362

The balance of Corporate impaired loans include £1,242m (2007 £1,648m) of impaired loans with no loss and £12,606m (2007 £1,570) of impaired loans with loss. Loans categorised as impaired with no loss represent loans that have been individually assessed as having impairment characteristics but where the Group expect, after taking consideration of collateral and other credit enhancements, full recovery of both interest and capital.

(1) For 2008 the ageing of the Corporate lending exposure is based upon the date the loan became overdue. For 2007, it is based upon the date the account entered impaired status.

Impairment provisions as a % of closing net advances are analysed in the following table:

	2008 £m	2008 As % of closing net advances	2007 £m	2007 As % of closing net advances
Retail	**3,038**	**1.19**	2,219	0.88
Corporate	**6,563**	**5.64**	832	0.76
International	**1,092**	**1.79**	322	0.48
Total impairment provisions	**10,693**	**2.46**	3,373	0.78

Notes to the Financial Statements continued

48 Credit Risk continued

Impaired loans as a % of closing net advances and impairment provisions as a % of impaired loans are analysed by division in the following table:

As at 31 December 2008		Net Advances £bn	Impaired loans* £m	Impaired loans* as % of closing advances %	Impairment provisions £m	Impairment provisions as % of impaired loans* %
Retail:	**Secured**	**238.5**	**6,914**	**2.9**	**1,219**	**18**
	Unsecured	**16.8**	**2,209**	**13.15**	**1,819**	**82**
	Total	**255.3**	**9,123**	**3.57**	**3,038**	**33**
Corporate[2]		**116.4**	**13,848**	**11.90**	**6,563**	**47**
International		**61.0**	**3,060**	**5.02**	**1,092**	**36**
Treasury & Asset Management		**2.5**				
Total		**435.2**	**26,031**	**5.98**	**10,693**	**41**

(2) Within Corporate the percentage of impaired loans as a % of closing advances which relates to impaired loans with a loss as a % of closing advances is 1.07% (2007 1.50%).

As at 31 December 2007		Net Advances £bn	Impaired loans* £m	Impaired loans* as % of closing advances %	Impairment provisions £m	Impairment provisions as % of impaired loans* %
Retail:	Secured	235.6	4,234	1.8	330	8
	Unsecured	17.0	2,269	13.35	1,889	83
	Total	252.6	6,503	2.57	2,219	34
Corporate[2]		110.1	3,218	2.92	832	26
International		67.1	641	0.96	322	50
Treasury & Asset Management		0.2				
Total		430.0	10,362	2.41	3,373	33

* Before impairment provisions

(2) Within Corporate the percentage of impaired loans as a % of closing advances which relates to impaired loans with a loss as a % of closing advances is 1.07% (2007 1.50%).

Collateral and other credit enhancements held
Financial assets that are past due or individually assessed as impaired may be partially or fully collateralised or subject to other forms of credit enhancement.

Assets in these categories subject to collateralisation are mainly corporate and residential mortgage loans.

For corporate loans, security may be in the form of floating charges where the value of the collateral varies with the level of assets such as inventory and receivables held by customer. For these and other reasons collateral given is only accurately valued on origination of the loan or in the course of enforcement actions and as a result it is not practicable to estimate the fair value of the collateral held.

A description and the estimated fair value of collateral held in respect of residential mortgage loans that are past due or individually assessed as impaired was as follows:

	2008 Fair value £m	2007 Fair value £m
Nature of assets		
- Residential property	**13,534**	10,660
	13,534	10,660

Collateral included in the above table reflects the Group's interest in the property in the event of default. That held in the form of charges against residential property in the UK is restricted to the outstanding loan balance. In other territories, where the Group is not obliged to return any sale proceeds to the mortgagee, the full estimated fair value has been included.

48 Credit Risk continued

Repossessed collateral

During 2008 the Group obtained assets as a result of the enforcement of collateral held as security, as follows:

	2008 Carrying amount £m	2007 Carrying amount £m
Nature of assets		
- Residential property	**617**	292
	617	292

The Group does not use assets obtained in its operations. Assets obtained are normally sold, generally at auction, or realised in an orderly manner to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

Credit ratings

The internal credit ratings of the Group are assessed on a comparable basis to those given by external credit rating agencies. Where external credit ratings are available, these have been used in the analysis below.

As at 31 December 2008	AAA %	AA %	A %	BBB %	Other rated %	Unrated %	Total %
Financial assets held for trading	**67.4**	**19.3**	**12.1**	**0.5**	**0.7**	**0.0**	**100.0**
Derivative assets	**4.1**	**34.5**	**44.3**	**0.8**	**0.0**	**16.3**	**100.0**
Loans and advances to banks	**29.6**	**36.6**	**22.3**	**8.7**	**0.8**	**2.0**	**100.0**
Reinsurance assets	**3.6**	**67.0**	**29.4**	**0.0**	**0.0**	**0.0**	**100.0**
Debt securities	**52.0**	**23.8**	**16.8**	**3.1**	**2.8**	**1.5**	**100.0**

As at 31 December 2007	AAA %	AA %	A %	BBB %	Other rated %	Unrated %	Total %
Financial assets held for trading	51.5	34.4	13.7	0.1	0.2	0.1	100.0
Derivative assets	4.3	62.0	16.4	0.5	0.0	16.8	100.0
Loans and advances to banks	15.5	47.7	15.5	19.2	0.2	1.9	100.0
Reinsurance assets	2.2	78.2	0.1	0.0	0.0	19.5	100.0
Debt securities	57.8	25.8	12.9	0.2	0.1	3.2	100.0

Financial assets held for trading

Financial assets held for trading are almost exclusively investment grade investments with 99% (2007 99%) of inter-bank and structured investment portfolios rated 'A' or above based on internal credit ratings. An analysis of financial instruments held for trading is given in Note 16.

Derivative assets

Derivative assets are primarily traded with investment grade counterparties with 83% (2007 83%) of derivatives rated 'A' or above based on internal credit ratings. The Company's derivatives are wholly traded with Bank of Scotland plc which has a credit rating of 'AA'. An analysis of derivatives is given in Note 17.

Loans and advances to banks

Loans and advances to banks are primarily invested with investment grade banks of which 89% (2007 79%) have a credit rating of 'A' or above based on internal credit ratings.

Debt securities

Debt securities are primarily held within the Treasury & Asset Management, Corporate and Insurance & Investment divisions and are almost exclusively issued by investment grade counterparties with 93% (2007 96%) of debt securities rated 'A' or above based on internal credit ratings. The Company's investment securities comprise UK government gilts with an external 'AAA' credit rating.

Reinsurance assets

Of the reinsurance assets 71% (2007 80%) are due from insurers with a credit rating of 'AA' or above.

Amounts owed by Group entities

The Company's inter-company assets are primarily transacted with companies in the Group that have credit ratings of 'AA'.

Contingent liabilities and commitments

Contingent liabilities and commitments are analysed in Note 43. This amount reflects the outstanding business at the year end and reflects the maximum credit exposure that could be drawn down. Some facilities will not be drawn down or may be only partially utilised.

Notes to the Financial Statements continued

48 Credit Risk continued

Treasury debt securities - credit exposure

As part of investment credit activities Treasury holds a portfolio of debt securities which are analysed below. The investment credit business has two functions: firstly it manages part of the Group's prudential liquidity portfolio and secondly it takes investment positions principally through the Grampian conduit.

Following the International Accounting Standards Board's (IASB) decision to permit the reclassification of financial assets, Treasury reclassified certain securities from assets held for trading into available for sale (AFS) portfolio and, subsequently, in light of increasing illiquidity in the markets for asset backed securities (ABS), changed the classification of ABS from AFS, to loans and receivables. Further details about these reclassifications are in Note 45.

Treasury's total debt securities portfolio as at 31 December 2008, net of fair value adjustments and impairments, is summarised in the following table:

				2008
Asset class	**Loans & Receivables £m**	**Available for Sale £m**	**Fair value through income statement £m**	**Total £m**
Asset Backed Securities:				
Direct	**20,443**		**3,054**	**23,497**
Grampian conduit	**16,730**			**16,730**
	37,173		**3,054**	**40,227**
Covered bonds		**4,062**		**4,062**
Bank/financial institutional Floating Rate Notes (FRNs)		**15,985**	**1,901**	**17,886**
Bank certificates of deposit (CDs)		**2,960**	**3,068**	**6,028**
Other[1]		**1,787**	**6,045**	**7,832**
Total Treasury Assets	**37,173**	**24,794**	**14,068**	**76,035**
Landale		**695**		**695**
Total (net of fair value adjustments and impairment provisions)	**37,173**	**25,489**	**14,068**	**76,730**

				2007
Asset class	Loans & Receivables £m	Available for Sale £m	Fair value through income statement £m	Total £m
Asset Backed Securities:				
Direct		9,612	13,729	23,341
Grampian conduit		18,563		18,563
		28,175	13,729	41,904
Covered bonds		3,070		3,070
Bank/financial institutional Floating Rate Notes (FRNs)		11,396	5,997	17,393[1]
Bank certificates of deposit (CDs)		1,774	13,618	15,392[1]
Other[1]		1,877	982	2,859
Total Treasury Assets		46,292	34,326	80,618
Landale		611		611
Total (net of net of fair value adjustments and impairment provisions)		46,903	34,326	81,229

(1) Principally Governments and Supra-nationals.

48 Credit Risk continued

Fair value adjustments and impairment losses

For the year to 31 December 2008, the impact of fair value adjustments and impairments on the Treasury debt securities portfolio (after reclassification) is as follows:

Asset class	**Income Statement Year ended 2008 £m**	Income Statement Year ended 2007 £m	**AFS Reserve Year ended 2008 £m**	AFS Reserve Year ended 2007 £m
Fair value adjustments				
Asset Backed Securities	**2,781**	167	**4,959**	443
FRNs	**343**	102	**1,309**	169
Other	**(597)**	(42)	**359**	95
Total fair value adjustments	**2,527[1]**	227[1]	**6,627**	707
Impairment losses				
Asset Backed Securities	**773**			
FRNs	**618**			
Other	**30**			
Total impairment losses pre tax	**1,421**			
Total fair value adjustments and impairment losses pre tax	**3,948**	227	**6,627**	707
Tax on Banking Book fair value adjustments			**(1,856)**	(198)
Total fair value adjustments taken to AFS reserve			**4,771**	509

(1) Included in Net Trading Income (Note 2) as part of interest bearing securities and related non hedging derivatives.

Exposure to Asset Backed Securities (ABS)

	Net Exposure As at 31.12.2008 £m	**Average Mark As at 31.12.2008 %**	Net Exposure As at 31.12.2007 £m	Average Mark As at 31.12.2007 %
Mortgage Backed Securities				
US RMBS[1]	**6,922**	**64**	9,307	98
Non-US RMBS	**7,867**	**93**	7,920	99
CMBS[1]	**3,314**	**95**	3,340	99
	18,103	**79**	20,567	99
Collaterised Debt Obligation				
CBO[1]	**2,129**	**49**	3,320	98
CLO[1]	**3,455**	**91**	3,214	99
	5,584	**68**	6,534	99
Personal Sector				
Auto loans	**1,620**	**98**	1,526	100
Credit cards	**3,494**	**96**	2,772	99
Personal loans	**1,096**	**95**	980	98
	6,210	**96**	5,278	99
FFELP Student Loans[1]	**6,992**	**94**	5,586	98
Other ABS	**637**	**89**	672	99
Total Uncovered ABS	**37,526**	**82**	38,637	99
Negative Basis[2]	**2,701**	**70**	3,267	99
Total ABS[3][4]	**40,227**	**81**	41,904	99

(1) RMBS means Residential Mortgage Backed Securities; CMBS means Commercial Mortgage Backed Securities; CBO means Collaterised Bond Obligations; CLO means Collaterised Loan Obligations; FFELP means Federal Family Education Loan Programme.
(2) Negative basis means bonds held with seperate matching credit default swap (CDS) protection.
(3) The total comprises US securities of £24,304m (2007 £16,333m), and Non-US securities of £15,923m (2007 £25,571m).
(4) There has been no increase in net exposure as a result of the purchase of ABS during the year. Any increase in net exposure is the result of exchange rate movements in excess of paydowns, fair value adjustments and impairments.

Notes to the Financial Statements continued

49 Market Risk

The Group's approach to managing market risk is set out on pages 22 to 25 of the Risk Management report. The following table shows, split by currency, the Group's sensitivity as at 31 December 2008 to an immediate interest rate shift of 25 basis points to all interest rates.

	2008		2007	
Impact of interest rate shift on income statement (expense)/income	+25 bps £m	-25 bps £m	+25 bps £m	-25 bps £m
Currency				
Sterling	**82.4**	**(119.6)**	(21.2)	21.6
US Dollar	**(2.9)**	**2.7**	(0.6)	0.5
Euro	**(8.0)**	**8.1**	(4.3)	4.3
Australian Dollar	**(1.5)**	**1.5**	0.1	(0.1)
Other	**(0.3)**	**0.3**	0.1	(0.1)
Total	**69.7**	**(107.0)**	(25.9)	26.2

The Company's approach to managing market risk is to transfer interest rate and foreign exchange risk to its subsidiary Bank of Scotland plc through a combination of inter-company loans, deposits and derivative instruments. The following table shows, split by currency, the Company's sensitivity as at 31 December 2008 to an immediate interest rate shift of 25 basis points to all interest rates.

	2008		2007	
Impact of interest rate shift on income statement (expense)/income	+25 bps £m	-25 bps £m	+25 bps £m	-25 bps £m
Currency				
Sterling	**(39)**	**39**	(34)	34
Australian Dollar			1	(1)
Total	**(39)**	**39**	(33)	33

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.

	2008			2007		
Functional currency of the operation	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	Remaining structural currency exposure £m	Net investments in overseas operations £m	Borrowing taken out to hedge net investments £m	Remaining structural currency exposure £m
Australian Dollar	**2,015**	**2,015**		2,023	2,023	
Euro	**3,011**	**3,011**		1,888	1,613	275
US Dollar	**191**	**181**	**10**	97	97	
Other	**(23)**		**(23)**	4		4
Total	**5,194**	**5,207**	**(13)**	4,012	3,733	279

At 31 December 2008 and 31 December 2007 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 exchange risk is set out on pages 23 to 24 of the Risk Management report.

50 Liquidity Risk

The Group's approach to managing liquidity risk is set out on pages 25 to 28 of the Risk Management report.

The tables below set out the contractual cash flows attaching to the Group's financial liabilities (excluding those related to policyholder funds) and the Company's financial liabilities. Except for the insurance contract liabilities these cash flows are not discounted and include both the contractual cash flows pertaining to the balance sheet liabilities and future contractual cash flows that they will generate. Certain long dated financial liabilities allow for the early termination at the option of the Group. Where the terms of these instruments have been designed to economically compel the Group to early settle, the earlier settlement date has been applied. For undated instruments the earlier of 20 years or expected date of maturity has been applied. The analysis of insurance contract liabilities is based on the expected timing of amounts recognised at the balance sheet date. Policyholder funds have been excluded from the analysis as the underlying risks are for the account of policyholders and have no material direct impact on the Group's results.

Group	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 year to 5 years £m	2008 Over 5 years £m
Liabilities					
Deposits by banks	**49,712**	**41,710**	**3,881**	**1,456**	**546**
Customer accounts	**160,616**	**15,648**	**41,634**	**6,474**	**1,670**
Financial liabilities held for trading	**10,994**	**4,640**	**3,518**		
Derivative liabilities:					
Gross settled derivatives – outflows	**35,701**	**31,615**	**19,016**	**42,827**	**35,077**
Gross settled derivatives – inflows	**(36,761)**	**(32,588)**	**(19,028)**	**(42,323)**	**(33,121)**
Gross settled derivatives – net flows	**(1,060)**	**(973)**	**(12)**	**504**	**1,956**
Net settled derivative liabilities	**1,041**	**1,085**	**8,557**	**15,201**	**7,708**
Derivative liabilities	**(19)**	**112**	**8,545**	**15,705**	**9,664**
Insurance contract liabilities	**107**	**131**	**597**	**923**	**1,990**
Investment contract liabilities			**1**		**26**
Debt securities in issue	**21,684**	**25,443**	**40,453**	**83,513**	**26,732**
Other borrowed funds	**28**	**1,238**	**1,668**	**13,604**	**24,750**
Other financial liabilities	**1,226**	**4**	**61**	**14**	**1,392**
Undrawn loan commitments	**44,961**	**3,041**	**7,031**	**23,263**	**7,071**
	289,309	**91,967**	**107,389**	**144,952**	**73,841**

Group	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 year to 5 years £m	2007 Over 5 years £m
Liabilities					
Deposits by banks	23,563	12,413	4,369	629	673
Customer accounts	193,031	19,276	25,220	7,934	1,642
Financial liabilities held for trading	10,610	5,556	6,540	242	
Derivative liabilities:					
Gross settled derivatives – outflows	20,580	21,966	15,575	39,030	15,700
Gross settled derivatives – inflows	(20,558)	(22,084)	(15,298)	(38,324)	(14,998)
Gross settled derivatives – net flows	22	(118)	277	706	702
Net settled derivative liabilities	332	516	1,347	4,133	2,024
Derivative liabilities	354	398	1,624	4,839	2,726
Insurance contract liabilities	99	61	495	1,185	1,821
Investment contract liabilities	1	2	1,907	13	98
Debt securities in issue	26,990	48,086	42,900	75,693	36,843
Other borrowed funds	48	246	2,145	11,776	23,911
Other financial liabilities	914				921
Undrawn loan commitments	48,060	2,670	5,761	22,006	6,995
	303,670	88,708	90,961	124,317	75,630

Notes to the Financial Statements continued

50 Liquidity Risk continued

Company	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 year to 5 years £m	2008 Over 5 years £m
Liabilities					
Derivative liabilities:					
Gross settled derivatives – outflows	**18**	**63**	**244**	**4,936**	**7,033**
Gross settled derivatives – inflows		**(60)**	**(238)**	**(5,813)**	**(6,957)**
Gross settled derivatives – net flows	**18**	**3**	**6**	**(877)**	**76**
Amounts owed to Group entities	**26,153**	**2,169**	**847**	**7,147**	**7,155**
Other borrowed funds		**530**	**812**	**8,369**	**18,361**
	26,171	**2,702**	**1,665**	**14,639**	**25,592**

Company	Up to 1 month £m	1 to 3 months £m	3 to 12 months £m	1 year to 5 years £m	2007 Over 5 years £m
Liabilities					
Derivative liabilities:					
Gross settled derivatives – outflows	12	77	564	4,539	6,356
Gross settled derivatives – inflows		(58)	(486)	(4,412)	(6,002)
Gross settled derivatives – net flows	12	19	78	127	354
Amounts owed to Group entities	16,597	1,050	2,814	10,208	11,568
Other borrowed funds		128	445	4,935	10,691
	16,609	1,197	3,337	15,270	22,613

51 Related Party Transactions

Banking transactions are entered into by the Company with its subsidiaries in the normal course of business and are at normal commercial terms. These include loans, deposits and foreign currency transactions. Balances between HBOS plc and its subsidiaries are shown on the Company balance sheet. Interest income and expense are £2,880m (2007 £1,909m) and £2,344m (2007 £1,718m) respectively. HBOS plc is the principal employer of the Group and staff and other costs in the year of £2,582m (2007 £2,457m) were recharged to subsidiaries.

In the year ended 31 December 2008, the Group provided both administration and processing services to Sainsbury's Bank plc. The amounts payable to the Group during the year are £26m (2007 £42m), of which £10m is outstanding at the year end (2007 £18m). At 31 December 2008, Sainsbury's Bank plc also has balances with the Group that are included in loans and advances to banks of £906m (2007 £726m) and deposits by banks of £1,274m (2007 £3,430m).

At 31 December 2008 there are loans and advances to customers of £14,196m (2007 £11,373m) outstanding and balances within customer accounts of £342m (2007 £575m) relating to jointly controlled entities and associated undertakings. In addition, £175m (2007 £175m) preference shares in esure are held by the Group and are reported in investment securities (Note 20).

At 31 December 2008, there are customer accounts of £30m (2007 £20m) and investment and insurance contract liabilities of £872m (2007 £425m) related to the Group's pension arrangements. Additionally, the Group's pension funds held HBOS plc ordinary shares with a value of £3m (2007 £19m) and HBOS plc bonds with a value of £nil (2007 £2m).

52 Transactions with Key Management Personnel

Key management personnel comprise the members of the Board of HBOS plc and, as the senior executive committee of the Group, the members of the HBOS Executive Committee.

Remuneration and other compensation

	2008 £'000	2007 £'000
Emoluments	**10,535**	13,276
Compensation for loss of office		1,475
Post retirement benefits	**82**	63
Equity compensation benefits	**2,083**	6,257

Product transactions

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 HBOS plc and its subsidiaries. These transactions 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 benefits in kind are declared to HM Revenue & Customs and taxed accordingly.

Key management personnel and connected persons have undertaken transactions with HBOS plc and its subsidiaries, jointly controlled entities and associated undertakings in the normal course of business, details of which have been disclosed to the Group, are given below:

Mortgages, credit cards and term loans

	Number of key management personnel	£'000
At 1 January 2007	10	5,049
Amounts advanced during the year	1	3
Interest charged	8	271
Amounts repaid during the year	11	(2,036)
Upon resignation	3	(1,460)
At 31 December 2007	7	1,827
Amounts advanced during the year	**8**	**453**
Interest charged	**9**	**110**
Amounts repaid during the year	**8**	**(567)**
At 31 December 2008	**8**	**1,823**

Included above is £1,675k (2007 £1,682k) in respect of mortgages, £18k (2007 £15k) in respect of credit cards and £130k (2007 £130k) in respect of term loans.

The number of Directors together with their connected persons who had transactions and balances with banking entities in the Group were as follows:

	2008 Number of Directors	2008 £'000	2007 Number of Directors	2007 £'000
Loans	**3**	**1,070**	6	1,440
Quasi-loans and credit cards	**4**	**12**	6	14
	7	**1,082**	6	1,454

Notes to the Financial Statements continued

52 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 2007	11	7,487	(1,017)	6,470
Upon appointment	3	413		413
Net movement during the year	15	(1,129)	(419)	(1,548)
Upon resignation	3	(130)	1,236	1,106
At 31 December 2007	12	6,641	(200)	6,441
Net movement during the year	**12**	**(2,893)**	**190**	**(2,703)**
At 31 December 2008	**11**	**3,748**	**(10)**	**3,738**

Savings and deposit accounts

	Number of key management personnel	£'000
At 1 January 2007	8	3,300
Upon appointment	2	1,550
Amounts deposited during the year	9	3,123
Interest credited	7	114
Amounts withdrawn during the year	7	(2,393)
Upon resignation	1	(32)
At 31 December 2007	10	5,662
Amounts deposited during the year	**8**	**4,601**
Interest credited	**9**	**311**
Amounts withdrawn during the year	**9**	**(7,725)**
At 31 December 2008	**7**	**2,849**

Life assurance and investment contracts

	Number of key management personnel	£'000
At 1 January 2007	8	6,989
Upon appointment	2	173
Premiums paid/amounts invested during the year	9	3,191
Other movements including investment returns	10	(1,995)
Upon resignation	2	(1,331)
Total sum insured/value of investment at 31 December 2007	8	7,027
Premiums paid/amounts invested during the year	**6**	**3,017**
Other movements including investment returns	**8**	**(4,489)**
Total sum insured/value of investment at 31 December 2008	**8**	**5,555**

53 Cash and Cash Equivalents

Group	2008 £m	2007 Restated £m
Cash and balances at central banks	**2,502**	2,945
Less: mandatory reserve deposits	**(296)**	(373)
	2,206	2,572
Loans and advances to banks	**17,645**	7,683
Less: amounts with a maturity of three months or more	**(7,748)**	(4,070)
	9,897	3,613
Cash and cash equivalents	**12,103**	6,185

Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day to day operations.

Included in total cash and cash equivalents at 31 December 2008 is £864m (2007 £658m) of cash held at the central bank as collateral against notes in circulation of £957m (2007 £881m).

Mandatory reserve deposits of £373m at 31 December 2007 have been reclassified from loans and advances to banks to cash and balances at central banks. In addition, total cash and cash equivalents at 31 December 2007 have been restated to include certain cash deposits held with the central Bank of Ireland of £853m (1 January 2007 £535m) and cash held at the central bank as collateral against notes in circulation of £881m (1 January 2007 £857m) which are available to finance the Group's day to day operations. The cash flow statements have been adjusted accordingly.

Company	2008 £m	2007 £m
Amounts owed by Group entities with an original maturity of less than three months	**1,870**	1,177
Cash and cash equivalents	**1,870**	1,177

54 Securities Borrowing and Lending, Repurchase and Reverse Repurchase Agreements

The Group enters into securities lending transactions and repurchase agreements, whereby cash and securities are temporarily received or transferred as collateral. Where the securities sold subject to repurchase or pledged as collateral are retained on the balance sheet the funds received under these arrangements are recognised as liabilities. These transactions are all in respect of standard securities borrowing and reverse repurchase agreements which are undertaken under standard market terms and conditions, or are in respect of securities exchange transactions under the Bank of England's Special Liquidity Scheme. Assets and liabilities relating to such arrangements at 31 December are as follows:

	Asset 2008 £m	Asset 2007 £m	Liability 2008 £m	Liability 2007 £m
Assets subject to repurchase				
Financial assets held for trading (Note 16)	**4,369**	4,711	**3,425**	4,523
Loans and advances to customers (Note 18)	**56,858**		**39,220**	
Investment securities (Note 20)	**37,263**	8,996	**31,682**	7,841
	98,490	13,707	**74,327**	12,364

In addition to the above, financial assets pledged as collateral as part of securities lending transactions amounted to £89,109m (2007 £11,918m).

Securities held as collateral under stock borrowed or under reverse repurchase agreements amounted to £76,018m (2007 £39,975m), of which £64,378m (2007 £28,817m) had been resold or repledged by the Group as collateral for its own transactions. These securities are not recognised as assets, and the cash advanced is recognised within financial assets held for trading, loans and advances to banks and loans and advances to customers.

Notes to the Financial Statements continued

55 Capital Management

The Group's approach to managing capital is set out on pages 31 to 33 of the Risk Management report. The Group's capital resources are set out below.

	As at 31 December 2008 £m	As at 1 January 2008 £m
Capital resources		
Core Tier 1		
Ordinary share capital	**1,352**	933
Eligible reserves	**15,227**	20,421
Minority interests	**381**	123
Perpetual non-cumulative preference shares		
Preference share capital	**3,195**	2,781
Innovative Tier 1		
Preferred securities	**3,092**	3,247
Deductions from Tier 1		
Goodwill & other intangible assets	**(2,475)**	(2,862)
Excess expected loss[1]	**(536)**	(875)
Other deductions	**(446)**	(37)
Total Tier 1 capital	**19,790**	23,731
Upper Tier 2		
Available for sale reserve		187
Undated subordinated debt	**8,096**	5,591
Collectively assessed impairment provisions	**1,454**	463
Lower Tier 2		
Dated subordinated debt	**10,306**	9,900
Deductions from Tier 2		
Excess expected loss[1]	**(536)**	(875)
Other deductions	**(287)**	(37)
Total Tier 2 capital	**19,033**	15,229
Supervisory deductions:		
Unconsolidated investments - life	**(4,562)**	(4,596)
Unconsolidated investments - other	**(482)**	(506)
Total supervisory deductions	**(5,044)**	(5,102)
Total capital resources	**33,779**	33,858

(1) Unaudited

The table below details movements in Tier 1 capital during the year.

	2008 £m
As at 1 January	**23,731**
Loss attributable to parent company shareholders	**(7,499)**
Ordinary dividends paid	**(1,205)**
Rights issue proceeds, net of expenses	**3,987**
Increase in minority interest (equity)	**258**
Decrease in goodwill and intangible assets	**387**
Preferred securities issued	**750**
Restriction on Innovative Tier 1	**(1,484)**
Decrease in Excess EL	**339**
Other	**526**
As at 31 December	**19,790**

The Group's practice is to use the Company to issue capital instruments and the Group's dividend policy requires surplus reserves to be remitted to the Company, except where they are required to be retained by the subsidiary for regulatory or financial reasons.

56 Long Term Assurance Business Capital Position Statement

The Capital Position Statement sets out the total capital resources relating to the life assurance business of the Group. The statement shows the shareholders' funds in the long term assurance business together with the adjustments required to reconcile these amounts with the amounts determined in accordance with the regulatory reporting framework.

					2008
	CMIGL UK with-profit fund £m	UK non-profit funds £m	UK life shareholder funds £m	Overseas life business £m	Total life business £m
Total shareholders' funds		**3,830**	**2**	**1,105**	**4,937**
Adjustments onto regulatory basis:					
Less value of in-force long term assurance business (Note 28)		**(2,166)**		**(826)**	**(2,992)**
Less purchased value of in-force investment business (Note 23)		**(291)**		**(1)**	**(292)**
Add unallocated surplus (Note 32)[a]	**551**				**551**
Less shareholders' share of realistic liabilities	**(39)**				**(39)**
Deferred taxation		**460**		**196**	**656**
Other adjustments		**(621)**	**51**	**(225)**	**(795)**
	512	**1,212**	**53**	**249**	**2,026**
Other qualifying capital:					
Loan capital			**1,282**		**1,282**
Total capital available[c]	**512**	**1,212**	**1,335**	**249**	**3,308**
The Group's long term insurance and investment contract liabilities are allocated as follows:					
With-profit business	**5,394**				**5,394**
Unit-linked business		**16,008**		**5,751**	**21,759**
Other life assurance business		**2,461**		**390**	**2,851**
Total insurance contract liabilities (Note 30)	**5,394**	**18,469**		**6,141**	**30,004**
Investment contract liabilities[b]		**25,877**		**3,180**	**29,057**
Investment contract liabilities with DPF	**6,161**				**6,161**
Total investment contract liabilities (Note 31)	**6,161**	**25,877**		**3,180**	**35,218**
Total policyholder liabilities	**11,555**	**44,346**		**9,321**	**65,222**

					2007
	CMIGL UK with-profit fund £m	UK non- profit funds £m	UK life shareholder funds £m	Overseas life business £m	Total life business £m
Total shareholders' funds		4,004	40	736	4,780
Adjustments onto regulatory basis:					
Less value of in-force long term assurance business (Note 28)		(2,476)		(708)	(3,184)
Less purchased value of in-force investment business (Note 23)		(320)		(1)	(321)
Add unallocated surplus (Note 32)[a]	1,493				1,493
Less shareholders' share of realistic liabilities	(81)				(81)
Deferred taxation		1,102		135	1,237
Other adjustments		(651)	55	87	(509)
	1,412	1,659	95	249	3,415
Other qualifying capital:					
Loan capital			1,039		1,039
Total capital available[c]	1,412	1,659	1,134	249	4,454
The Group's long term insurance and investment contract liabilities are allocated as follows:					
With-profit business	5,640				5,640
Unit-linked business		15,484		2,409	17,893
Other life assurance business		2,280		101	2,381
Total insurance contract liabilities (Note 30)	5,640	17,764		2,510	25,914
Investment contract liabilities		33,890		6,497	40,387
Investment contract liabilities with DPF	7,192				7,192
Total investment contract liabilities (Note 31)[b]	7,192	33,890		6,497	47,579
Total policyholder liabilities	12,832	51,654		9,007	73,493

(a) The with-profit fund unallocated surplus is determined on an adjusted realistic basis.
(b) Excludes investment contract liabilities related to the collective investment schemes.
(c) Provisional available capital.

Notes to the Financial Statements continued

56 Long Term Assurance Business Capital Position Statement continued

The Group has one UK with-profit fund, the Clerical Medical Investment Group Limited (CMIGL) with-profit fund, which is shown separately in the Capital Position Statement. The Group's UK non-profit businesses are aggregated as well as the Group's overseas life businesses for the purpose of this statement.

For the Group's UK with-profit fund, available capital and capital requirements are determined under the 'twin peaks' assessment as prescribed by the regulations of the Financial Services Authority (FSA). Under this assessment the available capital is determined by comparing admissible assets with the mathematical reserves determined on the 'regulatory peak' basis. This is adjusted by the with-profit insurance capital component (WPICC) to arrive at the available capital position for the purpose of this disclosure. The capital requirement, adjusting for the WPICC, consists of the long term insurance capital requirement (LTICR).

The WPICC is determined under the twin peaks test by comparing the regulatory peak with the realistic peak. If the latter is more onerous then this gives rise to a WPICC. At 31 December 2008 and at 31 December 2007, the realistic peak was more onerous. Accordingly, the available capital of the with-profit fund is adjusted by the WPICC and presented on a 'realistic' basis. As more fully described in Note 32, the unallocated surplus is determined on an adjusted realistic basis in accordance with FRS 27.

There are no formal arrangements, other than those relating to the CMIGL with-profit fund described below, for shareholders' funds or the surplus within the individual life funds to be used to support other businesses or life funds within the Group. However, as described below, subject to certain conditions being met, the available capital within the individual funds is potentially transferable to other parts of the Group. However, the capital within each fund is generally subject to restrictions as to its availability to meet requirements that arise elsewhere in the Group, including other long term businesses. In particular, for sections in the Capital Position Statement where aggregate capital amounts have been shown, such as for UK non-profit funds and overseas business, there are no prior arrangements in place to allow the capital to move freely between entities within these sections.

Restrictions to the application of capital
Restrictions apply to the transfer of assets from any long term fund. In particular, at all times, each long term fund must maintain an excess of assets over liabilities. Transfers of assets from a long term fund can only be made once management are satisfied that they have met the relevant requirements of the fund. The principal restrictions are:

(a) CMIGL with-profit fund
The unallocated surplus held in the fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses. Such distributions would also be subject to a tax charge. The use of capital within the fund is also subject to the terms of the scheme of demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. Capital within the Clerical Medical non-profit fund is available to meet the with-profit fund's capital requirements. There are no other arrangements that provide capital support to the fund.

(b) UK non-profit funds
Except as above, the capital held in the fund is attributable to the shareholders and, subject to meeting the regulatory requirements of these businesses, this capital is potentially available to meet capital requirements elsewhere in the Group. Any transfer of the surplus would give rise to a tax charge.

(c) Overseas life business
These include several smaller life companies outside the UK. In all cases the available capital resources are subject to local regulatory requirements including Germany and Ireland. The available capital held in each company is potentially available to meet the capital requirements in other parts of the Group, subject to additional complexity surrounding the transfer of capital from one country to another.

Target capital
For the UK with-profit fund, the Group is required to hold sufficient capital to meet FSA requirements, based on the risk capital margin (RCM) determined in accordance with the FSA's regulatory rules under its realistic capital regime. The determination of the RCM is based on the impact of specified changes in market prices of the fund assets as well as policyholder behaviour, taking into account the actions management would have taken in the event of the particular adverse changes.

For UK non-profit business, the relevant capital requirement is the LTICR and resilience capital requirement determined in accordance with FSA regulations.

Under the FSA's Individual Capital Adequacy Standards framework, each company is required to carry out its own assessment of the capital required to meet its liabilities in all reasonably foreseeable circumstances known as the individual capital assessment (ICA). The ICA takes into account certain business risks not reflected in the FSA's other capital requirements.

Management intends to maintain surplus capital in excess of the various regulatory requirements, including the ICA, in order to absorb changes in both the underlying businesses and the capital requirements over the short term. At 31 December 2008 the provisional available capital, excluding the with-profit fund, was 370% (2007 468%) of the provisional LTICR and resilience capital requirements of £756m (2007 £650m). At 31 December 2008, the total provisional available capital including the with-profit fund on a realistic basis was 263% (2007 399%) of the provisional LTICR and resilience capital requirements of £1,256m (2007 £1,116m).

56 Long Term Assurance Business Capital Position Statement continued

Changes in capital

The principal factors that resulted in changes to the total provisional available capital are set out in the table below:

	CMIGL UK with-profit fund £m	UK non-profit funds £m	UK life shareholder funds £m	Overseas life business £m	Total life business £m
At 1 January 2007	1,436	1,655	678	233	4,002
Impact of adopting PS06/14		279			279
Changes in non-investment assumptions[a]	(15)	42	59	(1)	85
Investment markets and changes in investment assumptions[b]	(112)	128		10	26
New business[c]		(423)		(138)	(561)
Other experience[d]	103	548	31	206	888
Transfers of capital and dividends[e]		(570)	366	(61)	(265)
At 31 December 2007	**1,412**	**1,659**	**1,134**	**249**	**4,454**
Changes in non-investment assumptions[a]	**(14)**	**57**		**(10)**	**33**
Investment markets and changes in investment assumptions[b]	**(883)**	**(98)**	**244**	**3**	**(734)**
New business[c]		**(333)**		**(10)**	**(343)**
Other experience[d]	**(3)**	**483**	**2**	**166**	**648**
Disposals				**(22)**	**(22)**
Transfers of capital and dividends[e]		**(556)**	**(45)**	**(127)**	**(728)**
At 31 December 2008	**512**	**1,212**	**1,335**	**249**	**3,308**

(a) There were no significant changes to the non-investment assumptions during the year.
(b) Net negative market condition in 2008 led to a decrease in the value of securities resulting in a decrease in the total capital available.
(c) The amount of capital has been reduced by the increase in liabilities and new business strain (excess of acquisition costs over margins due to significant volumes of new long term assurance business written since the last balance sheet date).
(d) This is the effect of current year experience on in-force blocks of business.
(e) This represents the dividends paid by, or transfers of capital to and from, the funds during the year.

Notes to the Financial Statements continued

57 Post Balance Sheet Events

a) Lloyds Banking Group

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

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

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

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

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

b) Other

As a result of the acquisition of the Group by Lloyds TSB, some of the share schemes vested in the period between 12 January 2009, being the date when the acquisition was approved by the Court of Session, and the 16 January 2009, the completion of the acquisition itself. The remainder of the share schemes will roll over into new Lloyds Banking Group Shares. These will continue until their original maturity date. As a non adjusting post balance sheet event there is no accounting impact on the primary statements as at 31 December 2008.

58 Ultimate Parent Undertaking

From 16 January 2009, HBOS plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc (formerly Lloyds TSB Group plc) which is incorporated in Scotland. Lloyds Banking Group plc will produce consolidated accounts for the year ended 31 December 2009. Copies of the annual report and accounts of Lloyds TSB Group plc for the year ended 31 December 2008 may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN.

Copies of the annual report and accounts of HBOS plc for the year ended 31 December 2008 may be obtained from HBOS plc's registered office at The Mound, Edinburgh, EH1 1YZ or downloaded via www.lloydsbankinggroup.com.