"We exist to help millions of people achieve financial security..."

Directors' Report and Accounts 1998

The Abbey National Group

Our corporate purpose

To achieve above average growth in shareholder value over the long term by meeting the needs of our customers, our staff and all of the other stakeholders in our business.

Our corporate objectives

To strengthen Abbey National's market position in UK personal financial services.

To win and hold competitive advantage through superior customer service.

To continue to diversify profit streams away from our traditional mortgage and savings activities.

To remain a low-cost operator.

To maintain strong management of risks.

To promote brand strength.

To develop synergies between our mutually supporting businesses.

Dividend policy

The directors will pursue a progressive dividend policy.

The effect of continuing to pursue a progressive policy is expected to result in full year dividends paid being covered by earnings by around two times during the current planning cycle.

During the current planning cycle, the directors expect to retain sufficient capital such that the equity content of the tier one capital ratio is in the region of 7.25% at the end of the period.

The interim dividend will normally represent one-third of the total dividend which will be paid for a full year.

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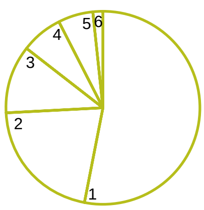
In 1999, it will be 150 years since the foundation of the National Freehold Land Society – the forerunner of Abbey National. To celebrate, shareholders, staff and customers are being invited to a series of anniversary roadshows taking place across the country.

Results highlights

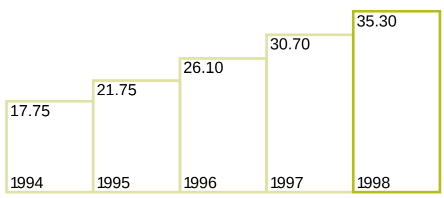
- Profit before tax increased by 19% to £1,520 million (£1,279 million).
- Improvement in the underlying Group cost:income ratio, down to 41.2% (42.3%).
- In 1998, diversified business activities accounted for 43.3% of total Group profit after tax and exceptional items.
- Earnings per ordinary share up 11% to 72.4 pence.
- Proposed final net dividend of 23.55 pence, making the full year net dividend 35.30 pence, an increase of 15%.
- Total Group assets up 18% since 31 December 1997 to £177.8 billion.

Profit before tax and exceptional items by business segment 1998
excluding Continental Europe and Group Central Holdings

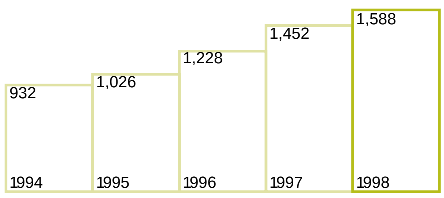
1 UK Retail Banking £900m
2 Treasury & Wholesale Banking £361m
3 Life Assurance £190m
4 Finance House £120m
5 General Insurance £98m
6 Wealth Management £26m



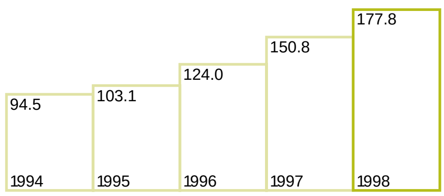
Net dividends (pence per ordinary share)



Profit before tax and exceptional items (£m)



Total assets (£bn)



Chairman

During a year of instability in world financial markets, Abbey National has underlined its credentials as a strong and secure bank, growing its balance sheet and its earnings

Abbey National has performed well in a year marked by economic uncertainty and market volatility, with profit before tax up 19% to £1,520 million. Total assets increased by 18% to £177.8 billion. The Board is proposing a final net dividend of 23.55 pence per ordinary share – this will increase total dividends per share for the year from 30.7 pence in 1997 to 35.3 pence, a growth of 15%.

In 1999, Abbey National celebrates 150 years since the foundation of the National Freehold Land Society which, as the National Building Society, merged with the Abbey Road Building Society in 1944 to form the Abbey National Building Society.

During these 150 years, Abbey National has changed almost beyond recognition, but has never lost sight of its central purpose of helping millions of people to achieve financial security. The diversification strategy followed by Abbey National since conversion to plc status in 1989 means that Abbey National can now provide that financial security through a wider range of services than ever before and in ways that meet its customers' constantly changing needs. During 1999, Abbey National will be inviting shareholders, staff and customers to celebrate the Company's 150th anniversary at a series of roadshows across the country.

During a year of instability in world financial markets, Abbey National has underlined its credentials as a strong and secure bank, growing its balance sheet and its earnings. In UK Retail Banking, we grew profit by 15% to £900 million – an excellent performance in very competitive conditions. Profit from our diversified businesses was £688 million – including a strong performance from Treasury & Wholesale Banking, which increased its profit by 22% to £361 million. Against a background of significant volatility in global markets, our Treasury business has demonstrated the advantages of its cautious approach to investment.

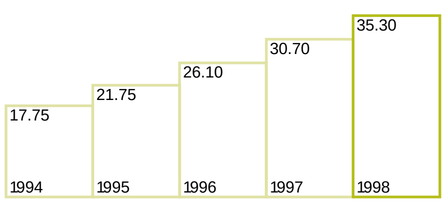
1998 was a year of change at the top, with the smooth succession of Ian Harley to become Chief Executive from 1 March – Mark Pain assuming the role of Finance Director in his place. On 1 October, we welcomed Leon Allen to the Board. As Chairman and Chief Executive of Tetley Group, he brings a wealth of experience with him. In December, we announced Malcolm Millington's appointment to the Board as Group IT Director with effect from 1 January 1999.

Following the AGM in April, Keith Woodley will be appointed a Deputy Chairman. Lord Shuttleworth will step down as Deputy Chairman but remains on the Board. Charles Villiers will be appointed a Deputy Chairman, also from that date.

At the Annual General Meeting in April, we say farewell to Deputy Chief Executive Charles Toner, who retires after nearly 35 years' service. Charles' contribution to the development of the Group cannot be underestimated: during his career with Abbey National he has led Abbey National's Retail and Life Assurance Divisions and played a major role in creating our new Wealth Management Division. Following the AGM, we will also say farewell to Deputy Chairman Martin Llowarch and to Lord Rockley, after serving respectively for ten years and nine years, and after contributing greatly to the development of the Group since conversion.

With the imminent retirement of Charles Toner, Mark Pain has taken on responsibility for Group communications. Charles Villiers has assumed responsibility for Scottish Mutual Assurance plc, Wealth Management and Continental European operations, whilst retaining responsibility for Group Corporate Development.

Net dividends (pence per ordinary share)



Value creating acquisitions offer a means of delivering our strategy faster. Acquiring three point-of-sale finance businesses in 1998 effectively doubled the size of Finance House

We also have a strong pool of executive talent immediately below the Board – providing a team which is well placed to take the business forward. Smooth succession plans are a key responsibility of the Board, and one which as Chairman I take particularly seriously.

During 1998, we continued to pursue organic growth, extended the markets in which we operate and made value creating acquisitions.

In July, we launched Abbey National's first motor insurance product, underwritten by CGU and sold over the telephone from our new offices at Liverpool's Brunswick Dock. The launch of motor insurance represents another diversification milestone for the Group and the venture has made good progress to date. We are now also selling private healthcare throughout our branch network.

In the autumn, our Retail Bank announced plans to build on its strategic partnership with Safeway by opening a further 20 in-store units over the following 18 months. This will keep Abbey National at the forefront of UK in-store banking, and provides a new and highly convenient channel through which customers can do business with us.

In December, Abbey National acquired three point-of-sale finance businesses from NatWest Group. This effectively doubled the size of our Finance House and enabled us to achieve our growth ambitions three years ahead of our strategic timescale. Abbey National's Finance House is now one of the major providers of consumer credit in the UK.

Two of the most critical issues for businesses in recent years have been the preparation of business systems for the Year 2000 and for Economic and Monetary Union. Management believes that the progress achieved with the Year 2000 project should satisfactorily resolve Year 2000 compliance exposures within Abbey National systems and that none of our business critical systems risk failing to meet Year 2000 compliance deadlines. EMU commenced in January 1999 for those economies participating in the first wave, and all our affected business areas are now operating within the euro currency framework.

Economic and Monetary Union presents a clear set of opportunities and challenges. The financial service industry is a successful and key element of the UK economy and, as a major participant within this industry, Abbey National stands to gain significantly in the long term from entry into the euro. We will have a huge market on our doorstep, larger even than the US. At present, the timetable for UK entry into the euro is uncertain; a clear lead from the Government on this issue will be necessary to enable UK financial service providers to seize the opportunities that a single currency will bring.

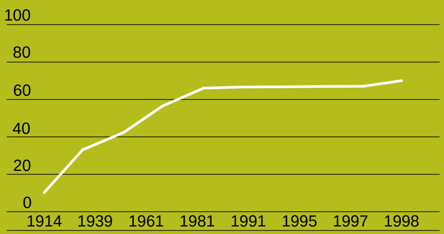
Finally, it remains for me to express my sincere thanks to Abbey National's staff for their contribution to our 1998 performance. We are proud of the partnership between our staff and the business, as nearly all of our staff are involved in some form of employee share ownership initiative. In addition to year end performance bonuses, we will be giving staff further free shares in recognition of their achievement in meeting our cost:income ratio target in 1998. People are the heart of our business, and it is only through the skills and dedication of our staff that Abbey National has been able to achieve the remarkable successes of the last 150 years.

Lord Tugendhat

Industry overview

Recognising the fact that some of its traditional markets are mature, Abbey National has developed into new areas and at 31 December 1998 43.3% of profit came from diversified businesses

Increase in UK home ownership
Level of owner occupation in the UK (%)



Mortgages
The UK mortgage market has always been sensitive to the effects of the economic cycle. Traditionally, periods of prosperity and strong economic growth have tended to stimulate house buying activity whilst rising interest rates have dampened it. With UK private home ownership lying close to 70%, the mortgage market is mature. In this context, it has been vital for organisations such as Abbey National to offset this effect by diversifying into other financial products and services. Abbey National recognised this need at the time of demutualisation and has since made diversification a key strategic priority. Despite this, the market remains attractive for large and established providers who offer wide distribution and product choice to their customers.

The recent cuts in interest rates have reduced mortgage rates to the lowest levels since the mid-1960s and the reduction in the cost of borrowing has significantly improved affordability in the housing market. This should boost consumer confidence as the year progresses. In 1999, our expectations remain that housing transaction volumes are likely to fall slightly, accompanied by a modest growth in the value of outstanding mortgages of around 5%, continuing the trend of the last five years. Improved affordability combined with modestly rising house prices should help to counteract any adverse effects on confidence from the general economic slowdown that has occurred.

Savings
In recent years, the market has been particularly distorted as building society de-mutualisations have encouraged savers to speculate on the mutual building society sector in the hope of gaining conversion bonuses. This factor was significantly reduced during 1998 and the market has since returned to more normal conditions. New entrants, including supermarket banks and life companies, have come into this market recently and have enjoyed periods of success by competing mainly on price. However, the power of established providers to attract new money and retain deposits should not be underestimated – and it is also they who have provided the distribution and infrastructure to support the product offerings of the supermarkets.

A key factor influencing the savings market since the mid-1990s has been the growth in demand for equity-based savings products. The relatively low interest rate environment has encouraged savers to look for ways of improving the performance of their investments. As a result, there has been a structural change in the market with competition between traditional deposit accounts and a new range of equity-based investments. This has been reflected in increased demand for PEPs and equity-based investment bonds. In this context, the new ISA vehicle which replaces TESSAs and PEPs will offer a significant opportunity to many savings providers. It is likely that growth in the stock of personal deposit savings will be in the order of 4-7% per annum over the next few years. Slower growth in the traditional savings market is likely to be more than offset by growth in the long term savings and life market as people save more to compensate for the lower nominal returns available.

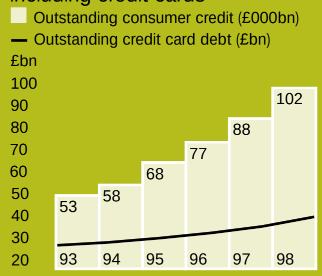
Current account banking
Since the mid-1980s, the traditional clearing banks have faced competition in the current account banking market – particularly from former building societies. Although they still have an overall share of more than 70% of the current account sector, the share held by new entrants such as Abbey National is rising.

It is clear that a primary current account banking relationship is a very strong basis upon which to build additional product relationships with the customer – but it is also recognised that considerable inertia exists in current account banking relationships. During 1998, Abbey National also launched a business and professional banking service to extend our fair banking proposition into the small business market.

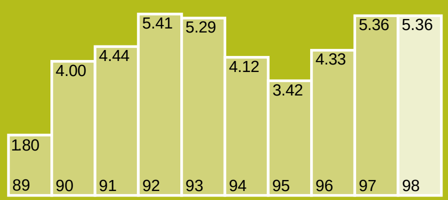
Technological advances are also changing the sector, with significant growth in the use of automated facilities, and with the increasing popularity of telephone banking services. The industry is also beginning to assess the opportunities and challenges of Internet banking: this will provide an additional customer service but it is still unclear whether establishing an early presence will lead to a lasting market advantage

Abbey National is effectively new to market in several key sectors and is able to benefit from its strong franchise and distribution

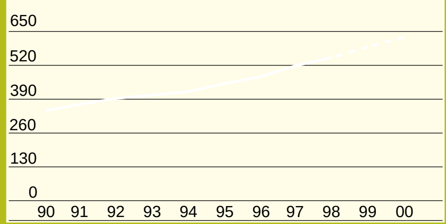
Outstanding consumer credit – including credit cards



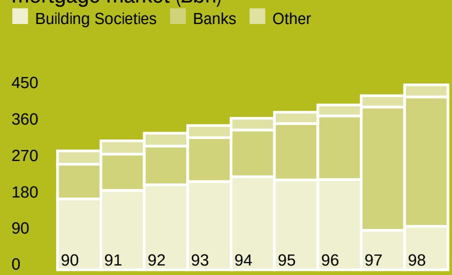
UK new business premium income – individual pension business: single premium (£000m)



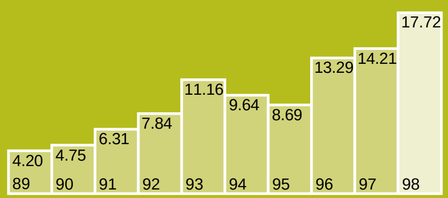
Total UK liquid savings market
UK liquid savings liabilities (£bn)
*1999 and 2000 estimated



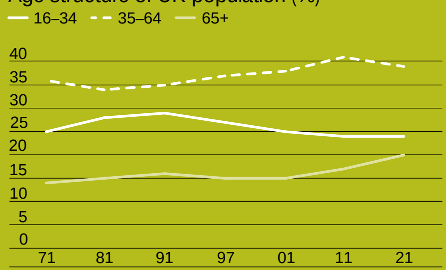
Building society and bank shares of the UK mortgage market (£bn)



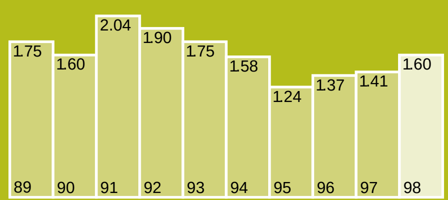
UK new business premium income – Life insurance, savings and protection: single premium (£000m)



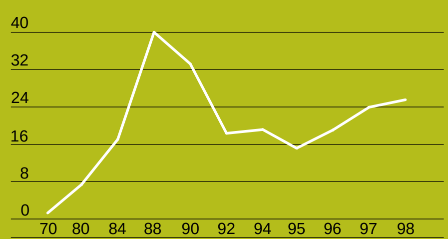
Future outlook: importance of long term savings
Age structure of UK population (%)

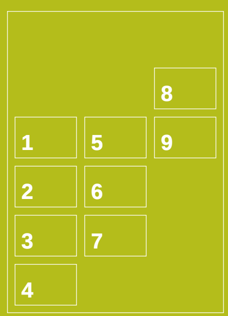


UK new business premium income – Life insurance, savings and protection: regular premium (£000m)



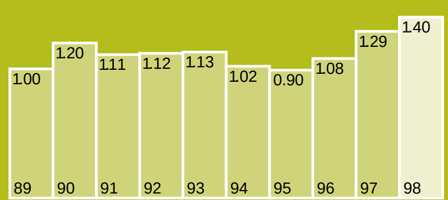
Total UK mortgage market 1970-1998 (£bn)





Sources
1, 2, 3, 4 These figures exclude collective investments, executive pensions, occupational pensions and pension annuities. Source: Association of British Insurers, Statistical Bulletin
5, 8 Office for National Statistics; Bank of England
6 Office for National Statistics
7, 9 Bank of England

UK new business premium income – individual pension business: regular premium (£000m)



or whether later entrants will be able to reap the benefits of others' experience.

Life assurance and pensions
The steady fall in the relative value of the state pension and growing awareness of the need to make adequate arrangements for family protection and future retirement have fuelled significant growth in the life assurance market. This effect has been further assisted by demographic change, with increased life expectancy and an ageing population. The current debate on Stakeholder Pensions and 'life-long individual savings accounts' in the UK is also helping to heighten awareness of the need for self-provision.

Changing working patterns and lower perceived levels of job security have led to an increase in the relative proportion of single premium life insurance and pensions business. Many consumers are not comfortable with entering into an ongoing commitment to pay a specified level of premiums and would rather make larger, periodic contributions. This sector of the industry has also benefited from the switch to equity-based savings products in response to lower returns from traditional deposit savings under a low interest rate environment. This is of particular advantage to bancassurers who have a strong brand franchise, broad distribution and who are well trusted by their customers.

Looking to the future, further consolidation in the industry is inevitable given falling stock market returns and the pressure for increased solvency ratios being brought to bear by regulators – particularly as individual players need increasing access to capital.

Personal lines insurance
There is significant potential for market growth within this sector in the UK. In the 1990s, the sector has been characterised by new entrants who are able to take advantage of low cost distribution channels, including the telephone. This includes providers like Abbey National who have a significant customer base and can build on.their existing customer relationships. The market is changing as traditional providers seek additional distribution to add to their manufacturing capability and as suppliers seek economies of scale and the opportunity to share underwriting risk.

In the last few months we have seen a very positive move in the partnership between government and the private sector: namely, in the government's sustainable home ownership initiative. This development in the area of creditor protection promises to facilitate a step change in the level of home owner insurance against accident, sickness and unemployment.

Finance House activities
In recent years there has been rapid growth in the market for consumer finance taken out at point-of-sale in areas such as home improvement, motor vehicles and electrical goods. The level of growth has been due to a number of factors, not least the increasing acceptance of debt and attractive, convenient offers of finance. Market profitability has, in the recent past, been relatively high and so is attracting greater levels of competition from existing and new entrants. As the economy slows, competition is expected to increase even further. This has already been felt intensely in the motor finance market and, overall, the consumer finance market is expected to grow more slowly than it has in recent years.

The various markets offering asset finance to small and medium sized businesses are set to grow at rates faster than inflation – in particular the markets for factoring, invoice discounting and small ticket leasing. As with consumer finance, the market for business finance is becoming increasingly competitive having historically been characterised by restrictive, overdraft-based lending practice from traditional business sector lenders. Providers of asset finance like finance houses tend to be more consistent in their desire to lend to businesses and so are well placed to compete.

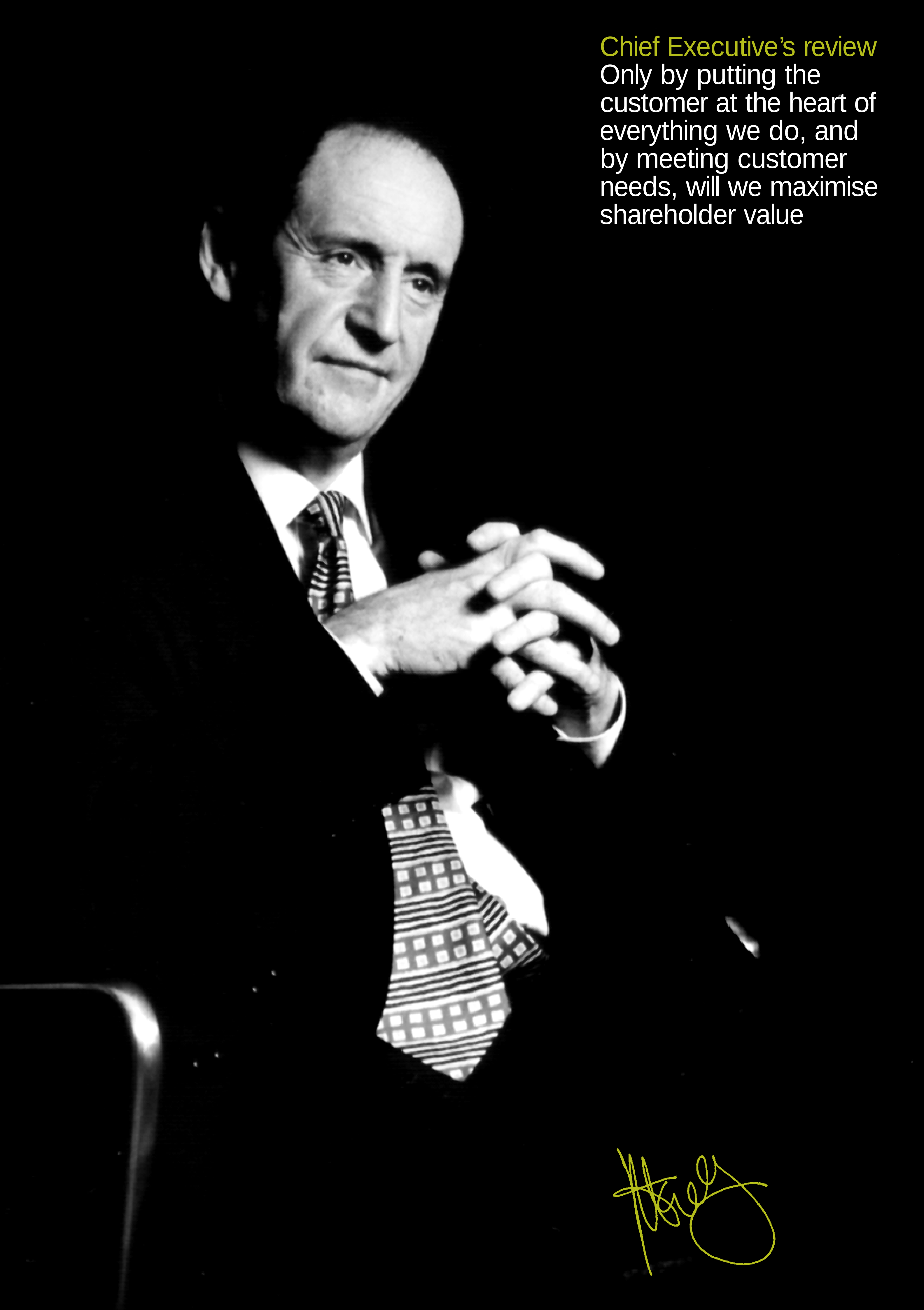
The wholesale banking markets
In the UK savings and mortgage markets, customers are becoming more demanding and require more complex and sophisticated offerings. A low interest rate environment may lead to more consumer demand for fixed and capped rate mortgage products, and bonds. In this context, it is important to support consumer demand for equity-linked and fixed rate products through access to equity derivative solutions.

This may also require greater levels of wholesale funding through the capital markets which, in turn, will involve more innovative approaches to marketing, product design, development and funding. All these areas require retail banks to have a competent and strong Treasury operation. The wholesale banking market continues to go through a period of change, with tremendous pressure on evolving markets and increased emphasis on established markets. These changes have resulted in a widening of investment margins during the latter part of the year. These are now stabilising at more normal levels, resulting in attractive returns on capital for established providers with capital, strong credit ratings and access to funding. The introduction of the euro also presents significant opportunities, with the debt and equity markets able to benefit from increasing flows of capital from Continental Europe.

As an established bancassurer, Abbey National is well placed to take advantage of the strength of the longer term savings market

Chief Executive's review

Only by putting the customer at the heart of everything we do, and by meeting customer needs, will we maximise shareholder value



Our purpose

The Abbey National Group aims to help millions of people achieve financial security. This is our central focus. Abbey National's success is based upon understanding the markets in which it operates, meeting the needs of customers in these markets and making our customers' lives easier. Only by putting the customer at the heart of everything we do, and by meeting their needs, will we maximise shareholder value.

Like all service providers, ours is a knowledge and people business. In order to meet the needs of our customers we depend upon the increasingly broad range of skills of the people who work for Abbey National. It is through the effective management of this knowledge and experience that the business has achieved 150 years of growth and development.

Our strategy

When I became Chief Executive, I had three priorities: first, to increase revenues across the business; second, to improve cost efficiency and productivity; and third, to manage our capital base in order to maintain strong returns on capital.

Increasing revenue

During 1998, we grew revenue strongly, increasing total income by 13% to £3,118 million. This was achieved both by extending the range of products and services offered to customers under the Abbey National brand, and also by growing revenues from our existing diversified businesses. Abbey National has significantly increased its cross-selling abilities – the average number of account holdings per customer at 31 December 1998 was 1.71 compared to 1.66 at 31 December 1997. Our intention is to grow our income significantly faster than costs over the next three years. We aim to increase revenue through organic growth and also, where appropriate, through acquisitions which enable us to fulfil our strategic objectives more quickly and where we can extract value.

Improve efficiency

Growth in revenue will be accompanied by tight control over costs, this is particularly important in an environment of lower economic growth. In 1998, operating expenditure increased by 10% to £1,285 million, however the cost:income ratio improved to 41.2% (1997: 42.3%) – excluding Year 2000 and EMU costs.

We have identified around 100 opportunities to improve our cost efficiency, 80 of which are capable of being implemented over the next three years or sooner. We are already improving cost efficiency in a number of fundamental ways: for instance, we are making a significant investment in telephone call technology and ATMs. This is helping us to re-configure our distribution channels and we are encouraging more of our customers to conduct their business through automatic facilities such as ATMs whilst also promoting greater use of telephone facilities.

By re-engineering business processes and making greater use of shared resources and common platforms we can improve customer service as well as improve cost efficiency. For instance, our Safeway Direct Saver account runs on the same system as our Bank Account and in Glasgow, Abbey National Life and Scottish Mutual both operate off the same administrative platform. We have also completed a major restructuring of our mortgage processing, reducing the number of centres from 48 to 5. As a result, processing costs per mortgage account have been reduced by over a fifth over the past three years. Work is now progressing on our bank account processing and, since 1997, the number of banking call centres has been reduced from 15 to 5. We will keep looking for ways to remove costly and unnecessary complexity, which provides no value, from our business processes.

Capital management

Over the last five years, through careful capital management we have reduced our equity capital ratios and increased our post tax return on equity. We will continue to explore capital and balance sheet management opportunities and we will regularly review our capital efficiency to ensure that appropriate levels of capital are allocated to each of the business segments.

We are increasing the focus on our core activities – in the first half of 1998, we sold our Spanish operation because we felt that the capital released from the sale could be more efficiently used in other parts of the business. Also in December, we sold our one-third share in Travelex and sold a major office development in Moorgate which was surplus to our requirements. In January 1999, we disposed of our 8.15% holding in Irish Permanent.

In February 1998, we launched a pilot securitisation followed by another in February this year. This has enabled us to test our systems capability in what could become an increasingly important capital management tool in the UK. We are actively exploring the possibility of adopting more effective capital structures, including tax efficient tier 1 capital. In December 1998, ANTS sponsored a US$5 billion asset-backed commercial paper programme which invests in a wide range of asset-backed securities. This adds flexibility to the ANTS balance sheet and represents an attractive capital management instrument for the future.

The Group's capital ratios provide sufficient flexibility to meet business objectives – for example providing resources to make value-enhancing acquisitions such as the three point-of-sale finance businesses acquired in December 1998. Following this purchase, the equity tier 1 ratio, which excludes preference shares, is 6.7%. Management's objective is to restore this ratio to around 7.25% by the end of the year 2000.

Development of the business

Retail banking

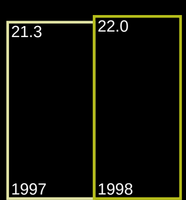
Our vision is to make our customers' lives easier. Our Retail Banking division's strategy has three clear elements:

1. To maintain our position in our traditional mortgage and savings markets whilst broadening the services offered to customers and continuing to diversify earnings.

In 1998, we increased our share of both mortgage lending and savings inflows. This pushed our share of net mortgage lending into our desired range of 5-10% whilst, at the same time, increasing the retail net interest spread from 1.99 to 2.10%. In 1998, we achieved the highest level of net lending since 1993, with gross lending exceeding £10 billion for the first time.

To meet the needs of our customers, we depend upon an increasingly broad range of skills from the people who work for Abbey National

Return on average ordinary shareholders' equity (%)



In business areas where Abbey National is effectively a new market entrant, we are taking market share from more established providers. During the course of 1998, Abbey National-branded unsecured personal loan assets increased by 8% to £1.23 billion (1997: £1.14 billion) and PEPs, unit trusts and investment bonds worth £801 million were sold. Abbey National now has nearly 1.9 million bank accounts – an increasing proportion of which are primary accounts and we now have over half a million credit card accounts as well as nearly 2.2 million debit cards. Abbey National markets private healthcare products through the branch network and we provide a full range of personal lines insurance products which are now being successfully marketed to non-borrowers through branches and over the telephone. In July, we started selling motor insurance for the first time from our direct operation in Liverpool. This initiative has made good progress since launch with exceptionally high response and conversion rates achieved through mailing our customers and shareholders. During 1998, total profit from Abbey National-branded activities increased by 11% to £1,137 million.

2. To build the strength of the Abbey National retail brand.

Following a re-launch in the autumn of 1997, we have continued to strengthen the Retail brand, with a high profile advertising and marketing campaign promoting the brand proposition "Abbey National – because life's complicated enough".

Three core values have been identified to support this proposition across all Abbey National-branded businesses: straightforwardness, flexibility and customer partnerships. During 1998, these values have been reinforced through a series of initiatives to provide more flexible opening hours, to reduce queues at lunch times, and to simplify form design and layout. We have also taken steps to simplify our product range, in particular our range of bond choices for customers. Abbey National was also the first major lender to remove extended tie-ins on all new mortgages.

3. To change the way that we do business with our customers, focusing on customer value management and cost effectiveness.

Our focus is on providing a flexible service that is valued by customers. Abbey National customers have access to a total of 21,796 ATMs. We now have 2,298 ATMs, including 888 non-branch ATMs, the second largest number of non-branch ATMs in the UK.

Usage of the telephone banking service, which is available to bank account customers and Instant Plus customers, increased by 56% to 9.3 million calls in 1998. Most in-bound telephone calls are now routed via a network of 3 centralised call centres, which has improved customer service and reduced costs. Within Abbey National's Retail branch network, we are moving the focus to larger branches in city centres and shopping centres – these are more convenient and accessible for customers. The success of this strategy is beginning to be seen, with strong growth in income and improvements in the cost efficiency of the retail bank. In 1998, the cost:income ratio in UK Retail Banking improved to 43.0% (1997: 45.2%).

Abbey National continues to extend the range of distribution channels available to customers. Last September, plans to open a further 20 Safeway in-store units were announced. This will enable Abbey National to provide banking services seven days a week in these stores together with extended daily opening hours. The new in-store units offer self-service machines for transactions, together with face-to-face advice on our full range of personal financial services. The success of the Abbey National Bonus Postal Account and the Safeway Direct Savings Account, indicates the value that customers place on having access to alternative distribution channels.

Work is continuing to improve local market segmentation analysis in order to ensure that our retail network resources are more closely aligned with the needs of local markets and individual customers.

Treasury & Wholesale Banking

Abbey National Treasury Services ("ANTS") continued to pursue its overall objectives of managing liquidity, raising wholesale funding and capital through activity in the international capital markets, providing risk management services and generating a profit – predominantly through investing in high quality assets. ANTS is now a significant business in its own right, contributing 23% of Group profit and is capable of growing its earnings and delivering an acceptable return on equity into the future. ANTS has continued to diversify its earnings streams through the contributions of Cater Allen International Limited and Abbey National Financial Products and cautious, controlled development of a small portfolio of higher yielding bonds. It has also established a team which has participated in deals arising from the government's Private Finance Initiative.

Recent market conditions have presented opportunities, and ANTS has selectively invested in a range of high quality investment securities at historically attractive levels which are expected to deliver strong income streams for the future. At the same time, with a high quality balance sheet, strong credit ratings and negligible exposures to troubled economies, ANTS is helping to ensure the Group's continuing access to the international capital and money markets. In 1998, ANTS raised in excess of $19 billion in the international capital markets, maintaining liquidity for the Group throughout the year.

Life Assurance

The strategy for Abbey National's life assurance focuses on three key areas: providing a broad range of products to customers through their preferred distribution channel; implementing continuous improvement in customer service standards, and reducing costs – helped by the implementation of new administration and workflow systems. The life business operates from a single shared platform and Abbey National's success as a bancassurer comes from having a strong brand, large customer franchise and broad distribution.

Scottish Mutual increased its profit by 18% to £77 million, with significant new business volumes now being generated by Pegasus and Scottish Mutual International. Abbey National Life increased profit by 11% to £113 million (1997: £102 million), with a 17% growth in new premium income.

Abbey National is now firmly established as a UK top ten life and pensions provider in terms of new business. Since 1993, year on year compound growth of total new business premiums has been 36%. In keeping with its position as a leading bancassurer, Abbey National intends to become a major provider of ISAs, building on our success with PEPs and TESSAs.

Finance House

This segment consists of the Abbey National-branded unsecured personal loan book and the business of First National. First National operates as a separately branded entity within the Abbey National Group with a strong focus on distribution through intermediaries. This enables it to exploit a distinct brand image while, at the same time, enjoying the benefits of being part of a large, secure Group. Its vision is to be the leading Finance House in the UK and a significant step was taken towards achieving this aim with the acquisition on 30 December 1998 of three point-of-sale finance businesses from Natwest Group – effectively doubling the size of Abbey National's Finance House Division. These businesses have been re-named and include:

– First National Motor Finance – making First National the UK's leading provider of finance for the purchase of new and used vehicles;

– First National Tricity Finance – which enhances First National's presence in point-of-sale finance for home improvement by adding access to retail point-of-sale finance for furniture and electrical goods;

– First National Business Equipment Leasing – which strengthens First National's position in the small ticket leasing and sales-aid leasing markets.

It is intended that, during the planning cycle, the strong returns on capital enjoyed by the existing Finance House will be extended to the three new point-of-sale businesses – following the necessary investment in infrastructure within these businesses. Making the most of synergies available within the rest of the Group and changing business processes should also help to improve cost efficiency.

General Insurance

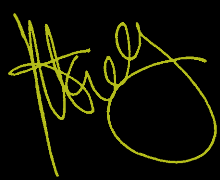
During 1998, Abbey National General Insurance continued to follow its strategy of broadening distribution channels and diversifying its product range with the launch in July of Abbey National's first motor insurance product. In 1998, investment in infrastructure and distribution has been significant. The Group now provides a full range of personal lines insurance products to savings and non-borrowing customers – this includes buildings and contents, travel, payment protection, healthcare policies and now motor insurance. Overall policy sales increased by 18% and sales to non-borrowers by 34%.

Wealth Management

Wealth management is a growing market which offers significant opportunities. Abbey National has not previously offered tailored products and services to customers with above average sums to invest. Our strategy is to increase earnings by expanding the Group's presence and capabilities in this market, both by attracting new business and by retaining and deepening our relationships with existing higher net worth customers. We will support this aim by building on our existing fund management, card issuance and banking capability.

In the offshore markets, Cater Allen's activities complement those of Abbey National, together offering a wide range of products from offshore bases in Jersey, the Isle of Man, Gibraltar, and through representatives in Hong Kong, Portugal and Dubai.

Onshore, Cater Allen Bank offers a range of products including a high interest cheque account, credit card, term deposits and multi-currency accounts which are sold through IFAs.



Ian Harley

Retail Banking

1998 was an excellent year for Abbey National Retail Banking. In a highly competitive market, profits have grown by 15% to £900 million. The announcement in September that we would open 20 new in-store units in Safeway stores highlights Abbey National's commitment to providing a wide range of channels through which customers can do business with us.

Abbey National provides Lego® tables for children to play with whilst their parents are doing business in the branch. Retail Banking has carried out a fundamental review to establish a new vision for the branch network. Using leading edge technology, each branch is being developed to best suit the needs of its local customer base.
A clear understanding of our customers gained at local level will help to improve the efficiency of the Group as a whole.

General Insurance

A landmark event for Abbey National's general insurance business was the launch in July of its first direct motor insurance product. This underlines the business's strategy of offering a full range of general insurance products via Abbey National branches and over the telephone. A special discount on the new motor insurance policy was offered to all Abbey National shareholders. Abbey National General Insurance continues to turn in a strong performance, generating profits of £98 million in 1998.

Life Assurance

Abbey National is a top ten life assurance and pensions provider, in terms of new business, with the central aim of providing financial security for all of its customers. Total premium income for the Life business as a whole rose to £2,523 million, an increase of 30%. This includes new business from Pegasus and Scottish Mutual International, which helped to boost the profit of the Life segment by 14% to £190 million.

Finance House

The acquisition of three point-of-sale consumer finance businesses in December effectively doubled the size of Abbey National's Finance House. In addition to its existing provision of finance for furniture, kitchens, bathrooms and vehicles, the acquisition means that Abbey National now offers finance for electrical consumer products at the point of sale. During 1998, Finance House achieved profits of £120 million and increased its assets to £9 billion.

Treasury & Wholesale Banking

In highly volatile world market conditions, Treasury & Wholesale Banking proved the strengths of its low-risk investment strategy with a 22% increase in profits to £361 million. Excluding the £31.6 billion of assets relating to Cater Allen International Limited, Treasury assets have grown to £53.3 billion. Assets owned by ANTS' big ticket leasing operation include trains, aeroplanes and satellites.

Wealth Management

Wealth Management Division provides products and services designed to help customers with substantial sums to invest to maximise the benefits of their assets. The Division includes the Group's offshore operations in Jersey, the Isle of Man, Gibraltar, Hong Kong and Dubai, as well as the onshore retail banking operations of Cater Allen, City Deal and Abbey National Independent Consulting Group (ANICG). In 1998, Wealth Management brought in profits of £26 million – this is a key growth area for the Group.

Operating and financial review

Overview of results

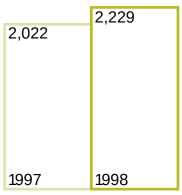
Abbey National's profit before tax increased by 19% to £1,520 million (1997: £1,279 million). Profit before tax and exceptional items increased by 9% to £1,588 million (1997: £1,452 million). Operating income grew 13% to £3,118 million, with cost growth of 10% to £1,285 million before exceptional items. The cost:income ratio improved to 41.2% (1997: 42.3%). Provisions for bad and doubtful debts increased by 66% to £201 million.

Abbey National has been relatively unaffected by pensions mis-selling. However, a charge of £21 million (1997: £19 million) has been made in respect of compensation for pension mis-selling and related administrative costs – primarily with regard to the proposed second phase of the Personal Investment Authority's review. Cumulative provisions for such costs since 1994 amount to £59 million.

Results of operations of the Group by nature of income and expense

Net interest income	1998	1997
Net interest income (£m)	**2,229**	2,022
Group net interest margin (%)	**1.61**	1.71
Average interest earning assets (£bn)	**135.1**	119.1
UK Retail Banking net interest spread (%)	**2.10**	1.99

Net interest income (£m)



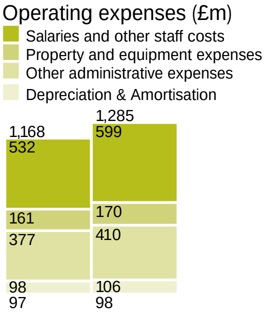
Net interest income increased by 10% to £2,229 million. Average interest earning assets grew 13% to £135.1 billion, reflecting the increase during 1998 in Treasury & Wholesale Banking investment assets, mortgage assets in UK Retail Banking and loan assets in Finance House. The Group net interest margin decreased by 10 basis points, mainly due to the impact of a higher proportion of Treasury assets in the balance sheet – offset partly by the higher margins achieved in UK Retail Banking. The UK Retail Banking net interest spread rose by 11 basis points despite continuing competitive pressures in the residential mortgage and liquid saving markets.

Commissions, fees & other income	1998 £m	1997 £m
Insurance income receivable	**249**	223
Other net fees and commissions receivable	**258**	228
Income from long term assurance business	**162**	149
Other operating income	**220**	138
Total	**889**	738

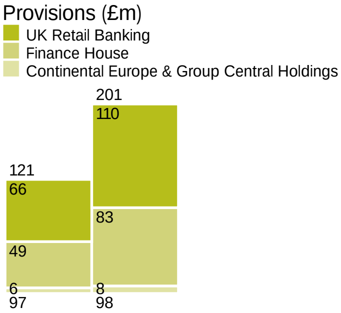
In total, commissions, fees and other income increased by 20% to £889 million. Insurance income increased by 12% to £249 million, reflecting increased sales to non-borrowing customers. Other net fees and commissions grew by 13% to £258 million, mainly as a result of increased banking income derived from the Abbey National Bank Account and Abbey National Credit Card and increased mortgage-related fee income. Income from long term assurance business increased by 9%, with growth in new business premiums from both Scottish Mutual Assurance and Abbey National Life. Other income rose 59% to £220 million, mainly reflecting the release of £39 million (1997: £12 million) deferred income to cover the relevant proportion of provisions on high loan-to-value (LTV) loans, and an additional £33 million (1997: £12 million) release made in respect of previous years' lending, where credit quality is such that the likelihood of further losses being incurred is considered remote. It also reflected the sale of Abbey National's Spanish operation and profit on sale of several properties.

Operating expenses	1998 £m	1997 £m
Salaries and other staff costs	**599**	532
Property and equipment expenses	**170**	161
Other administrative expenses	**410**	377
Depreciation and amortisation	**106**	98
Total	**1,285**	1,168

Operating expenses (£m)



Provisions (£m)



Total operating expenses increased by 10% to £1,285 million. Salaries and other staff costs increased by 13% to £599 million. The main components of this rise were: the impact of last year's pay round and other changes to the salary structure of the Group (7%); an increase of 935 (4%) in average full time equivalent headcount – most of which arose from a full year's service from ex-Cater Allen staff; around 200 new staff added as a result of the smaller acquisitions made by FNB Group earlier in the year, and a decrease in the amount of pensions surplus write-back.

Other administrative expenses rose £33 million to £410 million, largely reflecting increased ongoing investment in new products, as well as investment in distribution and customer systems. The Group cost:income ratio excluding exceptionals improved from 1997 to 41.2% (1997: 42.3%).

Provisions	**1998 £m**	1997 £m
Bad and doubtful debts		
UK Retail Banking	**110**	66
Finance House	**83**	49
Continental Europe	**4**	6
Group Central Holdings	**4**	–
Total	**201**	121
Contingent liabilities and commitments	**16**	16
Amounts written off fixed asset investments	**28**	3

Provisions for bad and doubtful debts increased by 66% from £121 million to £201 million in 1998.

The £44 million increase in UK Retail Banking related to increased provisions against UK residential mortgages. The results in 1997 benefited from favourable economic conditions which were not present in 1998.

Provisioning in the Finance House grew by £34 million to £83 million. The charge includes £57 million of provisions for Abbey National-branded unsecured loans (1997: £29 million) reflecting the strong asset growth over the last two years as well as increased arrears. Origination standards have been improved, loan collection activities enhanced and loan growth has slowed. Early arrears are now falling. The £26 million of FNB loan provisions (1997: £20 million) reflects asset growth of 3% during the year and growth in unsecured personal, motor and business finance asset in the past few years. No significant deterioration in arrears had been seen in these books.

All Treasury assets continue to perform fully. However, a prudent approach continues to be taken and £19 million has been added to provisions for amounts written off fixed asset investments during the year. The remaining £9 million in provisions for amounts written off fixed asset investments equates to the loss incurred in disposing of our one-third share in Travelex.

Taxation	**1998**	1997
Tax on profit on ordinary activities (£m)	**462**	326
Effective tax rate before the impact of exceptionals (%)	**30.4**	32.5

The tax charge for 1998 of £462 million (1997: £326 million) was 30.4% of profit before tax, following the fall in the rate of corporation tax.

UK Retail Banking

	1998 £m	1997 £m
Net interest income	**1,426**	1,335
Commissions, fees and other income	**360**	239
Operating expenses	**(768)**	(711)
Provisions for bad and doubtful debts	**(110)**	(66)
Provisions for contingent liabilities and commitments	**(8)**	(11)
Profit before tax and exceptional items	**900**	786
Cost:income ratio	**43.0**	45.2
Market share of increase in UK personal liquid savings (%)	**4.8**	3.5
Market share of UK personal liquid savings stock (%)	**8.9**	9.2
Market share of increase in UK mortgages outstanding (%)	**5.9**	3.3
Market share of UK mortgage stock (%)	**13.6**	14.1

UK Retail Banking increased its profit before tax and exceptional items by 15% to £900 million.

Net interest income increased by 7% to £1,426 million. Despite competitive pressure in traditional markets, the spread between UK Retail Banking's average lending rates and average funding rates increased from 1.99% at 31 December 1997 to 2.10% at 31 December 1998. This has resulted in an increase in the UK Retail Banking net interest margin to 2.39% (1997: 2.28%).

Commissions, fees and other income grew by 51% to £360 million as a result of increased personal banking activity, driven by an expanded bank account and credit card base, an enlarged ATM network and income from mortgage activity, including administration fees generated by strong fixed rate mortgage business. Abbey National now has: 1.86 million bank accounts (1997: 1.68 million), over 54% of which are customers' primary accounts; 675,000 Instant Plus accounts (1997: 556,000); nearly 2.2 million debit cards (1997: 1.8 million), and 507,000 (1997: 457,000) credit card accounts in operation. The increase in other income also reflected the release of £39 million (1997: £12 million) of deferred income to cover the relevant proportion of provisions on high LTV loans, and an additional £33 million (1997: £12 million) release made which relates to the lending of certain previous years where credit quality is such that the likelihood of further losses being incurred is considered remote.

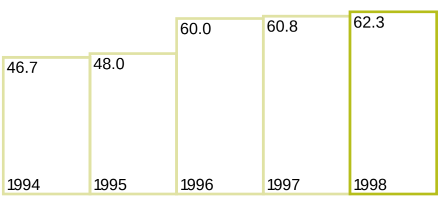
Operating expenses rose by 8% to £768 million (1997: £711 million). Excluding normal inflationary salary increases, the growth in expenditure is mainly linked to ongoing investment in new products, distribution and customer systems, in particular our telephone network. The cost:income ratio improved to 43.0% (1997: 45.2%).

The provisions charge was £110 million, with £56 million (1997: £12 million) relating to residential mortgages. Since the end of 1997, the number of mortgages six months or more in arrears has increased from 14,692 to 17,122 – reflecting, to some extent, the number of recent rate changes where lower monthly repayments result in an increase in the number of months' arrears on individual cases. The average provision for capital losses and interest arrears for a repossessed property under offer has fallen from £5,330 at 31 December 1997 to £4,420 at 31 December 1998. The stock of repossessed properties fell by 1% from 1,908 in December 1997 to 1,883 at 31 December 1998. Repossessions during 1998 decreased by 6% to 4,944 cases (1997: 5,272 cases).

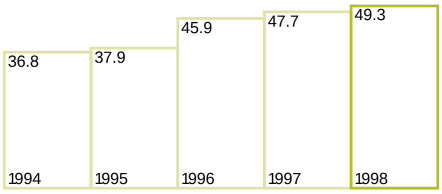
Provisions charges against overdrafts and credit cards increased to £56 million (1997: £54 million), representing 11% of asset (1997: 13%). At the year end, Abbey National's credit card asset was £282 million (1997: £234 million), while the overdraft asset has grown from £197 million to £233 million in 1998.

As at 31 December 1998, Abbey National had a UK mortgage asset of £62.3 billion (31 December 1997: £60.8 billion), an estimated 13.6% market share. The £1.5 billion increase in the year represents an estimated 5.9% (1997: 3.3%) market share of the increase in UK mortgages outstanding. This reflects an estimated 12.1% (1997: 11.7%) share of gross mortgage lending amounting to £10.9 billion, and an estimated 14.6% (1997: 15.4%) market share of mortgage capital repayments (equating to £9.4 billion).

Abbey National UK residential mortgage asset (£bn)



Abbey National UK retail savings liability (£bn)



As at 31 December 1998, Abbey National had retail liabilities of £49.3 billion (31 December 1997: £47.7 billion), an estimated 8.9% share of the total UK personal liquid savings stock. Abbey National enjoyed a £1.5 billion net inflow of liquid savings during the year (1997: £1.3 billion). This represents an estimated 4.8% (1997: 3.5%) market share of the increase in UK liquid savings, reflecting the continued success of the Abbey National Bonus Postal Account and the direct savings account with Safeway and, in part, the successful integration of the Cater Allen businesses together with the success of retention strategies aimed at customers with maturing accounts. In addition, Abbey National PEPs, unit trusts and investment bonds have attracted £801 million of new business premiums (1997: £680 million), the majority of which came from Abbey National savings accounts, indicating changing customer preferences towards longer term savings products. Continued success in cross-selling these products has been a key driver behind the growth in Abbey National Life.

Treasury & Wholesale Banking

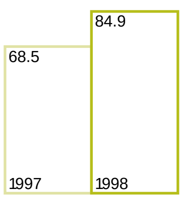
	1998 £m	1997 £m
Net interest income	**399**	282
Commissions, fees and other income	**67**	79
Operating expenses	**(86)**	(63)
Amounts written off fixed asset investments	**(19)**	(1)
Profit before tax and exceptional items	**361**	297
Assets (£bn):		
Investment assets	**47.7**	44.8
Trading book	**5.6**	7.6
Cater Allen International Limited	**31.6**	16.1
Total	**84.9**	68.5

In 1998, Treasury & Wholesale Banking profit before tax and exceptional items was 22% higher than in 1997 at £361 million. The increase in profit principally reflected growth in a diversified portfolio of investment assets and a full year of Cater Allen International Limited's (CAIL) profits. CAIL's assets grew to £31.6 billion. The integration of CAIL has progressed well and the business as a whole has started to enjoy the benefits of synergies which exist between the respective wholesale money market operations.

Net interest income within Treasury & Wholesale Banking increased 41% to £399 million, reflecting the increased size of the balance sheet and the benefit of a full year's operating income from CAIL.

Commissions, fees and other income within Treasury & Wholesale Banking decreased 15% to £67 million (1997: £79 million). The weakness in global markets, particularly in the autumn, affected dealing profits with adverse market movements mitigated in part by the decision to continue reducing the level of trading securities. Nevertheless, there was a strong performance from other trading activities, and as a result, trading profits only fell £9 million to £42 million. The trading securities portfolio fell from £7.6 billion at 31 December 1997 to £5.6 billion at 31 December 1998. Taking advantage of the attractive levels available in the latter part of the year, investment assets have increased by £2.9 billion in 1998. The overall credit quality of Treasury's exposures was maintained, with exposures rated AA- or better representing over 70% of total credit exposures at 31 December 1998.

Treasury & Wholesale Banking total assets (£bn)



Operating expenses increased by £23 million to £86 million. This reflects the inclusion of a full year of CAIL and other Cater Allen costs of £9 million, plus increased systems spend and associated headcount increases within core Treasury businesses to generate new income streams and to ensure smooth implementation of new back office systems. The cost:income ratio increased to 18.5% (1997: 17.5%).

All Treasury assets have continued to perform. However, a prudent approach has been taken in relation to potential credit risk and therefore, given the growth in investment assets, £19 million has been added to provisions for amounts written off fixed asset investments during 1998.

Treasury & Wholesale Banking has continued to raise funding in the international capital markets at favourable rates, raising public debt securities totalling US$19 billion, of which over one tenth was denominated in euro or ECU.

Life Assurance

	1998 £m	1997 £m
Profit before tax and exceptional items		
Abbey National Life*	**113**	102
Scottish Mutual**	**77**	65
Total	**190**	167
Annualised premium income		
Abbey National Life*	**136**	129
Scottish Mutual**	**224**	172
Total	**360**	301
New business premiums		
Abbey National Life*	**851**	727
Scottish Mutual**	**1,672**	1,212
Total	**2,523**	1,939

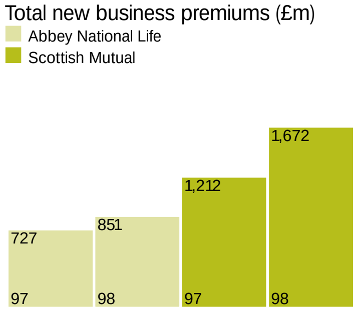
*including Abbey National Unit Trust Managers and Abbey National PEP Managers
**including Pegasus, Scottish Mutual International and Scottish Mutual Portfolio Managers

Life Assurance increased profit before tax and exceptional items by 14% to £190 million as a result of growth in business volumes in a strong market. Life and pensions business in the IFA market continues to be highly competitive and as a result margins have tightened. Funds under management increased from £10.5 billion at 31 December 1997 to £13.8 billion at 31 December 1998.

Abbey National Life increased pre-tax profits before exceptional items by 11% to £113 million (1997: £102 million). Annualised premium income increased by 5% to £136 million and total new business premium income increased by 17%. Sales of PEPs and unit trusts grew significantly in 1998, generating £664 million of premium income, representing a 7.7% market share of net new business sales. The sale of non mortgage-related investment, pensions and protection products to UK Retail Banking customers accounted for 78% of policies sold. These policies represent a major component of the Abbey National Life product offering.

Scottish Mutual increased pre-tax profits before exceptional items by 18% to £77 million (1997: £65 million). Annualised premium income increased by 30% to £224 million, and total new business premium income increased by 38%. Scottish Mutual has continued to diversify its product range and target markets, with significant new business volumes now being generated by Pegasus and Scottish Mutual International – an offshore company based in Dublin's International Financial Services Centre, which sells predominantly into the UK and Continental European markets.

Total new business premiums (£m)



Finance House

	Abbey brand £m	FN brand £m	Total 1998 £m		Abbey brand £m	FN brand £m	Total 1997 £m
Net interest income	**96**	**241**	**337**		81	224	305
Commissions, fees and other income	**23**	**(15)**	**8**		16	(12)	4
Operating expenses	**(36)**	**(106)**	**(142)**		(35)	(92)	(127)
Provisions	**(57)**	**(26)**	**(83)**		(29)	(20)	(49)
Profit before tax and exceptional items	**26**	**94**	**120**		33	100	133
Net loan assets*							
Unsecured	**1,225**	**755**	**1,980**	1,741	1,138	622	1,760
Motor Finance	**–**	**590**	**590**	2,165	–	557	557
Business Finance	**–**	**500**	**500**	208	–	335	335
Secured	**–**	**1,728**	**1,728**	–	–	1,924	1,924
Total	**1,225**	**3,573**	**4,798**	4,114	1,138	3,438	4,576

*figures given are before the acquisition of three point-of-sale businesses bought on 30 December 1998. The assets acquired with these businesses are shown in black.

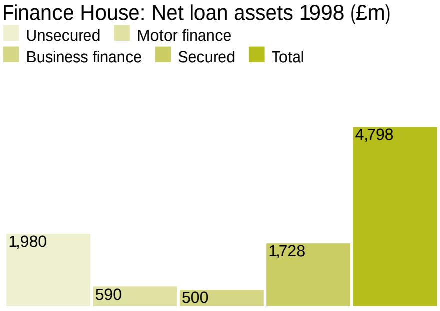
Finance House profit before tax and exceptional items fell 10% to £120 million. However, profit before provisions increased 12% to £203 million. Total income in the Finance House increased 12% to £345 million supported by 16% growth in net unsecured lending, motor and business finance assets since 31 December 1997 to £3.1 billion. Assets at 31 December 1998 were £8.9 billion, including £4.1 billion of point-of-sale finance assets acquired on 30 December 1998 from NatWest Group. Operating expenses increased 12% to £142 million, reflecting the cost of new business and acquisition and infrastructure investment. Provision charges increased £34 million to £83 million, and as a result, profit before tax and exceptional items fell 10% to £120 million. The cost:income ratio was 41.3% (1997: 41.1%).

Total income in the Abbey National-branded unsecured loan business increased 23% to £119 million with profit before tax and provisions increasing 34% to £83 million. However, provisions increased by £28 million, leading to a fall in profit before tax of £7 million to £26 million. Much of the increase in provisions can be attributed to the lag effect of the build up of the book in 1996 and 1997. Early action was taken to increase score card cut-offs, reassess target customer segments and enhance collection activities and processes. As a result, growth in asset was reduced to 8% (1997: 25%), particularly in the final quarter of 1998.

Total income in the First National Group increased 7% to £226 million. Net interest income increased by 8%, with 21% growth in net unsecured lending (to £755 million) and 6% growth in motor finance loan assets (to £590 million) since 31 December 1997. Operating expenses increased by 15% to £106 million, reflecting the cost of acquiring and integrating new businesses, with profit before tax and provisions unchanged. Provisions increased by £6 million to £26 million, reflecting unsecured loan asset growth.

Motor Finance assets increased by 6% to £590 million reflecting strong organic growth. The Business Finance area was strengthened during the first half of 1998 by the acquisition of TSB Factors Limited (now re-named First National Invoice Finance) and State Securities Plc (a small ticket leasing company). Secured lending activity includes second mortgage loans by FNB, and the centralised mortgage portfolios of Abbey National Mortgages and HMC. Gross lending under the HMC brand increased 154% from £50.6 million in 1997 to £128.4 million in 1998.

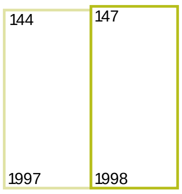
Finance House: Net loan assets 1998 (£m)



General Insurance

	1998 £m	1997 £m
Net interest income	**(5)**	(3)
Commissions, fees and other income	**147**	144
Operating expenses	**(44)**	(36)
Profit before tax and exceptional items	**98**	105

General insurance commissions, fees and other income (£m)



General insurance profit before tax and exceptional items fell 7% to £98 million. However, in 1998, costs of developing new operations were £4 million higher than the previous year. In 1997, costs benefited from an £8 million contribution received from the other party to the joint venture relating to costs incurred in setting up a direct operation. As a result, underlying profit from continuing activities before tax and exceptional items actually increased 5% to £102 million (1997: £97 million). Insurance income grew 2% to £147 million, reflecting increased non mortgage-related sales (particularly sales of contents policies) and the benefits arising from the joint venture arrangements on the household and creditor portfolios. Total policy sales increased 18% to 214,000 with a 34% increase in sales to non-borrowers.

Wealth Management

	1998 £m	1997 £m
Net interest income	**47**	23
Commissions, fees and other income	**38**	31
Operating expenses	**(58)**	(39)
Amounts written off fixed asset investments	**(1)**	(1)
Profit before tax and exceptional items	**26**	14

Wealth Management profit before tax and exceptional items increased 86% to £26 million. This reflects strong growth in retail deposits in 1998, both onshore and offshore, and a full year's contribution from the various Cater Allen businesses acquired in 1997.

During 1998, the offshore business successfully assimilated the Cater Allen banking, investment management, stockbroking and trust company businesses.

Continental Europe

	1998 £m	1997 £m
Underlying business:		
Spain (1998: 4 months)	**(2)**	(10)
France	**(11)**	(14)
Italy	**–**	(2)
Underlying loss before tax	**(13)**	(26)
Profit arising from the sale of Spanish operation	**13**	–
Loss before tax and exceptional items	**–**	(26)

Continental Europe's pre-tax loss fell from £26 million in 1997 to £13 million in 1998, helped by the improved £2 million operating loss in the four months prior to the disposal of the Spanish operation in May 1998 (1997: loss £10 million).

Group Central Holdings

	1998 £m	1997 £m
Central Services	**(119)**	(109)
Financial Holdings	**18**	67
Non-core businesses	**(6)**	18
Loss before tax and exceptional items	**(107)**	(24)

Group Central Holdings comprises Central Services, Financial Holdings (which contains the earnings on the difference between the Group's statutory capital and the target regulatory capital allocated to segments) and the results of certain small non-core businesses. In Financial Holdings, greater utilisation of regulatory capital in the operating businesses during 1998 reduced the available surplus regulatory capital – thereby reducing profit in the segment. In the non-core businesses, the 1997 results benefited from a one-off profit arising from investment activities.

Development of the business

Investment for the future

The following major steps have been taken to enhance future results.

On 30 December 1998, Abbey National acquired three point-of-sale businesses from NatWest Group. These have significantly enhanced the existing Finance House businesses – most notably in the areas of motor finance, retail point-of-sale credit and small ticket 'sales aid' leasing as indicated in the chart below:

Type of business	Market share (%)	Market position
Home improvement p.o.s.	72	1st
Motor finance (used)	14	1st =
Retail p.o.s. credit	27	1st =
Small ticket 'sales aid' leasing	15	2nd =

Significant investment has been undertaken in updating and introducing new systems. This has included introducing:
– image, workflow and new administration systems in Scottish Mutual and Abbey National's processing centres;
– infrastructure spend on a new computer network, PC desk top environment and loan accounting in FNB;
– the move to low-cost, centralised distribution for larger dealer groups in FNB;
– replacement of the core back office system in Treasury;
– introduction of a customer administration system to facilitate segmentation across the customer database.

The improvement in the cost:income ratio during 1998 indicates that investment and associated activity is beginning to have a positive impact on the business.

Capital expenditure to 31 December 1998 amounted to £111 million (1997: £187 million). This included £17 million of expenditure relating to branch modernisation and maintenance, and £19 million relating to mortgage centres and other property expenditure. Of the remaining capital expenditure £62 million relates to computer infrastructure and ATM investment, £3 million to cars for the motor finance business, and £10 million to other asset categories.

Return to shareholders

Abbey National believes that the best overall measure of Group performance is total return to shareholders (TSR), which equates to gross dividends paid plus the movement in the share price over time. Share price for any given year is defined as the average of daily share prices. In 1998, TSR achieved was 37%, ranking Abbey National 29th in the FTSE 100. Since 1989, annualised TSR achieved has been 31%, the best performance among the FTSE 100 companies at the time of Abbey National's flotation. At the end of 1998, the Company had a market capitalisation of £18.2 billion supported by an 18% increase in share price to 1287 pence and ranked as the 15th largest UK quoted company and 12th largest European bank on this measure. Executive remuneration via the Long Term Incentive Plan is also based on TSR performance of the Company relative both to specified financial institutions and the constituents of the FTSE 100.

Abbey National's internal financial measures to evaluate plans and to monitor performance are closely aligned with shareholder value creation. The main measures used internally are 'value based cash flow' and 'profit after regulatory equity charge' ('PAREC'). Value based cash flow (profit attributable to ordinary shareholders less the additional regulatory equity required to support the business) was £528 million in 1998, down from £551 million in 1997, largely as a consequence of increased Treasury assets. PAREC (profit after tax less a notional charge for average Group equity capital) grew 14% in 1998 to £568 million, reflecting the increase in the post-tax return on average ordinary shareholders' equity from 21.3% to 22.0%.

In 1998, earnings per share increased by 11% to 72.4 pence per share. Ordinary dividends of (35.30 pence) are payable to shareholders and are covered 2.0 times by earnings (1997: 2.1).

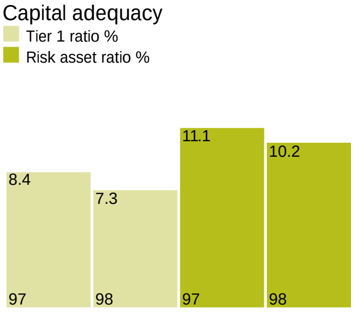
Capital management

Abbey National continues to increase shareholder value by active management of its capital resource and will continue to explore capital and balance sheet management opportunities. Its capacity to securitise assets was demonstrated in early 1998 and again in February 1999. In December 1998, ANTS sponsored a US$5 billion asset backed commercial paper programme principally issued by Moriarty Limited, which invests in a wide range of asset backed securities. This adds flexibility to ANTS' balance sheet and represents a further avenue for the management of capital. As at 31 December, the commercial paper assets stood at US$1.6 billion. Abbey National will continue to manage its balance sheet gearing and is reviewing the impact of tax efficient tier 1 capital. The Group will continue to monitor its capital efficiency to ensure that appropriate levels of capital are allocated to each of the business segments.

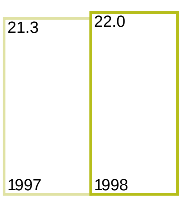
Abbey National's risk asset ratio remains comfortably above the minimum standards for the Group set by the Financial Services Authority. Following the acquisition of the three point-of-sale finance businesses on 30 December 1998, the equity tier 1 ratio is 6.7%. Management's objective is to use the strong capital generation of its business to restore the equity tier 1 ratio to around 7.25% by the end of the year 2000. Going forward, Abbey National intends to continue to balance the interests of shareholders and debt holders in determining the capital resources required for the business.

The Board has assessed the existing dividend policy in the light of the Group's capital requirements for the current planning cycle and, based on current plans, believes that stronger returns can continue to be achieved by retaining capital in the business, rather than returning it to shareholders. This is underlined by the fact that post-tax return on average ordinary shareholders' equity increased to 22.0% (1997: 21.3%). If future plans do not envisage value-creating organic growth or acquisition opportunities, the Board would then consider returning surplus capital to shareholders, but only if at least £500 million could be returned over a 12 to 18 month period. Confidence in the business is reflected in the 15% increase in the dividend.

Capital adequacy



Post-tax return on average ordinary shareholders' equity (%)



Capital resources

The basic instruments of capital monitoring are the risk asset ratio, which compares total regulatory capital to total risk weighted assets, and the tier 1 capital ratio. As at 31 December 1998, the Group's risk asset ratio was 10.2% (31 December 1997: 11.1%) and the tier 1 ratio was 7.3% (31 December 1997: 8.4%). The reduction in the ratios reflected 23% growth in risk weighted assets and the goodwill incurred on acquisitions, partly offset by retained earnings and, in the case of the risk asset ratio, the issue of new subordinated capital securities. The equity tier 1 ratio, which excludes preference shares, fell to 6.7% (1997: 7.6%).

Capital resources	1998 £m	1997 £m
Tier 1 capital	**5,205**	4,878
Tier 2 and Tier 3 capital	**3,146**	2,500
less supervisory deductions	**(1,107)**	(947)
Total regulatory capital	**7,244**	6,431
Total risk weighted assets:		
Banking book	**67,489**	54,680
Trading book	**3,787**	3,297
	71,276	57,977
Capital ratios:		
Risk asset ratio	**10.2%**	11.1%
Tier 1 ratio	**7.3%**	8.4%
Equity tier 1 ratio	**6.7%**	7.6%

Abbey National's tier 1 capital (ordinary and preference shareholders' funds after deducting goodwill), increased by £327 million to £5,205 million (31 December 1997: £4,878 million). The main elements of this increase were £523 million of retained earnings less an increase in goodwill of £213 million, £167 million of which was incurred in the purchase of the three point-of-sale finance businesses from NatWest Group. There was an increase in tier 2 capital (subordinated liabilities and general provisions) of £646 million, including the issue of DM 1 billion of dated subordinated debt and US$500 million of perpetual subordinated capital securities. Supervisory deductions mainly represent investments in life assurance and insurance companies within the Group.

Balance Sheet

Total assets increased by 18% to £177.8 billion in 1998. This growth of £27.0 billion was primarily funded through the wholesale debt markets, £8.3 billion of this growth resulted from increased stock borrowing and lending business by Cater Allen International Ltd. As at 31 December 1998, wholesale liabilities represented 57% of total liabilities. The percentage of UK mortgage assets funded from retail savings has been maintained at 80% (31 December 1997: 80%). The assets acquired in the three point-of-sale consumer finance businesses at 30 December 1998 of £4.1 billion were included in these figures.

Financial risk management

Abbey National's financial risk management focuses on the major areas of credit risk, market risk and liquidity risk.

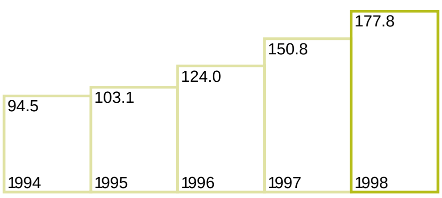
Abbey National has a well developed structure for managing financial risk, which consists of a comprehensive set of committees. Of these, the principal committees are the Assets and Liabilities Committee (ALCO), which is charged with the responsibility of monitoring and controlling the level of Group structural balance sheet risk, and the Group Credit Committee (GCC) which monitors and reviews credit risk exposures and approves Group credit policies. There are further risk and credit committees in each major business area which report into Group committees.

Credit risk

Credit risk is the risk that counterparties will not meet their financial obligations, which may result in Abbey National losing the principal amount lent, the interest accrued, and any unrealised gains (less any security held). Credit risk occurs mainly in the Group's loan and investment assets, and in derivative contracts.

In UK Retail Banking, a national mortgage lending policy is applied, supported by a number of processes (including credit scoring) which enhance the ability to manage and monitor the credit quality of mortgage assets, to manage arrears and collections and to optimise the values raised from properties in possession. For the bank account and credit card, behavioural scoring is used for both the granting of additional credit facilities and for card and overdraft renewals. Behavioural scoring is also being used to focus collections activity.

Total assets (£bn)



In Finance House, all applicants go through an application process which involves the use of credit reference agencies, fraud detection systems, and credit scoring (or behavioural scoring if the applicant has a bank account). Where appropriate, applicants are referred to underwriters for subsequent investigation and review before a final decision is made. After an application has been accepted, performance monitoring is carried out to ensure the overall credit assessment meets the original risk criteria. All Finance House balances which are in default are subject to arrears management in order to manage the account out of default, or collections activity in order to minimise the level of write-off.

In ANTS a clear set of credit mandates and policies has been established, designed to ensure that a substantial majority of credit exposure is rated AA- or better. Analyses of credit exposures and credit risk trends are provided in summary to the ANTS board each month, and in detail each quarter. Large exposures (as defined by the Financial Services Authority (FSA)) are reported monthly internally, and quarterly to the FSA.

Market risk

Market risk is the risk of financial loss arising from adverse price movements associated with the interest rate, foreign exchange and equity markets. The most significant sources of market risk arise in Treasury & Wholesale Banking as a result of investment, trading, funding and derivatives activities, and in UK Retail Banking, primarily from the provision of fixed rate and structured mortgage and savings products.

Abbey National recognises that market risk is an inevitable result of being an active participant in financial markets. The Group manages its exposure by limiting the adverse impact of market movements on profitability while seeking to enhance earnings within clearly defined parameters. Abbey National ensures that business areas have sufficient expertise to manage the risks associated with their operations, and to devolve the responsibility for risk management. Within this framework, policies, limits and mandates are established and monitored by ALCO each month as well as at business area market risk committees.

In measuring exposure to market risk, all business areas use a sensitivity analysis approach as a common tool within their risk management process. This measures the potential change in the value of assets and liabilities, (including derivatives), resulting from the statistically determined potential adverse movement in a range of risk factors that can be expected over a selected period of time and within a defined level of confidence. Other approaches such as Value At Risk and stress testing are used as additional risk management tools as appropriate to individual business areas. Management have recognised the different characteristics of market risk exposures across the Group, and that different risk measures are required to best reflect the risks faced in different types of business activities.

Treasury & Wholesale Banking, which includes both trading and non-trading portfolios, is primarily exposed to short term changes in liquid markets. The risk sensitivity is calculated by applying the statistically determined potential of adverse movements in market rates that can be expected within a 95% level of confidence as a result of overnight market movements. For more complex interest rate products entered into by Treasury & Wholesale Banking, risk exposures are calculated using several alternative models. Where exposures thus calculated differ significantly from approved models, a provision is made for the greatest exposure for monitoring and reporting purposes.

Other business areas, including UK Retail Banking, involve only non-trading activities and have a structure of assets and liabilities which are generally exposed to market movements over a longer time horizon. The risk sensitivity is calculated by applying the statistically determined potential of adverse movements in market risk factors that can be expected within a 99% level of confidence as a result of market movements over a one month time horizon. Within the Life Division, market risk arises on the returns from the long term assurance funds. The risk is managed within a framework of mandates delegated to the Life Assurance Boards.

The following table shows the sensitivity based exposures for the major risk classes run by all Group companies as at 31 December, 1998, together with the highest, lowest and average exposures for the year. It should be noted that due to the range of possible modelling techniques and assumptions and their statistical nature, these measures are not precise indicators of expected future losses but are estimates of the maximum foreseeable change in the value of the portfolio over a specified time horizon and within a given confidence level.

From time to time, losses may exceed the amounts stated where movements in market rates fall outside the statistical confidence interval used in the calculation of the sensitivity analysis. The Group addresses this risk by monitoring stress testing measures across the different business areas as appropriate, and by calculating the sensitivity measures on a prudent basis without making any allowance for correlation between risk classes.

The figures below are based upon overnight market movements within a 95% level of confidence for trading instruments, and market movements over a one month time horizon within a 99% level of confidence for non-trading instruments.

			Exposure for the year ended 31 December					
	Exposure as at 31 December		Average exposure		Highest exposure		Lowest exposure	
	1998 £m	1997 £m	1998 £m	1997 £m	1998 £m	1997 £m	1998 £m	1997 £m
Trading instruments								
Interest rate risk	1.4	0.7	1.1	0.7	1.8	1.7	0.6	0.4
Other risk	11.5	6.4	6.7	7.5	11.6	9.2	4.3	1.7

Other risks include yield curve risk, basis risk, volatility risk and spread risk.

Non-trading instruments								
Interest rate risk	27.0	48.4	27.5	62.8	61.0	91.6	14.3	46.9
Foreign exchange risk	2.6	1.6	2.9	2.2	3.8	3.8	2.2	1.6
Basis risk	1.7	3.2	2.6	3.9	3.5	4.3	1.7	3.2

Liquidity risk

Liquidity risk arises across the Group balance sheet. Liquidity is managed on behalf of the Group by ANTS in accordance with policy guidelines set by the Board and monitored by ALCO. This policy is reviewed annually and is in compliance with the FSA's 'Sterling Stock Liquidity' framework. Abbey National views the essential elements of liquidity management as controlling potential cash outflows, maintaining prudent levels of highly liquid assets and ensuring that access to funding is available from a diversity of sources. These elements are underpinned by a comprehensive management and monitoring process. ANTS management focuses on cashflow planning and day-to-day cashflow control, and on balancing the maturity profiles of ANTS' liquid assets and wholesale funding to ensure Group funding and liquidity ratios are adequate. Abbey National's liquidity position is reported to the FSA on a monthly basis.

Derivatives

Derivatives are important risk management tools for financial institutions and their customers. Derivatives are used by Abbey National for trading purposes within Abbey National Financial Products and ANTS, and for non-trading purposes in order to match or eliminate risk from potential movements in market rates inherent in the Group's non-trading assets, liabilities and positions.

For a more detailed description of the Group's use of derivatives, financial disclosures and accounting policy, see pages 61 and 89 to 92 of the Accounts respectively.

Year 2000 and EMU

Year 2000

Historically, most computer systems and equipment with embedded chips or processors have tended to rely on two rather than four digits to define a specific year. This has created the risk that, from 1 January 2000, dates could be treated by computer systems as dates in the 1900s. If systems calculate, compare or sort using the incorrect date, the resulting errors could lead to a range of problems such as inaccurate or incomplete transaction processing or even system failure. The potential risks associated with these events could include business interruption or shutdown, financial loss, reputational loss and legal liability.

In 1996, Abbey National recognised the need for a co-ordinated approach throughout the Group to address the Year 2000 issue and established a Steering Group with senior representatives from all major business units reporting directly to the Board of Abbey National plc. The Steering Group includes both internal officers and external consultants, providing functional expertise and independent oversight of the initiative. This Group is supported by a Group Programme Office which monitors the progress of the ten major sub-programmes which together ensure coverage of the Abbey National Group's entire portfolio of systems.

The Group's action plan comprises five stages:
1 documenting an inventory of all systems;
2 assessing the Year 2000 impact;
3 identifying solutions;
4 taking remedial action and testing to ensure compliant operation; and
5 testing interfaces and final compliance testing.

Plans address the compliance of major IT applications and infrastructure, end user systems and embedded chip technology as well as the Group's dependency on suppliers of critical IT and non-IT goods and services. The Group has fully completed the first three stages and is well advanced in renovating and testing all its systems, with a planned completion date of June 1999. Work is also under way with the final phase of the programme in which Treasury has conducted interface and final compliance testing on critical systems, and UK Retail Banking has tested interbank interfaces including BACS, CREST, and IBDE.

Management believes that the activities it is undertaking in the Year 2000 project should satisfactorily resolve Year 2000 compliance exposures within systems throughout the Group, and that no critical systems are at risk of failing to meet Year 2000 compliance deadlines.

The Year 2000 programme in the three point-of-sale finance businesses acquired from NatWest Group in December 1998 is progressing well. Progress will be overseen and monitored by the Abbey National Group Programme Office.

Abbey National already has a range of contingency plans in place primarily aimed at recovering from loss of workplace and providing computer standby facilities. However, the Board recognises that the Year 2000 issue presents a number of unique threats to businesses in general and there is a need for specific contingency arrangements. To this end, a Group-wide review and update of Business Continuity Plans is in progress and is scheduled to be completed by June 1999. The review methodology will identify and evaluate risks, develop solutions and test the solutions prior to implementation.

Management believes that the Group's plans significantly reduce the risk of a Year 2000 issue serious enough to cause business disruption. One of the major concerns across the industry is the perceived risk of loss of supply from utility companies caused by Year 2000 failures. The Group is, however, mitigating this risk by maintaining close contacts with utility companies both direct and via the BBA. Furthermore, current contingency plans will provide Abbey National's major sites with a continuous power supply for a number of weeks in the case of failure. Customer demand for banking services is likely to be increased immediately prior to and after the 1999 year end, and Abbey National's contingency planning includes volume sensitivity analysis in liaison with industry associations including APACS.

Economic and Monetary Union

Abbey National recognises that a single currency zone presents opportunities and risks to Abbey National regardless of whether or not the UK joins EMU.

The task of preparing for EMU represents a major commitment for the Group. During 1997 and 1998, an EMU Steering Committee, comprising key executive directors of the Group, directed and oversaw preparations made for both the launch of EMU and for the possibility of UK entry into EMU in the future. The UK government has declared itself in favour of EMU entry in principle and the Group continues to prepare for this possibility.

The areas of the Group which are directly affected by EMU are divisions and subsidiaries operating in a participating country or in the wholesale markets. All these businesses completed their EMU preparations in time for the opening of the financial markets on 4 January 1999. ANTS and the Investments and Finance Divisions of ANFIS are making payments in euro which were originally due in legacy currencies and are able to receive euro for subsequent sales of investments. EMU represents a major funding opportunity for ANTS and in 1999 it has already raised 2 billion euro in these markets. The Group's Wealth Management Division has launched a series of euro products for personal customers both offshore and onshore.

Analysis of Year 2000/EMU Spend

The total expected cost of achieving Year 2000 and EMU compliance is £144 million in the years 1997-2001. £134 million is allocated to Year 2000 and £10 million to EMU. These figures include the direct costs of internal resources such as salaries and premises.

Total projected spend on the Year 2000 and EMU projects is broken down below. The figures for EMU do not take into account any costs that are likely to be incurred should the decision be taken by the UK to join the euro. Also provided is an analysis of the actual spend to date by expense category and business segment.

Total project spend to end-2001 (£ million)

	Capital	Revenue	Internal	Total
Year 2000	20	96	18	134
EMU	2	7	1	10
Total	22	103	19	144

Analysis of Year 2000/EMU spend

	Other income	Operating expenses	Total revenue expenditure	Capital expenditure	Total
1998 full year (£m)					
UK Retail Banking	–	41	41	2	43
Treasury & Wholesale Banking	–	2	2	2	4
Life Assurance	7	–	7	1	8
Finance House	–	1	1	1	2
General Insurance	–	4	4	–	4
Wealth Management	–	1	1	–	1
Continental Europe	–	4	4	–	4
Group Central Holdings	–	8	8	–	8
	7	61	68	6	74
1997 full year* (£m)					
UK Retail Banking	–	21	21	12	33
Treasury & Wholesale Banking	–	–	–	–	–
Life Assurance	2	–	2	–	2
Finance House	–	–	–	–	–
General Insurance	–	1	1	–	1
Wealth Management	–	–	–	–	–
Continental Europe	–	4	4	1	5
Group Central Holdings	–	–	–	–	–
	2	26	28	13	41

*All costs incurred in second half of 1997

The Board
Chairman and Executive directors

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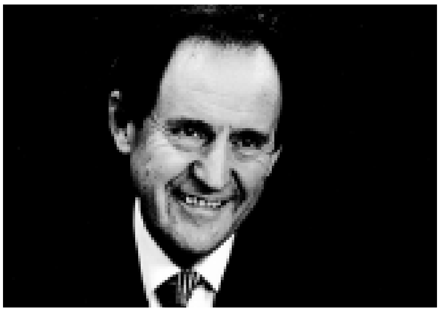
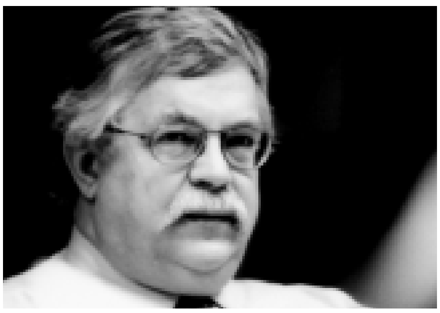




Chairman

1. The Lord Tugendhat*

Lord Tugendhat was appointed as joint Deputy Chairman in June 1991 and as Chairman in July of the same year. He is also Chairman of Blue Circle Industries PLC, a non-executive director of Eurotunnel plc and Rio Tinto PLC, and Chancellor of Bath University. Formerly a Member of Parliament and a vice-president of the European Commission, he has also served as Chairman of the Civil Aviation Authority and the Royal Institute of International Affairs. Aged 62.

Executive directors

2. Ian Harley FCA FCIB*
Chief Executive

Ian Harley was appointed Finance Director in 1993 and Chief Executive in March 1998. He began his career with Touche Ross & Co and joined Abbey National as a Financial Analyst from Morgan Crucible Ltd in 1977. He has since held various appointments including management positions in the Finance Division; Regional Manager, Retail; Commercial Manager, Business Development Division; Assistant General Manager, Finance; Finance Director, Retail Operations; and Group Treasurer and Chief Executive, Abbey National Treasury Services plc. Ian Harley is also Chairman of the Association for Payment Clearing Services, a director of Dah Sing Financial Holdings Limited and a member of the Deposit Protection Board. Aged 48.

3. Timothy Ingram FCIB
Managing Director, Consumer Finance

Timothy Ingram was appointed a director in 1996. A career-long banker, he worked for 22 years with ANZ Grindlays Bank, holding various senior international banking appointments. He joined Abbey National in 1995 when it acquired First National Finance Corporation plc. He is currently Chairman of First National Bank. Aged 51.

4. Gareth Jones FCA FCT
Managing Director, Treasury and Wholesale Banking

Gareth Jones was appointed a director in 1993. His past experience includes the roles of Finance Director, First Mortgage Securities Limited and Group Treasurer, Redland plc. Gareth Jones joined Abbey National in 1989 as Assistant General Manager and Group Treasurer before becoming Chief Executive of Abbey National Treasury Services plc. He subsequently held the position of Director, Retail Operations before returning to Abbey National Treasury Services plc as Group Treasurer and its Chief Executive. He is a past Chairman of the Association of Corporate Treasurers. Aged 50.

5. Malcolm Millington
IT Director

Malcolm Millington was appointed IT Director in January 1999. He joined Abbey National in 1975 and was appointed Head of IT for Retail in 1993 and Group IT Director in 1997. His current responsibilities include Information Technology, Money Transmission Strategy and Electronic Commerce. Aged 47.

6. Mark Pain FCA
Finance Director

Mark Pain was appointed Finance Director in January 1998. He began his career at Touche Ross & Co and joined Abbey National in 1989. He has previously held appointments as Manager, Strategic Planning; Manager, European Operations; Regional Director, Retail; and Group Financial Controller. His current responsibilities include Investor Relations and Corporate Affairs. Aged 37.

7. Andrew Pople
Managing Director, Retail Division

Andrew Pople was appointed a director in 1996. His early career was with the Civil Service followed by the Bank of England. He joined Abbey National in 1988 and has since held appointments as Regional Director, Retail; Chief Executive, Scottish Mutual Assurance plc and Head of the Life Division. His current responsibilities cover the retail-branded business including General Insurance.
He is a member of the Board of the Association of British Insurers.
Aged 41.

8. Charles Toner
Deputy Chief Executive

Charles Toner was appointed a director in 1992 and Deputy Chief Executive in 1996. He joined Abbey National in 1964 and has since held numerous appointments in the retail business including General Manager and Managing Director, Retail Division. His responsibilities have included heading the Wealth Management and Life Divisions. Charles Toner is currently a non-executive director of the National House Building Council. Aged 57.

9. Ian Treacy FCA
Director and Secretary

Ian Treacy was appointed as Company Secretary in 1991 and as a director in January 1998. He started his career with Peat, Marwick, Mitchell and Co and subsequently gained experience in stockbroking. He joined Abbey National in 1983 and has held appointments as Manager, European Operations and Deputy Secretary.
He is currently responsible for the Group Risk Division. Aged 54.

10. Charles Villiers FCA
Managing Director, Corporate Development

Charles Villiers joined Abbey National and was appointed a director in 1989. His early experience was gained at Arthur Andersen & Co and ICFC.
He was formerly Chief Executive of Natwest Investment Bank Ltd, Chairman of County Natwest Ltd and a director of National Westminster Bank plc. He is also a non-executive director of Debenham, Tewson and Chinnocks Holdings PLC. His current responsibilities include the Group's European Operations, the Life Division and the Wealth Management Division. Aged 58.

Non-executive directors

11. Martin Llowarch FCA*#†
Deputy Chairman and Senior Independent Non-Executive Director

Martin Llowarch was appointed a director in 1989 and a Deputy Chairman in 1994. He was previously Chief Executive of British Steel plc and is currently Chairman of Transport Development Group plc and Firth Rixson plc. He is also a non-executive director of Hickson International plc. Aged 63.

12. The Lord Shuttleworth JP FRICS*#
Deputy Chairman

Lord Shuttleworth was appointed a director and Deputy Chairman in 1996. He was formerly Chairman of the National and Provincial Building Society and the Rural Development Commission. Lord Shuttleworth is also Lord-Lieutenant for the County of Lancashire. Aged 50.

13. Leon Allen

Leon Allen, a US citizen, was appointed a director in October 1998. Following an 18 year career with Procter and Gamble, he held appointments as Chairman and Chief Executive of Del Monte Foods International Ltd; President and Chief Executive of Del Monte Foods Europe and non-executive Chairman of Devro plc. He is currently Chairman and Chief Executive of The Tetley Group Limited and a Trustee of the Royal Association for Disability & Rehabilitation (RADAR). Aged 59.

14. Mair Barnes*#

Mair Barnes was appointed a director in 1992. She was previously Managing Director of Woolworths plc, Chairman of Vantios Plc and was Veuve Clicquot Business Woman of the Year 1988. She is currently a non-executive director of George Wimpey PLC and Scottish Power plc and an honorary Doctor of Laws, University of Wales. Aged 54.

15. Sir Terence Heiser GCB†

Sir Terence was appointed a director in 1992. He was previously a Permanent Secretary to the Department of the Environment and is currently a non-executive director of J Sainsbury plc. He is a director of the Personal Investment Authority, a trustee of the Victoria and Albert Museum and of the Prince of Wales Phoenix Trust, and member of the Executive Committee of the National Trust. He is also a Governor and honorary Fellow of Birkbeck College, London University and a Freeman of the City of London. Aged 66.

16. Peter Ogden

Peter Ogden was appointed a director in 1994. He is a former Managing Director of Morgan Stanley & Co. Peter Ogden is currently Chairman of Computasoft Limited and Omnia Limited, and a director of Computacenter PLC. Aged 51.

17. The Lord Rockley†

Lord Rockley was appointed a director in 1990. He was formerly a director of Kleinwort Benson Group PLC, Equity & Law plc and Christies International plc. He is also a past Chairman of the Issuing Houses Association. Lord Rockley is currently a non-executive director of The Foreign and Colonial Investment Trust Plc and Cobham Plc. Aged 64.

18. James Tuckey FRICS#

James Tuckey was appointed a director in 1990. He is Chief Executive of MEPC plc and investment adviser to BP Pensions Services Ltd. He is also a Vice-President of the British Property Federation. Aged 52.

19. Keith Woodley FCA*†

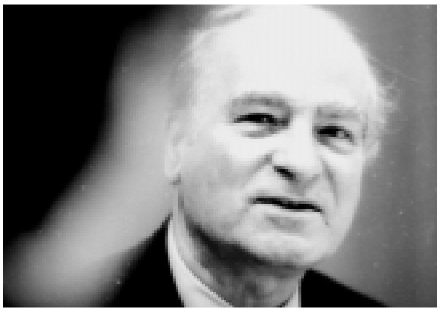
Keith Woodley was appointed a director in 1996. He is a former non-executive director of National and Provincial Building Society, a former partner of Deloitte Haskins & Sells and a past President of the Institute of Chartered Accountants in England and Wales. He is currently Complaints Commissioner for the London Stock Exchange, the Personal Investment Authority and the Securities and Futures Authority. He is also a Council Member of the National Association of Citizens Advice Bureaux, and a director of the Learning through Landscapes charity. Aged 59.

* Nomination Committee Member
\# Personnel and Remuneration Committee Member
† Audit Committee Member

If the dates of appointment to the Board are in 1989, then these dates refer to appointments to the Board of Abbey National Building Society, the predecessor of Abbey National plc. The directors concerned were appointed to the Board of Abbey National plc on 28 February 1989.

Non-executive directors



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Directors' report

The directors have pleasure in submitting their report for Abbey National plc for the year ended 31 December 1998.

Principal activities

The principal activity of Abbey National plc and its subsidiaries continues to be the provision of an extensive range of personal financial services. The Operating and Financial Review for the year, including a review of non-banking activities, is set out on pages 20 to 33 of this document. Note 23 to the accounts on pages 76 to 78 provides a list of the principal subsidiaries and the nature of each company's business as well as details of overseas branches. Details of important events which have occurred since the end of the financial year and prospects for 1999 are included in the Chairman's Statement, and in the Operating and Financial Review under 'Development of the business'.

Results and dividends

The profit on ordinary activities before tax for the year ended 31 December 1998 was £1,520 million (1997: £1,279 million).

An interim net dividend of 11.75 pence per ordinary share was paid on 5 October 1998 (1997: 10.20 pence per ordinary share).

The directors propose a final net dividend for the year of 23.55 pence per ordinary share (1997: 20.50 pence per ordinary share) to be paid on 30 April 1999.

Corporate governance

A report on corporate governance is set out on pages 42 to 45.

Payment policy and practice

Abbey National deals with a large number of suppliers operating in a diverse range of industries and accordingly does not operate a single payment policy in respect of all classes of suppliers. Each individual operating area is responsible for agreeing terms and conditions under which business is to be transacted and for making the supplier aware of these beforehand. It is, and will continue to be, the Company's policy to ensure payments are made in accordance with the terms and conditions agreed, except where the supplier fails to comply with those terms and conditions.

The Company's practice on payment of creditors has been quantified under the terms of the Companies Act 1985 (Directors' Report) (Statement of Payment Practice) Regulations 1997. Based on the ratio of amounts invoiced by trade creditors during the year to amounts of Company trade creditors at 31 December 1998, trade creditor days for the Company were 29 (1997: 30). The equivalent period calculated for the UK Group is 24 days (1997: 29 days).

Environmental policy

The Company considers environmental issues, wherever practical, in all business areas throughout the Group. The Company has an environmental policy which is approved by the Board and is updated on a regular basis. An Environmental Working Group is in place that oversees environmental initiatives and reports are made to the Board. A dedicated energy team has been established to implement projects which reduce energy and water consumption and a campaign to increase the recycling of waste and packaging is under way.

The Company also ensures that environmental principles are taken into account when building, purchasing and refurbishing properties. It has largely phased out its earlier policy of providing company cars. The Company has ensured that its major suppliers all have environmental policies in place.

The Company has signed up to the United Nations Programme – 'Financial Institutions Initiative on the Environment'. This initiative seeks to advance the level of dialogue within the financial sector about relationships between the environment and trade and development, and in so doing, foster greater consideration of the environment in credit, investment and operational decisions.

Ethical policy

The Board recognises that the tone of a company's culture is an important element in its high-level control framework and in December 1998 it adopted a Statement of Ethical Principles which will be communicated to staff during 1999. Suitable compliance arrangements underpin this Statement which will be subject to regular review.

Employees

As in previous years, in 1998 Abbey National invited eligible employees to become financial stakeholders in the Company by participating in the Company's Sharesave Scheme. Additionally, 150 share options were granted to each eligible employee as part of the Company's 'Shared Rewards' initiative. Through these schemes, and others that have been introduced over the years, nearly all employees now have a shareholding interest in the Company.

Employees continued

Employee involvement and effective communication remain vital to Abbey National's continued success. During 1998, the Company added to its comprehensive approach to communication. A new quarterly employee magazine 'Abbeyview' was launched combining work related issues and information with more general topical articles. Abbey National also launched its own intranet which is currently available at most Head Office sites. Access to this will soon be extended to branches. These innovations, together with more traditional methods of communication, aim to ensure that employees are fully informed of news and developments including information on the Company's performance. Abbey National understands that communication is a two-way process, and has been actively seeking employee views and opinions in a number of ways. For example, last summer the Company launched a new Quarterly Opinion Survey, the results of which are widely published. Abbey National also runs schemes to encourage and reward employees for their ideas and suggestions to improve the business.

This year, in recognition of their shared values and mutual objectives, Abbey National entered into a 'Partnership Agreement' with ANSA, the trade union it recognises for employee representation. Consultation with ANSA takes place at both national and local levels.

Abbey National's commitment to equal opportunities for all its employees and customers continued throughout the year. Support of national campaigns such as Opportunity 2000, Race for Opportunity and the EASE (Ease of Access to Services and Employment) Awards continue to play a part in the Company's strategy and this high-level commitment is reflected in the initiatives carried out at local level.

Employees have continued to take an active role in mentoring programmes, including the National Mentoring Consortium, which offers support and guidance to ethnic minority undergraduates and projects like the Equal Choices Schools Initiative, which aims to broaden the career aspirations of such students.

The Company remains a committed user of the Department of Employment Service 'Positive about Disabled People' symbol, and continues to encourage applications from people with disabilities. All practical measures are taken to assist in the recruitment, retention and career development of disabled people.

Share capital

The authorised and issued share capital of the Company are detailed in note 40 to the accounts on pages 85 and 86.

During the year, 2,768,606 ordinary shares were issued on the exercise of options under the Sharesave Scheme, 42,125 ordinary shares were issued on the exercise of options under the terms of the Employee Share Option Scheme and 1,940,759 ordinary shares were issued under the terms of the Executive Share Option Scheme. No shares were issued under the terms of the Share Participation Scheme. During 1998, shares to meet grants under the Executive Share Option Scheme were purchased in the market by the Abbey National ESOP Trust. Similarly, shares awarded under the Long Term Incentive Plan were bought in the market and held by the Abbey National Employee Trust.

At the Annual General Meeting on 30 April 1998, shareholders authorised the Company to make market purchases of its own shares, to a maximum of 141,298,897 ordinary shares of 10 pence each. No purchases have been made during the year under this authority. This authority remains valid until the forthcoming Annual General Meeting, when it is intended that a resolution will be put to shareholders to renew it. Authority will also be sought for the Company to make market (or other) purchases of its sterling preference shares.

Market value of land and buildings

On the basis of a regular review process, the estimated aggregate market value of the Group's land and buildings exceeds the fixed asset net book value of £361 million, as disclosed in note 26 to the accounts on pages 79 and 80, by approximately £7 million (1997: estimated deficit of £51 million).

Charitable donations

The Company has continued to support a wide range of charitable projects, particularly through Abbey National Charitable Trust Limited (the 'Trust').

During the year, Abbey National plc donated £600,000 (1997: £565,000) to the Trust's funds. The Trust also received income from its invested Permanent Endowment Funds. Total cash donations of £1,075,131 (1997: £964,561) to charities were made through the Trust and by other Abbey National Group companies in 1998.

The total value of support given to charities and the voluntary sector amounted to £1,830,000 (1997: £1,430,000). This comprised mainly cash donations through the Trust, and other support given in kind, including the value of staff time.

The Trust has continued to give priority to charities working to improve equality of opportunity for people with disabilities. It has also given major support to charities helping homeless people and families in crisis. The Trust supports the charity fund-raising efforts of Abbey National staff and the Company also sponsors the Royal Association for Disability & Rehabilitation ('RADAR') People of the Year Awards.

Political contributions
No contributions were made for political purposes.

Directors and directors' interests
Details of all the current directors are included on pages 34 to 37.

Leon Allen and Malcolm Millington were appointed to the Board on 1 October 1998 and 1 January 1999 respectively and having been appointed since the last Annual General Meeting they will retire and, both being eligible, offer themselves for election at the forthcoming Annual General Meeting.

All other directors listed on pages 34 to 37 have served on the Board for the whole of the period 1 January 1998 to 31 December 1998. Mair Barnes, Gareth Jones, Timothy Ingram and Charles Villiers will retire by rotation at the Annual General Meeting and, all being eligible, offer themselves for re-election. Charles Toner and Lord Rockley will also be retiring by rotation but will not be seeking re-election. In addition, Martin Llowarch, Deputy Chairman and Senior Independent Non-Executive Director, will be retiring from the Board at the conclusion of the Annual General Meeting. At the same time Keith Woodley will replace Lord Shuttleworth as a Deputy Chairman and become the Senior Independent Non-Executive Director. Charles Villiers will also take up post as a Deputy Chairman.

No director had a material interest in any contract of significance, other than a service contract, with the Company or any of its subsidiaries at any time during the year. Disclosures required by Financial Reporting Standard (FRS) 8, 'Related Party Disclosures', are set out in note 52 on page 96 of the accounts.

Directors' interests in the shares of the Company, awards under the Long Term Incentive Plan and options to acquire shares are set out in the Directors' Remuneration report on pages 46 to 53.

Substantial shareholdings
As at 18 February 1999, the Company had not been notified of any disclosable interests in the issued ordinary share capital of the Company in accordance with sections 198 to 208 of the Companies Act 1985.

Auditors
Coopers & Lybrand, the Company's Auditors, merged with Price Waterhouse on 1 July 1998 to form PricewaterhouseCoopers. As the merged entity constituted a new firm, Coopers & Lybrand resigned and the Board then filled the casual vacancy by appointing PricewaterhouseCoopers.

The merger of Price Waterhouse and Coopers & Lybrand prompted the Board to instigate a review of external audit requirements as it was concerned about the resultant concentration of UK banking and life assurance audits. It was also felt that it would be a valuable and timely exercise to reconsider the provision of audit services to the Group as these had not been subject to a competitive review process for a number of years. The Board's preferred choice was Deloitte & Touche who have signified their willingness to act as Auditors of the Company. Accordingly, a resolution to appoint Deloitte & Touche as Auditors will be proposed at the forthcoming Annual General Meeting. PricewaterhouseCoopers have stated that there are no matters connected with their ceasing to hold office which should be brought to the attention of shareholders or auditors. The Board is greatly appreciative of the services which the Company has received from the retiring auditors over many years.

Annual General Meeting
Details of the business of the Annual General Meeting can be found in the accompanying booklet 'Notice of Annual General Meeting 1999'.

By Order of the Board

Ian K Treacy
Director and Secretary
18 February 1999

Corporate governance

Corporate governance is concerned with how companies are directed and controlled and in particular with the role of the Board of Directors and the need to ensure a framework of effective accountability.

Combined Code

In June 1998, the Listing Rules of the London Stock Exchange were revised, requiring listed companies to disclose how they comply with a new Code of Practice known as the Combined Code. This Code consolidated the principles of the earlier Cadbury, Greenbury and Hampel Committees. This statement, together with the Directors' Remuneration report, set out on pages 46 to 53, explains how Abbey National has applied the principles set out in Section 1 of the Combined Code.

The Board

At 31 December 1998, the Board comprised a part-time Chairman, eight executive directors, including the Chief Executive, and nine independent non-executive directors, who bring a wide range of skills and experience to the Board. Biographical details of all directors are to be found on pages 35 and 36. The roles of Chairman and Chief Executive are separated and clearly defined. The Chairman is primarily responsible for the working of the Board and the Chief Executive for the running of the business and implementation of Board strategy and policy. The Chief Executive is assisted in managing the business on a day-to-day basis by the Executive Committee, which he chairs and which meets weekly and comprises his direct reports. All the non-executive directors are independent of management and they make a significant contribution to the functioning of the Board, thereby helping to ensure that no one individual or group dominates the Board's decision-making process. The full Board met on 12 occasions during 1998, including a separate session specifically devoted to the long term strategic direction of the Group. The Board's focus is on strategy formulation, policy and control. A framework of high-level authorities is in place which maps out the structure of delegation below Board level as well as specifying those issues which remain within the Board's preserve. This framework of high-level authorities was revised and updated during the year and a high-level risk management framework was endorsed by the Board during 1998.

As external events have demonstrated, risk management in banking continues to be critical and the Board devotes appropriate time to considering the risks associated with liquidity, foreign exchange, interest rates and credit as well as compliance and other operational risks. Two management committees play an important role here. The Assets and Liabilities Committee ('ALCO') monitors and controls the level of Group structural balance sheet risk. ALCO operates a subcommittee, the Group Credit Committee ('GCC'), which reviews and oversees high-level credit policies and exposures. ALCO meets monthly, chaired by the Chief Executive, and its membership comprises all the executive directors plus one executive manager. GCC meets fortnightly and comprises two executive directors plus several members of the Executive Management Group. The Board, at its regular monthly meetings, reviews in detail the minutes of ALCO which incorporate key points from the minutes of GCC.

One of the responsibilities of the Chairman is to ensure that Board members receive sufficient and timely information regarding corporate and business issues to enable them to discharge their duties. In this regard the particular views of non-executive directors on the adequacy of the management information supplied to them through Board papers was canvassed during 1998 and the structure and quality of such information has since been refined.

All directors have access to the advice and services of the Company Secretary and the Board has established a procedure whereby directors, wishing to do so in the furtherance of their duties, may take independent professional advice at the Company's expense. The Company Secretary is also charged with ensuring that all new Board members are equipped to fulfil their duties and responsibilities. As part of the early familiarisation programme, new non-executive directors are encouraged to meet the executive directors individually and engage in a programme of visits to all areas of the Group.

Non-executive directors are now initially appointed for a three year term after which their appointment may be extended upon mutual agreement. It is envisaged that the maximum term for a non-executive director under this regime would be a total length of service unlikely to exceed nine years. In accordance with the Company's Articles of Association, one-third of the Board are required to retire by rotation each year. The Combined Code now requires that over a three year period all directors should have retired from the Board and faced re-election. In order to ensure that this provision applies, the Company is seeking shareholder approval for an amendment to its Articles of Association. Details of the proposed amendment are contained in the Notice of the forthcoming Annual General Meeting.

As Abbey National continues to diversify, a growing responsibility falls on the Boards of Directors of its subsidiary companies, particularly those in the Life Assurance, Treasury and Wholesale Banking and Finance House Divisions. Each of these Boards (Scottish Mutual Assurance plc, Abbey National Life plc, Abbey National Treasury Services plc and First National Bank plc) includes at least one independent non-executive director with requisite expertise who is not necessarily a member of the Abbey National plc Board. During the year, Keith Woodley joined the Board of Abbey National Treasury Services plc and became Chairman of its Audit Committee.

Board committees

The Board now maintains three standing committees, all of which operate within written terms of reference. Their minutes are circulated for review and consideration by the full complement of directors, supplemented by oral reports from the Committee Chairmen.

Audit Committee

The Audit Committee met five times in 1998. Its prime tasks are to review the scope of external and internal audit, to receive regular reports from PricewaterhouseCoopers and the Chief Internal Auditor, and to review the half-yearly and annual accounts before they are presented to the Board, focusing in particular on accounting policies and compliance, and areas of management judgement and estimates. The Committee more generally acts as a forum for discussion of internal control issues and on behalf of the Board reviews the effectiveness of the Company's internal control and risk management systems and processes. The Audit Committee, and in particular its Chairman, Keith Woodley, a past President of the Institute of Chartered Accountants in England and Wales, played a key role in the recommendation to the Board that shareholders should be invited to appoint Deloitte & Touche as the new Auditors to the Company. Details of the proposed resolution are contained in the Notice of the forthcoming Annual General Meeting. Membership of the Audit Committee is restricted to independent non-executive directors.

Personnel and Remuneration Committee

The Personnel and Remuneration Committee is chaired by Martin Llowarch and met five times in 1998. Its principal function is to monitor the human resource policies of the Group to ensure they are consistent with the Company's business objectives and philosophy. Following a change to its constitution, prompted by the publication of the Combined Code in June 1998, the Committee is now charged with recommending to the full Board the Company's policy on executive director and executive management remuneration. However, it continues to determine the individual remuneration packages of executive directors. The Board's report to shareholders on how directors are remunerated, together with details of individual directors' remuneration packages, is to be found on pages 46 to 53.

Nomination Committee

As was explained in some detail in the 1997 Report and Accounts, the Board had not previously operated a Nomination Committee. However, following the introduction of the Combined Code, a Nomination Committee was established by the Board on 22 September 1998. The Committee is chaired by Lord Tugendhat and comprises six members. It is intended that the Committee will meet when necessary and at least once in each year. The Committee's primary function is to make recommendations to the Board on all new appointments and also to advise generally on issues relating to Board composition and balance. It met once during 1998.

The number of full Board meetings and Committee meetings attended by each director during the year was as follows:

	Board meetings	Audit Committee meetings	Personnel and Remuneration Committee meetings	Nomination Committee meetings
The Lord Tugendhat	12			1
Ian Harley	12			1
Leon Allen (appointed 1 October 1998)	2			
Mair Barnes	12		5	1
Sir Terence Heiser	12	4		
Timothy Ingram	12			
Gareth Jones	10			
Martin Llowarch	11	5	5	1
Peter Ogden	11			
Mark Pain	12			
Andrew Pople	12			
The Lord Rockley	12	5		
The Lord Shuttleworth	12		4	1
Charles Toner	12			
Ian Treacy	10			
James Tuckey	11		4	
Charles Villiers	12			
Keith Woodley	12	5		1

Relations with shareholders

Abbey National values its dialogue with both institutional and private investors. Effective two-way communication with fund managers, institutional investors and analysts is actively pursued and this encompasses issues such as performance, policy and strategy. During 1998, Abbey National directors held discussions with over 90 institutional investors whose combined shareholdings represented over 25% of the total issued ordinary share capital of the Company.

Relations with shareholders continued
Private investors are encouraged to participate in the Annual General Meeting at which the Chairman presents a review of the results and comments on current business activity. The Chairmen of the Audit, Personnel and Remuneration and Nomination Committees will be available at the Annual General Meeting to answer any shareholder questions.

This year's Annual General Meeting will be held on 22 April 1999. The Notice of the Annual General Meeting, which is in plain English, is circulated more than 20 working days before the Meeting and Abbey National will continue its practice of proposing only unbundled individual resolutions, including a separate resolution relating to the Directors' Report and Accounts. In order to comply with the Combined Code, proxy votes will be announced at the Annual General Meeting, following each vote on a show of hands, except in the event of a poll being called.

Pension funds
The assets of the Company's main pension schemes are held separately from those of the Group and are under the control of the trustees of each scheme. The four Abbey National pension schemes have a common corporate trustee which has nine directors, comprising six Company appointed directors, including Lord Tugendhat and two other directors of the Company, together with three member-nominated directors. The National and Provincial Pension Scheme has a different corporate trustee, the Board of which comprises Lord Shuttleworth, two other Company appointed directors and three member-elected directors. The Scottish Mutual Assurance plc Staff Pension Scheme is administered by six trustees, of which Scottish Mutual appoints four (two of whom are directors), whilst the active members appoint two of their number as trustees.

Asset management of the schemes (with the exception of the SMA Staff Pension Scheme) is delegated to a number of independent fund managers and, where appropriate, property managers and the trustees receive independent professional advice on the performance of the external managers. Asset management of the SMA Staff Pension Scheme is through a Group pension policy invested in units of SMA's Pooled Managed Fund.

Legal advice to the trustees of the various schemes is provided by external firms of solicitors. The audit of the Abbey National pension schemes is separated from that of Abbey National, being undertaken by Deloitte & Touche. Consequent upon the change of auditors of Abbey National, this arrangement will be reviewed. The audit of the SMA Staff Pension Scheme is undertaken by KPMG Audit Plc.

Going concern
The directors confirm that they are satisfied that the Company and the Group has adequate resources to continue in business for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.

Internal control
The Board of Directors has overall responsibility for systems of internal control throughout the Abbey National Group. However, it is important to note that the size and complexity of the Group's operations mean that such systems can only provide reasonable and not absolute assurance against material misstatement or loss. Monitoring of the effectiveness of internal control systems is undertaken by the Audit Committee on behalf of the Board.

The rationale for the systems of internal control is to enable the Group to achieve its corporate objectives within an acceptable risk profile, and the effectiveness of internal control has to be viewed in this context. The Board and executive management structures summarised above describe the processes for determining strategies, policies and the control environment.

The key elements of internal control, operating within the Group are:
– A framework of high-level authorities (see 'The Board' section above).
– A high-level risk management framework which outlines the risk management philosophy and resultant control environment.
– A planning framework which incorporates a Board approved rolling three year plan, with detailed annual operating objectives and milestones to business unit levels.
– A Group high-level risk map which identifies the policy mechanisms and independent risk monitoring functions for all risks within broad risk categories; credit, market position, liquidity, insurance, business event, strategic and operational.
– A comprehensive system of reporting to the Board, based on an annual budget with monthly reports against actual results, analysis of variances, scrutiny of key performance indicators, plus regular reforecasting. The reports increasingly include non-financial as well as financial information.
– Well-defined regulations governing appraisal and approval of project expenditure. These include an annual budget, detailed project approval procedures, incorporating appropriate levels of authority, and a post-investment review process.
– A network of risk committees, including ALCO and GCC (see 'The Board' section above), supplemented by independent risk functions within Group Risk Division which monitor and report on financial, compliance, legal and operational risk exposures. The Division is headed by an executive director.
– The use of control manuals to document key controls against identified risks, supplemented by procedure manuals at the operating level.

Internal control continued

- Procedures have also been developed whereby management, including executive directors, submit Self Certification Statements against material risks. The Audit Committee considers a report on the Self Certification process.
- Internal Audit provides independent and objective assurance to Audit Committee that the processes by which risks are identified, assessed and managed are appropriate and effectively applied, and achieve residual risk exposures consistent with management's risk policy, reporting any material exceptions and following up management responses to ensure effective resolution of issues.

The Audit Committee has, on behalf of the Board, reviewed the effectiveness of the internal control systems during the period covered by the Directors' Report and Accounts. The review covered all controls, including financial, operational and compliance controls and risk management.

The directors' review of the systems of internal control has been undertaken before formal guidance from the professional accountancy bodies has been issued as to the scope of such a review and the procedures to be undertaken, and may not therefore, constitute a review for the purposes of the Combined Code as ultimately interpreted.

Compliance with the Combined Code

Save for the exceptions detailed below, Abbey National has complied with the Code provisions (set out in Section 1 of the Combined Code) throughout the accounting period. The exceptions arise as the London Stock Exchange Listing Rules, incorporating the new Code provisions, came into effect in June 1998 whilst the compliance statement must relate to the whole of the year ended 31 December 1998. The only exceptions are as follows:

- The Nomination Committee was established by the Board in September 1998.
- The terms of reference of the Personnel and Remuneration Committee were similarly amended in September 1998 so that the Committee now makes recommendations to the Board on the Company's policy framework for executive director remuneration, whereas previously, under the requirements of the earlier Greenbury Committee, it had determined it.
- As required by the Code, the Board will, at the 1999 Annual General Meeting, announce the proxy votes in favour of and against each resolution following a vote by a show of hands, save where a poll is called. In respect of the April 1998 Annual General Meeting, this information was made available to shareholders at the conclusion of the Annual General Meeting.

Directors' remuneration

The purpose of this report by the Board is to inform shareholders of its policy on directors' remuneration and to provide details of the remuneration of individual directors, as determined by the Personnel and Remuneration Committee.

Remuneration strategy

Abbey National operates in a competitive market. If the Company is to continue to compete successfully, it is essential that it attracts, develops and retains high quality staff at all levels. Remuneration policy has an important part to play in achieving this objective. The Company aims to offer all its staff a remuneration package which is competitive in the relevant employment market and which is set in relation to individual performance. The Company also seeks to align the interests of shareholders and staff by giving staff the opportunity to build up a shareholding in the Company. Through a series of offers under the Sharesave, Share Participation and Employee Share Option Schemes, nearly all staff now have a shareholding interest.

Personnel and Remuneration Committee

The Committee exists to provide a mechanism through which the Board can satisfy itself that the Company is adopting human resource policies which are consistent with the Company's business objectives and philosophy. Its written terms of reference were amended in September 1998 so that it no longer determines the Company's policy on executive directors' remuneration but rather recommends such policy to the Board. This change was made following the introduction of the new Combined Code in June of that year. In practice, this has not been a significant amendment since the remuneration policy itself has not changed materially during the year. The Committee continues, in accordance with the provisions of the Combined Code, to determine the remuneration of each executive director, including pension rights and any compensation payments.

The Committee, which is chaired by Martin Llowarch (Deputy Chairman and Senior Independent Non-Executive Director), also comprises Mair Barnes, Lord Shuttleworth and James Tuckey. Its membership is restricted to independent non-executive directors, although the Committee consults, as appropriate, with both the Chairman and the Chief Executive. The Committee is assisted in its deliberations by the Human Resources Director and takes advice from time to time from external advisers.

Remuneration policy for executive directors

The aim of the Board and the Personnel and Remuneration Committee is to maintain a policy which:

- establishes a remuneration structure which will attract, retain and motivate executive directors of appropriate calibre;
- rewards executive directors according to both individual and Company performance;
- establishes an appropriate balance between fixed and variable elements of total remuneration with the performance related element forming a potentially significant proportion of the total remuneration package;
- aligns the interests of executive directors with those of shareholders through the use of performance related rewards and encouraging them to acquire a shareholding in the Company;
- ensures that directors' remuneration packages are in line with the Group's remuneration policy; and
- ensures that basic salaries are around the median for Abbey National's comparator group.

The comparator group used in consideration of remuneration matters comprises retail banks, insurance companies and other companies in a variety of fields with a market capitalisation broadly similar to Abbey National's. The Committee obtains advice and information from external experts when making its comparison.

Details of each director's remuneration package, together with details of interests in shares and share options, are set out below. There are no elements of remuneration, other than basic salary, which are treated as being pensionable.

The remuneration package is made up of the following elements:

– Basic salary

Basic salaries are normally reviewed annually and are set to reflect market conditions, personal performance and those paid for similar sized jobs in comparable organisations.

– Annual performance related bonus

The discretionary annual performance related bonus scheme is designed to provide a direct link between each individual's remuneration and the performance of the Company in the short term. It is based on individual and Company performance. It will pay out in March 1999 in relation to performance in 1998. The maximum potential cash payment, to be shared among the executive directors and other members of the top management team, is 30% of that group's basic salary earned during the year. Such payments are not pensionable.

The aggregate payment under the scheme is determined by the Personnel and Remuneration Committee's view of the Company's performance set against the Chief Executive's objectives included in the annual budget. The budget and objectives are set before the start of the financial year and approved by the Board.

– Annual performance related bonus continued
The Committee pays particular attention to certain quantifiable targets and may then modify that assessment in the light of its view of performance against qualitative objectives, such as customer service, product quality, and the dynamics of the market. The key financial targets for 1998 were: budgeted levels of operating expenses and income; market share targets for key products; and a specified measure of shareholder value (known as the value based management profit after capital charge). In setting the level of bonuses, the Personnel and Remuneration Committee is guided by a formula which envisages an on-target performance equating to half the maximum potential cash payment.

The distribution of the aggregate payment to individual executive directors reflects their individual performance and contribution during the year. The Committee is assisted in the assessment of individual performance of the Chief Executive by the Chairman, and of the other executive directors by the Chief Executive. Aggregate payments under the scheme for 1998 represented approximately 18% of the salaries earned during the year (1997: 24%).

– Long Term Incentive Plan
A Long Term Incentive Plan for senior executives was adopted at the 1997 Annual General Meeting. It is designed to enhance the link between the remuneration of executives and the Company's medium and long term performance and incorporates challenging performance targets, measured over a three year period. The performance targets are based on the share price and dividend performance (total shareholder return) of the Company relative both to specified financial institutions and to the constituents of the FTSE-100 Share Index. For the 1998–2000 performance period, the specified financial institutions are: Bank of Scotland, Barclays, Lloyds TSB, National Westminster Bank, Royal Bank of Scotland, Legal & General, Prudential, Alliance & Leicester, Halifax, Northern Rock and Woolwich.

At the outset of the scheme, the individuals are conditionally granted shares to a maximum value of 70% of their basic salary. The shares are held in trust for them and the number which are eventually awarded to the individual depends upon the extent to which the performance conditions are met. Half of the awards will be determined by the total shareholder return of the Company relative to the constituents of the FTSE-100 Share Index. The other half of the awards will be determined by the total shareholder return of the Company relative to specified financial institutions. The two parts of the award are determined separately. For each part, the award will be made in full if the Company is ranked in the top quartile of the relevant comparator group; 25% of the award will be made if the Company is ranked at median; and pro rata between these two points. For each part, no award will be made if the Company is ranked below the median of the relevant comparator group. Thus, if the Company is ranked below the median of both comparator groups, no award will be made. Similarly, for the award to be made in full, the Company must be ranked in the top quartile of both comparator groups.

In normal circumstances, to the extent that the performance conditions are satisfied, one half of a participant's award will be made after three years, while the other half remains in trust for a further two years.

The Plan is currently open only to the ten members of the Executive Committee. Details of the grants to directors under this Plan are set out below.

– Previous long term incentives
Prior to the introduction of the Long Term Incentive Plan, the Company's long term incentive arrangements consisted of a three year cash bonus scheme and an executive share option scheme. No new awards have been made under the three year bonus scheme since March 1996 and no payments will be made under the scheme after March 1999. In addition, those who participate in the Long Term Incentive Plan will not participate in new grants under the Executive Share Option Scheme. Payments under the three year bonus scheme will be made in March 1999 for the period 1996 to 1998. The maximum potential cash payment under the scheme, to be shared among the executive directors and other members of the top management team, is 30% of that group's basic salary.

In determining whether or not to make a payment under the three year bonus scheme, and if so its size, the Personnel and Remuneration Committee was guided by a formula which compared, over the relevant three year period, total shareholder return (i) against the FTSE-100 Share Index, and (ii) performance against relevant quoted comparator competitors. The maximum bonus is paid for performance in the 15th percentile or better and there is no payment for performance below the 65th percentile, with pro rata payments in between.

Each of the executive directors participated in the three year bonus scheme pro rata to his service during that period. In respect of the 1996–1998 scheme, entitlements represented 19% of participants' salaries at 31 December 1998 and are detailed below (1997: 25%).

As from 1 January 1997, executive directors no longer participate in new grants under the Executive Share Option Scheme. Prior grants of executive share options were made on the determination of the Personnel and Remuneration Committee on a phased basis and reflected both corporate and individual performance. Directors' interests in share options are set out below.

– Previous long term incentives continued
From 1 January 1997, and in future, participation by way of new grants in the Company's Executive Share Option Scheme has been and will be primarily confined to less senior executives, a group of approximately 120 managers.

– Other payments
In addition, the Personnel and Remuneration Committee may in certain circumstances make ex gratia payments. These circumstances include where an individual executive director has rendered a particular and outstanding contribution. Ex gratia payments may also be made where the employment market for particular directors suggests that the median remuneration for specialist jobs is higher than that paid to the executive directors concerned. No ex gratia payments have been made in respect of 1998 (1997: £65,000).

Shareholders have approved an employee sharesave scheme and an employee share option scheme. These schemes are available to all employees including executive directors. During 1998, employees of the Company were awarded 150 share options under the employee share option scheme, save for executive directors and employees of executive management grade, who were specifically excluded from this award.

– Benefits
Taxable benefits for executive directors include medical expenses and subsidised mortgage loans.

Service contracts
Executive directors seeking election or re-election at the 1999 Annual General Meeting will each have an unexpired contract term of one year. Non-executive directors do not have service contracts, save for the Chairman whose contract is renewable on an annual basis at the first Board meeting in each year following the Annual General Meeting and provides for payment of fees for a period of twelve months.

All of the executive directors have rolling one year service contracts. If an executive director is made redundant within the meaning of the relevant employment legislation, he may claim a total payment (which would include payment in lieu of notice period) of up to a maximum of two years' salary depending on length of service. Fifteen years of continuous service would be required to secure this maximum payment. This provision is in line with Abbey National's well-established practices on redundancy which equally apply to the service contracts of Abbey National's executive managers.

Chairman and non-executive directors
The remuneration arrangements of the Chairman and non-executive directors are determined by the Board and are detailed as follows:

The Chairman's emoluments consist wholly of fees, benefits and expenses in respect of services. He is not entitled to participate in any bonus or profit sharing arrangements nor is he entitled to participate in the Long Term Incentive Plan or the Executive Share Option Scheme. However, he is entitled to participate in the Company's Sharesave Scheme which is available to all eligible employees. The Chairman's appointment is non-pensionable and he makes his own private pension arrangements.

Fees are paid to non-executive directors. The basic fee for non-executive directors was increased during the year by £5,000 to £25,000 per annum and is augmented by £5,000 for service on each of the Audit Committee and Personnel and Remuneration Committee. Lord Shuttleworth and Martin Llowarch as Deputy Chairmen each receive additional fees. Keith Woodley's remuneration includes payments for services as a director of Abbey National Treasury Services plc and as Chairman of its Audit Committee.

Taxable benefits for non-executive directors include the reimbursement of travel and other incidental expenses for attendance at Board meetings.

Directors' emoluments

The following table shows an analysis of directors' emoluments excluding pensions, details of which are provided below:

	Salary/ Fee £	Performance related annual bonus £	Performance related 3 year bonus £	Taxable benefits £	1998 Total £	1997 Total £
Chairman						
The Lord Tugendhat	310,000			17,706	327,706	307,856
Executive directors						
P G Birch (retired 28 February 1998)	77,500	–	68,717	280	146,497	657,169
I Harley	375,000	67,500	71,250	7,261	521,011	389,070
T C W Ingram	225,000	40,500	42,750	1,337	309,587	274,280
D G Jones	265,000	47,700	50,350	7,454	370,504	423,466
M A Pain (appointed 1 January 1998)	175,000	31,500	11,083	1,979	219,562	–
A H Pople	235,000	42,300	44,650	2,334	324,284	412,423
C G Toner	252,000	45,360	47,880	3,822	349,062	359,846
I K Treacy (appointed 1 January 1998)	200,000	36,000	38,000	3,004	277,004	–
C N Villiers	263,000	47,340	49,970	2,254	362,564	373,600
Non-executive directors						
L R Allen (appointed 1 October 1998)	6,250			–	6,250	–
M Barnes	27,500			2,500	30,000	25,731
Sir Terence Heiser	27,500			683	28,183	25,320
M E Llowarch	48,750			852	49,602	43,421
P J Ogden	22,500			–	22,500	20,000
The Lord Rockley	27,500			312	27,812	25,000
The Lord Shuttleworth	42,500			1,803	44,303	40,289
J L Tuckey	27,500			312	27,812	25,000
K S Woodley	46,667			2,196	48,863	26,916
Totals	2,654,167	358,200	424,650	56,089	3,493,106	3,429,387

Note:

During the year ended 31 December 1998, payments under the three year cash bonus scheme will be made to two former directors: R F Knighton £24,067 (£51,667) and J M Fry £3,547 (£18,667), relating to the period in which they both served as directors.

Directors' pensions

Executive directors are eligible to join one of the Company's pension schemes.

The following table shows an analysis of the accrued pension benefits as at 31 December 1998 for executive directors participating in the Company's defined benefits pension schemes. Further information concerning the Company's pension schemes is set out in note 50 to the accounts.

	Contributions from directors during 1998 £	Increase in accrued pension during 1998 (1)(5)£	Transfer value of the increase in accrued pension during1998 (2)£	Total accrued pension as at 31 December 1998 (3)£	Total accrued pension as at 31 December 1997 (4)£
Executive directors					
P G Birch (retired 28 February 1998)	775	(1,579)	(25,941)	296,107	293,328
I Harley	9,600	50,073	623,878	155,426	101,692
D G Jones	2,650	8,981	116,379	64,925	54,000
M A Pain (appointed 1 January 1998)	1,750	16,233	121,166	34,708	17,833
A H Pople	7,496	9,101	73,082	49,350	38,850
C G Toner	2,520	7,126	124,260	161,414	148,927
I K Treacy (appointed 1 January 1998)	30,000	16,602	229,657	100,000	80,500
C N Villiers	39,450	13,039	202,714	119,227	102,498
Totals	94,241	119,576	1,465,195	981,157	837,628

Notes:

1 The increase in accrued pension during 1998 represents the increase in the annual pension which each director would be entitled to receive from normal retirement age (less the statutory inflationary increase of 3.6%, where relevant), if he had left service voluntarily at 31 December 1998 or at his actual retirement date if earlier.

2 The transfer value of the increase in accrued pension represents the current capital sum which would be required, using demographic and financial assumptions, to produce an equivalent increase in accrued pension and ancillary benefits, excluding the statutory inflationary increase, and after deducting members' contributions (including Additional Voluntary Contributions). Although the transfer value represents a liability to the Company, it is not a sum paid or due to be paid to the individual director and cannot therefore meaningfully be added to the annual remuneration.

3 The accrued pension as at 31 December 1998 represents the annual pension which each director would be entitled to receive from normal retirement age if he had left service voluntarily at 31 December 1998 or at his actual retirement date if earlier. In respect of P G Birch the accrued pension is stated at the date he ceased to be a director.

4 Stated as at the date of appointment if later.

5 The figure for the increase in accrued pension during 1998 which appears in the table does not in all cases equal the difference between the total accrued pension as at 31 December 1998, and the total accrued pension as at 31 December 1997. The difference arises where the increase in accrued pension is stated after deducting the statutory inflationary increase which would have been applied to the deferred pension entitlement had the director left at the start of the year. This deduction had been made where directors have been in service for the whole year, and is made in order to present a figure showing that element of the increase which results from an extra full year of service and from changes in remuneration.

6 Peter Birch retired from the Board on 28 February 1998. He retired from the Company on 30 April 1998.

7 The pension provision for Timothy Ingram has been made on a defined contributions basis during 1998. The cost of this provision, including ancillary benefits, amounted to £21,675 during the year. He made contributions of nil during the year.

8 Additional Voluntary Contributions made have been included in the above table where these payments result in an increase in the value of the directors' pension entitlements earned during the year.

Gains made on exercise of directors' share options

During the year the exercise of share options by directors resulted in gains as set out below:

	1998 Total £	1997 Total £
P G Birch (retired 28 February 1998)	**–**	123,376
I Harley	**572,016**	9,547
D G Jones	**283,347**	514,285
M A Pain (appointed 1 January 1998)	**79,227**	–
A Pople	**395,106**	–
C G Toner	**703,625**	9,547
I K Treacy (appointed 1 January 1998)	**465,797**	–
The Lord Tugendhat	**–**	47,737
C N Villiers	**634,233**	9,547
Total	**3,133,351**	714,039

Note:

Details of the options giving rise to these gains are set out on pages 51 to 53. The gains are based on the amount by which the market value of shares on the date of exercise exceeded the option price, irrespective of whether the shares were sold or retained.

Directors' share interests

The beneficial interests of directors and their immediate families in the ordinary shares of 10 pence each in the Company are shown below:

Ordinary shares:

	At 1.1.98 or date of appointment if later	No of shares At 31.12.98
L Allen (appointed 1 October 1998)	–	1,000
M Barnes	1,000	1,000
I Harley	29,212	51,307
Sir Terence Heiser	1,500	1,000
T C W Ingram	18,900	19,012
D G Jones	66,145	41,169
M E Llowarch	1,750	1,750
P J Ogden	4,000	4,000
M A Pain	5,581	16,064
A H Pople	3,565	37,141
The Lord Rockley	5,000	5,000
The Lord Shuttleworth	816	816
C G Toner	23,551	31,987
I K Treacy	9,078	41,372
J L Tuckey	12,000	12,000
The Lord Tugendhat	17,845	17,858
C N Villiers	25,492	29,000
K S Woodley	2,160	2,160

In addition, at 31 December 1998, T C W Ingram held £76,529 Abbey National Floating Rate Unsecured Loan Notes 2000 issued on 23 August 1995 in consideration for shares held in FNFC plc (1997: £116,529).

Share options:

	At 1.1.98	Granted	No. of options exercised	At 31.12.98	Exercise price £	Market price at date of exercise £	Date from which exercisable	Expiry date	Notes
I Harley	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
	568			568	6.07		01/04/02	30/09/02	Sharesave
		349		349	9.88		01/04/03	30/09/03	Sharesave
	15,000		15,000		3.69	11.14	29/03/96	29/03/03	Executive
	6,825		6,825		3.14	11.14	29/03/98	29/03/03	Executive
	23,237		23,237		4.68	11.14	11/04/97	10/04/04	Executive
	7,745			7,745	4.68		11/04/97	10/04/04	Executive[1]
	40,500		40,500		4.83	11.14	10/04/98	09/04/05	Executive
	38,053			38,053	5.65		25/03/99	24/03/06	Executive
	36,379			36,379	5.91		09/09/99	08/09/06	Executive[#]
	150			150	5.91		09/09/99	08/09/06	Employee
	170,875	349	85,562	85,662					
T C W Ingram	3,701			3,701	4.66		01/04/01	30/09/01	Sharesave
	4,180			4,180	4.097		31/08/96	30/08/03	Executive[#]
	25,663			25,663	5.65		25/03/99	24/03/06	Executive
	150			150	5.91		09/09/99	08/09/06	Employee
	33,694			33,694					
D G Jones	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
	568			568	6.07		01/04/02	30/09/02	Sharesave
		179		179	10.87		01/04/01	30/09/01	Sharesave
	8,525		8,525		3.14	10.43	29/03/98	29/03/03	Executive
	8,012			8,012	4.68		11/04/97	10/04/04	Executive[1]
	39,500		39,500		4.83	10.43	10/04/98	09/04/05	Executive
	36,106			36,106	5.65		25/03/99	24/03/06	Executive
	22,829			22,829	5.91		09/09/99	08/09/06	Executive[#]
	150			150	5.91		09/09/99	08/09/06	Employee
	118,108	179	48,025	70,262					

Directors' share interests continued
Share options continued:

	At 1.1.98	Granted	No. of options Exercised	At 31.12.98	Exercise price £	Market price at date of exercise £	Date from which exercisable	Expiry date	Notes
M A Pain	1,071		1,071		3.22	9.44	31/08/98	28/02/99	Sharesave
	1,285			1,285	6.07		01/04/04	30/09/04	Sharesave
		698		698	9.88		01/04/03	30/09/03	Sharesave
	11,500		11,500		4.83	11.14	10/04/98	09/04/05	Executive
	13,008			13,008	5.65		25/03/99	24/03/06	Executive
	13,850			13,850	7.22		24/03/00	23/03/07	Executive
	150			150	5.91		09/09/99	08/09/06	Employee
	40,864	698	12,571	28,991					
A H Pople	1,939		1,939		2.32	9.44	01/10/98	31/03/99	Sharesave
	1,882			1,882	2.39		01/06/99	30/11/99	Sharesave
	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
	568			568	6.07		01/04/02	30/09/02	Sharesave
		349		349	9.88		01/04/03	30/09/03	Sharesave
	25,000		25,000		4.00	11.14	01/09/97	31/08/04	Executive
	30,000		30,000		4.83	11.14	10/04/98	09/04/05	Executive
	23,008			23,008	5.65		25/03/99	24/03/06	Executive
	150			150	5.91		09/09/99	08/09/06	Employee
	84,965	349	56,939	28,375					
C G Toner	2,221			2,221	4.66		01/04/01	30/09/01	Sharesave
	24,449		24,449		3.69	11.14	29/03/96	29/03/03	Executive
	8,149		8,149		3.14	11.14	29/03/98	29/03/03	Executive
	24,038		24,038		4.68	11.14	11/04/97	10/04/04	Executive
	8,012		8,012		4.68	11.14	11/04/97	10/04/04	Executive[1]
	39,500		39,500		4.83	11.14	10/04/98	09/04/05	Executive
	30,884			30,884	5.65		25/03/99	24/03/06	Executive
	35,364			35,364	5.91		09/09/99	08/09/06	Executive[#]
	150			150	5.91		09/09/99	08/09/06	Employee
	172,767		104,148	68,619					
I K Treacy	4,849		4,849		2.32	8.98	01/10/98	31/03/99	Sharesave
	4,707			4,707	2.39		01/06/99	30/11/99	Sharesave
	4,759		4,759		3.14	11.14	29/03/98	29/03/03	Executive
	14,277		14,277		3.69	11.14	29/03/96	29/03/03	Executive
	12,682		12,682		4.68	11.14	11/04/97	10/04/04	Executive
	4,227		4,227		4.68	11.14	11/04/99	10/04/04	Executive
	28,500		28,500		4.83	11.14	10/04/98	09/04/05	Executive
	25,042			25,042	5.91		09/09/99	08/09/06	Executive
	18,353			18,353	5.65		25/03/99	24/03/06	Executive
	150			150	5.91		09/09/99	08/09/06	Employee
	117,546		69,294	48,252					
The Lord Tugendhat		1,745		1,745	9.88		01/04/03	30/09/03	Sharesave
		1,745		1,745					
C N Villiers	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
	568			568	6.07		01/04/02	30/09/02	Sharesave
		349		349	9.88		01/04/03	01/10/03	Sharesave
	37,111		37,111		2.54	11.14	05/05/97	05/05/02	Executive
	31,145		31,145		3.69	11.14	29/03/96	29/03/03	Executive
	10,381		10,381		3.14	11.14	29/03/98	29/03/03	Executive
	9,612			9,612	4.68		11/04/97	10/04/04	Executive
	3,204			3,204	4.68		11/04/97	10/04/04	Executive[1]
	32,086			32,086	4.83		10/04/98	09/04/05	Executive
	10,055			10,055	5.65		25/03/99	24/03/06	Executive
	36,988			36,988	5.91		09/09/99	08/09/06	Executive[#]
	150			150	5.91		09/09/99	08/09/06	Employee
	173,718	349	78,637	95,430					

[#] Replacement options

Directors' share interests continued

Notes:

The executive share options detailed above become exercisable if the average growth of earnings per ordinary share exceeds the average increase in the retail price index in any three years prior to exercise. For those executive options granted since 1997, the average growth of earnings per ordinary share must exceed the average increase in the retail price index by 2%. Parallel discounted options were granted over the shares noted 1 and are exercisable at £3.98 from 11.4.1999 to 10.4.2004.

Parallel discounted options become exercisable if the average growth in earnings per ordinary share exceeds the average increase in the retail prices index by at least 10% in any five year period prior to the date of exercise. The option holder may exercise either the standard or discounted option, but not both, thereby reducing both options, subject to the achievement of the appropriate performance criteria. The Board determined in 1994 that it would no longer make grants of discounted options.

The options refer to those granted under the Company's Executive Share Option, Employee Share Option and Sharesave schemes, as set out in note 40 to the accounts on pages 85 and 86.

Options shown under the headings 'Granted' or 'Exercised' refer to options granted or exercised during the year.

Market price at the date of exercise is the Middle Market Quotation, as derived from the London Stock Exchange Daily Official List. The market price of the shares on 30 December 1998 was 1287p (31 December 1997: 1093p) and the range during 1998 was 882p to 1340p.

There have been no changes to the beneficial and other interests of the directors in the ordinary shares of the Company as shown above up to 18 January 1999, other than the acquisition of two shares by T C W Ingram, on 4 January 1999, on the automatic reinvestment of dividends arising from the Abbey National Personal Equity Plan.

Long Term Incentive Plan

Details of the Company's ordinary shares over which the directors have conditional rights under the Long Term Incentive Plan are as follows:

	Shares held under plan @ 1/1/98	Conditional rights granted during year	Shares held under plan @ 31/12/98
I Harley	19,527	22,474	42,001
T C W Ingram	14,270	13,484	27,754
D G Jones	18,025	15,881	33,906
M A Pain	–	10,488	10,488
A H Pople	15,772	14,083	29,855
C G Toner	18,025	15,102	33,127
I K Treacy	13,143	11,986	25,129
C N Villiers	18,776	15,761	34,537

Notes:

1 Shares awarded under the Plan during the year were bought in the market and are held by the Abbey National Employee Trust (the 'Trust'), which is administered by an independent professional trustee. The cost of these conditional awards is being charged to the profit and loss account over the three year performance period to which they relate. In 1998, £872,198 (1997: £278,514) was charged to the profit and loss account.

2 Subject to the performance criteria being met, 50% of the above awards are exercisable three years from the date of grant and the remainder five years from the date of grant. The awards will be included in directors' emoluments in the year of exercise.

3 The aggregate maximum value of the awards shown above, based on the maximum number of shares that would be transferred to the directors if the Company is ranked in the top quartile of both the relevant comparator groups, and on the market price of the Company's ordinary shares at 30 December 1998, 1287p (31 December 1997: 1093p), would have been £3,047,577 (1997: £1,141,037). As stated above, all of these awards are subject to performance criteria and none of the awards may be exercised if the Company is ranked below the median of both the relevant comparator groups.

4 By virtue of their being potential beneficiaries of the Trust, each executive director is deemed, for the purpose of the Companies Act 1985, to have an interest in the shares held in the Trust. At 31 December 1998, the Trust held 268,936 ordinary shares (31 December 1997: 129,780 ordinary shares) for the above-named directors and other senior executives.

Directors' responsibilities for accounts

The directors of Abbey National plc are required by UK company law to prepare accounts which give a true and fair view of the state of affairs of the Company and the Group as at the end of the financial year, and of the profit for the year. They are also responsible for ensuring that proper and adequate accounting records have been maintained and that reasonable procedures have been followed for safeguarding the assets of the Group and for preventing and detecting fraud and other irregularities.

In respect of the accounts the directors are required to:
– ensure that suitable accounting policies, which follow generally accepted accounting practice, have been applied consistently;
– ensure that reasonable and prudent judgements and estimates have been used in the preparation of the accounts;
– prepare the accounts on the going concern basis unless it is inappropriate to presume that the Company and the Group will continue in business; and
– state whether applicable accounting standards have been followed and to disclose and explain any material departures in the accounts.

Auditors' report to the members of Abbey National plc

We have audited the accounts on pages 55 to 96.

Respective responsibilities of directors and auditors
The directors are responsible for preparing the Annual Report, including as described above, the accounts. Our responsibilities, as independent auditors, are established by statute, the Auditing Practices Board, the Listing Rules of the London Stock Exchange, and our profession's ethical guidance.

We report to you our opinion as to whether the accounts give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the accounts, if the 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 or the Listing Rules regarding directors' remuneration and transactions with the company is not disclosed.

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

We review whether the statement on page 45 reflects the Company's compliance with those provisions of the Combined Code specified for our review by the London Stock Exchange, and we report if it does not. We are not required to form an opinion on the effectiveness of the Company's corporate governance procedures or its internal controls.

Basis of audit opinion
We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the 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 accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the accounts.

Opinion
In our opinion the accounts give a true and fair view of the state of affairs of the Company's and the Group's affairs as at 31 December 1998 and of the profit and cash flows of the Group for the year then ended and have been prepared in accordance with the Companies Act 1985.

PricewaterhouseCoopers

PricewaterhouseCoopers
Chartered Accountants and Registered Auditors
London
18 February 1999

Consolidated profit and loss account for the year ended 31 December 1998

Notes		1998 Before exceptional items £m	1998 Exceptional items (see note 3) £m	1998 Total £m	1997 Total £m
	Interest receivable:				
	Interest receivable and similar income arising from debt securities	**3,011**		**3,011**	2,008
2	Other interest receivable and similar income	**6,467**		**6,467**	5,823
3	Adjustment to net investment in finance leases	**–**		**–**	(133)
4	Interest payable	**(7,249)**		**(7,249)**	(5,809)
	Net interest income	**2,229**		**2,229**	1,889
5	Dividend income	**4**		**4**	3
	Fees and commissions receivable	**643**		**643**	547
	Fees and commissions payable	**(136)**		**(136)**	(96)
	Dealing profits	**44**		**44**	52
	Other operating income:				
21	Income from long term assurance business	**162**	**(7)**	**155**	147
3,21	Adjustment to income from long term assurance business	**–**		**–**	(12)
6	Other operating income	**172**		**172**	83
	Total operating income	**3,118**	**(7)**	**3,111**	2,613
7	Administrative expenses	**(1,179)**	**(61)**	**(1,240)**	(1,096)
9	Depreciation and amortisation	**(106)**		**(106)**	(98)
	Provisions:				
10	Provisions for bad and doubtful debts	**(201)**		**(201)**	(121)
38	Provisions for contingent liabilities and commitments	**(16)**		**(16)**	(16)
	Amounts written off fixed asset investments	**(28)**		**(28)**	(3)
	Profit on ordinary activities before tax	**1,588**	**(68)**	**1,520**	1,279
11	Tax on profit on ordinary activities	**(483)**	**21**	**(462)**	(326)
12	**Profit on ordinary activities after tax**	**1,105**	**(47)**	**1,058**	953
	Minority interests – equity	**–**		**–**	1
	Profit attributable to the shareholders of Abbey National plc	**1,105**	**(47)**	**1,058**	954
41	Transfer to non-distributable reserve			**(125)**	(78)
13	Dividends including amounts attributable to non-equity interests			**(535)**	(469)
	Profit retained for the financial year			**398**	407
	Profit on ordinary activities before tax includes:				
	for acquired operations			**–**	7
	for discontinued operations (with prior year comparative)			**5**	(1)
14	**Earnings per ordinary share – basic**			**72.4p**	65.2p
14	**Earnings per ordinary share – diluted**			**71.7p**	64.7p

The Group's results as reported are in all material respects on an historical cost basis. Accordingly, no note of historical cost profits and losses has been presented.

Consolidated balance sheet for the year ended 31 December 1998

Notes		1998 £m	1998 £m	1997 (restated) £m	1997 (restated) £m
	Assets				
	Cash and balances at central banks		**329**		329
15	Treasury bills and other eligible bills		**2,057**		1,628
16	Loans and advances to banks		**7,428**		8,271
17	Loans and advances to customers		**72,261**		66,878
18	Net investment in finance leases		**5,326**		4,655
19	Debt securities		**54,203**		46,454
	Assets under stock borrowing and lending agreements		**15,026**		6,678
20	Equity shares and other variable yield securities		**123**		83
21	Long term assurance business		**760**		649
22	Interests in associated undertakings		**20**		21
25	Intangible fixed assets		**201**		–
26	Tangible fixed assets		**731**		698
27	Operating lease assets		**223**		67
28	Other assets		**3,332**		2,273
29	Prepayments and accrued income		**2,376**		2,023
21	Assets of long term assurance funds		**13,383**		10,101
	Total assets		**177,779**		150,808
	Liabilities				
30	Deposits by banks		**35,610**		23,814
31	Customer accounts		**52,924**		55,719
32	Debt securities in issue		**42,989**		40,201
	Liabilities under stock borrowing and lending agreements		**15,026**		6,678
	Dividend proposed		**334**		290
33	Other liabilities		**4,564**		2,678
35	Accruals and deferred income		**3,015**		2,842
36	Provisions for liabilities and charges		**1,194**		1,144
39	Subordinated liabilities including convertible debt		**3,333**		2,463
21	Liabilities of long term assurance funds		**13,383**		10,101
			172,372		145,930
40	Called up share capital – ordinary shares	**142**		141	
	– preference shares	**325**		325	
40	Share premium account	**1,493**		1,460	
41	Reserves	**433**		308	
41	Profit and loss account	**3,014**		2,644	
42	Shareholders' funds including non-equity interests		**5,407**		4,878
	Total liabilities		**177,779**		150,808
	Memorandum items				
	Contingent liabilities				
44	Guarantees and assets pledged as collateral security		**1,844**		1,915
45	Other contingent liabilities		**552**		779
			2,396		2,694
46	Commitments		**2,810**		2,164

Further details in respect of the 1997 balance sheet restatement can be found in notes 16, 17, 30 and 31.

The accounts on pages 55 to 96 were approved by the Board on 18 February 1999 and signed on its behalf by:

Lord Tugendhat
Chairman

Ian Harley
Chief Executive

Mark Pain
Finance Director

Company balance sheet for the year ended 31 December 1998

Notes		1998 £m	1998 £m	1997 £m	1997 £m
	Assets				
	Cash and balances at central banks		**324**		315
16	Loans and advances to banks		**3,361**		586
17	Loans and advances to customers		**62,169**		60,636
19	Debt securities		**1,491**		2,567
20	Equity shares and other variable yield securities		**4**		23
22	Interests in associated undertakings		**11**		24
23	Shares in Group undertakings		**2,776**		2,435
26	Tangible fixed assets		**564**		611
28	Other assets		**564**		444
29	Prepayments and accrued income		**694**		560
	Total assets		**71,958**		68,201
	Liabilities				
30	Deposits by banks		**11,533**		8,324
31	Customer accounts		**50,730**		51,011
32	Debt securities in issue		**23**		43
	Dividend proposed		**334**		290
33	Other liabilities		**740**		735
35	Accruals and deferred income		**1,014**		1,032
36	Provisions for liabilities and charges		**72**		145
39	Subordinated liabilities including convertible debt		**3,343**		2,477
			67,789		64,057
40	Called up share capital – ordinary shares	**142**		141	
	– preference shares	**325**		325	
40	Share premium account	**1,493**		1,460	
41	Profit and loss account	**2,209**		2,218	
42	Shareholders' funds including non-equity interests		**4,169**		4,144
	Total liabilities		**71,958**		68,201
	Memorandum items				
	Contingent liabilities				
44	Guarantees and assets pledged as collateral security		**107,615**		85,639
45	Other contingent liabilities		**10**		16
			107,625		85,655
46	Commitments		**338**		289

The accounts on pages 55 to 96 were approved by the Board on 18 February 1999 and signed on its behalf by:

Lord Tugendhat
Chairman

Ian Harley
Chief Executive

Mark Pain
Finance Director

Statement of total recognised gains and losses for the year ended 31 December 1998

Notes		1998 £m	1997 £m
	Profit attributable to the shareholders of Abbey National plc	**1,058**	954
41	Translation differences on foreign currency net investment	**–**	(5)
13	Exchange adjustments on US dollar preference shares	**–**	(4)
	Total recognised gains relating to the year	**1,058**	945

Consolidated cash flow statement for the year ended 31 December 1998

Notes		1998 £m	1997 £m
49a	**Net cash inflow from operating activities**	**4,688**	7,658
	Returns on investments and servicing of finance:		
	Interest paid on subordinated liabilities	**(195)**	(176)
	Preference dividends paid	**(36)**	(23)
	Net cash outflow from returns on investments and servicing of finance	**(231)**	(199)
	Taxation:		
	UK corporation tax paid	**(236)**	(163)
	Overseas tax paid	**(52)**	(21)
	Total taxation paid	**(288)**	(184)
	Capital expenditure and financial investment:		
	Purchases of investment securities	**(26,335)**	(18,577)
	Sales of investment securities	**14,314**	6,583
	Redemptions and maturities of investment securities	**8,102**	5,866
	Purchases of tangible fixed assets	**(219)**	(182)
	Sales of tangible fixed assets	**70**	38
	Transfers to life assurance funds	**(4)**	(14)
	Net cash outflow from capital expenditure and financial investment	**(4,072)**	(6,286)
49e,g	**Acquisitions and disposals**	**(214)**	(237)
	Equity dividends paid	**(454)**	(387)
	Net cash inflow (outflow) before financing	**(571)**	365
	Financing:		
	Issue of ordinary share capital	**17**	15
	Issue of preference share capital	**–**	125
	Issue of loan capital	**857**	70
	Repayments of loan capital	**–**	(8)
49c	**Net cash inflow from financing**	**874**	202
49b	**Increase in cash**	**303**	567

For the purposes of the consolidated cash flow statement, cash includes all cash in hand and loans and advances to banks repayable on demand without notice or penalty, including amounts denominated in foreign currencies.

Accounting policies

Basis of presentation
The consolidated accounts are prepared in accordance with the special provisions of Part VII of the Companies Act 1985 applicable to banking companies and banking groups.

Accounting convention
The Group prepares its accounts under the historical cost convention, modified by the revaluation of certain assets in accordance with applicable UK accounting standards and the Statements of Recommended Accounting Practice issued by the British Bankers' Association and the Irish Bankers' Federation.

Basis of consolidation
The Group accounts comprise the accounts of the Company and all its subsidiary undertakings. The accounting reference date of the Company and its subsidiary undertakings is 31 December, with the exception of two recently acquired entities and those leasing, investment, insurance and funding companies, which, because of commercial considerations, have various accounting reference dates. The accounts of these subsidiaries have been consolidated on the basis of interim accounts for the period to 31 December 1998.

The assets and liabilities of the long term assurance funds are presented separately from those of other businesses in order to reflect the different nature of the shareholders' interest therein.

Interests in subsidiary and associated undertakings
The Company's interests in subsidiary undertakings and associated undertakings are stated at cost less any provisions for impairment. The Group's interests in associated undertakings are stated at the Group's share of the book value of the net tangible assets of the associated undertakings.

Goodwill
The Group has adopted Financial Reporting Standard (FRS) 10, 'Goodwill and Intangible Assets', in its accounts for the year ended 31 December 1998. The standard does not require restatement for goodwill arising and taken to reserves in previous periods. All goodwill which arose in previous periods continues to be carried in reserves except where recognised in the profit and loss account, in accordance with the applicable Group accounting policy, as stated below.

Goodwill arising on consolidation as a result of the acquisitions of subsidiary and associated undertakings after 1 January 1998, and goodwill arising on the purchase of businesses after 1 January 1998, is capitalised under the heading Intangible fixed assets and amortised on a straight line basis over its expected useful economic life. Such goodwill is subject to review for impairment in accordance with FRS 11, 'Impairment of fixed assets and goodwill' (see below). The useful economic life is calculated using a valuation model which determines the period of time over which returns are expected to exceed its cost of capital, subject to a maximum period of 20 years.

Goodwill arising on consolidation as a result of the acquisitions of subsidiary and associated undertakings prior to 1 January 1998, and goodwill which arose on the purchase of businesses prior to 1 January 1998, has previously been taken to reserves. On disposal of subsidiary and associated undertakings and businesses, such goodwill is charged to the profit and loss account balanced by an equal credit to reserves. Where such goodwill in continuing businesses has suffered a permanent diminution in value, a similar charge to the profit and loss account and credit to reserves is made.

Impairment of fixed assets and goodwill
Tangible fixed assets, other than investment properties, and goodwill are subject to review for impairment in accordance with FRS 11. The carrying values of tangible fixed assets and goodwill are written down by the amount of any impairment, and the loss is recognised in the profit and loss account in the period in which this occurs. Should an external event reverse the effects of a previous impairment, the carrying value of the tangible fixed assets and goodwill may be written up to a value no higher than the original depreciated cost.

Depreciation
Tangible fixed assets are depreciated on a straight line basis over their estimated useful lives. The following annual rates are used:

Premises and Equipment	
Freehold buildings:	1.0%
Long and short leasehold premises:	Over the remainder of the lease, with a maximum of 100 years. Acquisition premiums are depreciated over the period to the next rent review.
Office fixtures, equipment and furniture:	12.5%
Computer equipment:	
Mainframes	25.0%
Peripherals	20.0%
No depreciation is provided on freehold land.	

Investment properties
In accordance with Statement of Standard Accounting Practice (SSAP) 19, 'Accounting for investment properties', investment properties are included in the consolidated balance sheet at their open market value in existing use and are revalued annually. Changes in market value are reflected in the investment revaluation reserve except where the property is permanently impaired when the loss is taken directly to the profit and loss account.

No depreciation is provided in respect of investment properties. This is a departure from the requirements of the Companies Act 1985 which requires all properties to be depreciated. Such properties are not held for consumption but for investment and the directors consider that to depreciate them would not give a true and fair view. Depreciation is only one amongst many factors reflected in the annual valuation of properties and accordingly the amount of depreciation which might otherwise have been charged cannot be separately identified or quantified.

Deferred taxation
Deferred taxation is accounted for where it is probable that a liability or asset will arise. Provision is calculated at rates expected to be applicable when the liability or asset crystallises.

Interest receivable
Interest is suspended where due but not received on loans and advances in arrears where recovery is doubtful. The amounts suspended are excluded from interest receivable on loans and advances until recovered.

Fees, commissions and dividends receivable
Fees and commissions receivable in respect of services provided are taken to the profit and loss account when the related services are performed. Where fees, commissions and dividends are in the nature of interest, these are taken to the profit and loss account on a systematic basis over the expected life of the transaction to which they relate, and are included under the heading, Interest receivable. Fees which are receivable in order to cover a proportion of future losses, as explained in more detail under Deferred income, are taken to the profit and loss account as the relevant losses are identified and provided for, and are included under the heading, Other operating income. Income on investments in equity shares and variable yield securities is recognised as and when dividends are received, and included within Dividend income.

Lending-related fees and commissions payable and discounts
Under certain schemes, fees and discounts may be granted to customers as incentives to take out loans. It is usually a condition of such schemes that incentive payments are recoverable by way of early redemption penalty charges in the event of redemption within a specified period, 'the penalty period', and it is the Group's policy and normal practice to make such charges. Such incentive payments are charged to the profit and loss account over the penalty period where their cost is recoverable from the net interest income earned from the related loans over the penalty period, or from the penalty charge in the event of early redemption. When the related loan is redeemed, sold or becomes impaired any amounts previously unamortised are charged to the profit and loss account. The profit and loss account charge for such fees and discounts is included under the heading, Interest receivable.

Commissions payable to introducers in respect of obtaining certain lending business, where this is the primary form of distribution, are charged to the profit and loss account over the anticipated life of the loans. The profit and loss account charge for such commissions is included under the heading, Fees and commissions payable.

Deferred income
The Company has entered into insurance arrangements with certain insurance subsidiaries to cover a proportion of future losses on certain UK loans and advances secured on residential properties with high loan to value ratios, for which a fee may be charged.

In the Group accounts, such fees are deferred and are included in the balance sheet under the heading, Accruals and deferred income. The deferred income balance is held to cover anticipated losses in connection with such lending, and deferred income is released to the profit and loss account following a regular assessment of the relevant loans for impairment.

Securities
Debt securities, equity shares and other variable yield securities (securities) held for investment purposes are stated at cost, adjusted for any amortisation of premium or discount on an appropriate basis over their estimated remaining lives. Provision is made for any permanent diminution in value. Investment securities are intended for use on a continuing basis by the Group and have been identified as such.

In accordance with industry practice, securities which are not held for the purpose of investment and the associated funding of these assets are stated at market value and profits and losses arising from this revaluation are taken directly to the profit and loss account. The net return on these assets appears in Dealing profits in the profit and loss account. This net return comprises the revaluation profit and loss referred to above, plus profits and losses on disposal of these assets, plus interest receivable on these assets less interest payable on their associated funding. The difference between the cost and market value of securities not held for investment is not disclosed as its determination is not practicable.

Where securities are transferred from portfolios held for investment purposes to portfolios held for other purposes, the securities are transferred at market value. Gains and losses on these transfers are taken directly to the profit and loss account, and are included within Other operating income.

Securities continued
Interests in securities are recognised as assets or, in the case of short positions, liabilities, at the date at which the commitment to purchase or sell is considered to be binding.

Securities sold subject to sale and repurchase agreements are retained on the balance sheet where the risks and rewards of ownership of the securities remain with the Group. Similarly, securities purchased subject to purchase and resale agreements are treated as collateralised lending transactions where the Group does not acquire the risks and rewards of ownership.

Sale and repurchase agreements
The Group enters into purchase and resale and sale and repurchase agreements as part of its money market business. These amounts are included within Loans and advances to banks, Loans and advances to customers, Deposits by banks and Customer accounts. The difference between sale and repurchase and purchase and resale prices for such transactions is charged or credited to the profit and loss account over the life of the relevant transactions within Interest receivable and Interest payable.

Stock borrowing and lending arrangements
The Group enters into stock borrowing agreements as a means of carrying out its money market business. In addition, stock borrowing and lending agreements are entered into for acquiring and selling equities. The related balances have been included in the balance sheet as Assets under stock borrowing and lending agreements and Liabilities under stock borrowing and lending agreements.

These balances were reported as Loans and advances to banks, Loans and advances to customers, Deposits by banks and Customer accounts in 1997 and have been reclassified in this year's accounts.

Income earned and expense paid on these agreements is reported as Fees and commissions receivable and Fees and commissions payable, except when in the nature of interest, in which case they are reported as Interest receivable and Interest payable.

Debt securities in issue
Premiums, discounts and expenses relating to bonds and notes issued as part of the Group's funding programme are amortised over the life of the underlying transaction. Bonds and notes issued are therefore stated at net issue proceeds adjusted for amortisation. Where premiums, discounts and expenses are matched by swap fees, the presentation of these premiums, discounts and expenses has been matched with the presentation of the swap fees, in Other assets and Other liabilities.

Derivatives
Transactions are undertaken in derivative financial instruments, 'derivatives', which include interest rate swaps, cross-currency swaps, futures, equity derivatives, options and similar instruments, for trading and non-trading purposes. Credit derivatives are accounted for within Guarantees and assets pledged as collateral security.

Derivatives classified as trading are held for market making or portfolio management purposes within the Group's trading books. Trading book activity is the buying and selling of financial instruments in order to take advantage of short term changes in market prices or for market making purposes in order to facilitate customer requirements. Trading derivatives are carried at fair value in the balance sheet within Other assets and Other liabilities. Valuation adjustments to cover credit and market liquidity risks and future administration costs are made. Positive and negative fair values of trading derivatives are offset where the contracts have been entered into under master netting agreements or other arrangements that represent a legally enforceable right of set-off which will survive the liquidation of either party. Gains and losses are taken directly to the profit and loss account and reported within Dealing profits.

Derivatives classified as non-trading are those entered into for the purpose of matching or eliminating risk from potential movements in foreign exchange rates, interest rates, and equity prices inherent in the Group's non-trading assets, liabilities and positions. Non-trading assets, liabilities and positions are those intended for use on a continuing basis in the activities of the Group.

A derivative is designated as non-trading where there is an offset between the effects of potential movements in market rates on the derivative and designated non-trading asset, liability or position being hedged. Non-trading derivatives are reviewed regularly for their effectiveness as hedges. Non-trading derivatives are accounted for on an accruals basis, consistent with the assets, liabilities, or positions being hedged. Income and expense on non-trading derivatives are recognised as they accrue over the life of the instruments as an adjustment to interest receivable or payable.

Where a non-trading derivative no longer represents a hedge because either the underlying non-trading asset, liability or position has been derecognised, or transferred into a trading portfolio, or the effectiveness of the hedge has been undermined, it is restated at fair value and any change in value is taken directly to the profit and loss account and reported within Other operating income. Thereafter the derivative is classified as trading or redesignated as a hedge of a non-trading item and accounted for accordingly.

In other circumstances, where non-trading derivatives are reclassified as trading or where non-trading derivatives are terminated, any resulting gains and losses are amortised over the remaining life of the hedged asset, liability or position. Unamortised gains and losses are reported within Other assets and Other liabilities on the balance sheet.

Derivatives hedging anticipatory transactions are accounted for on a basis consistent with the relevant type of transaction. Where anticipatory transactions do not actually occur, related derivatives are restated at fair value and changes in value are taken directly to the profit and loss account and reported within Other operating income. Where retained, such derivatives are reclassified as trading or redesignated as a hedge of a non-trading item and accounted for accordingly.

Equipment leased to customers

Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. All other assets leased to customers are classified as Operating lease assets. The net investment in finance leases represents total minimum lease payments less gross earnings allocated to future periods. Income from finance leases is credited to the profit and loss account using the actuarial after tax method to give a constant periodic rate of return on the net cash investment. Operating lease assets are shown at cost less depreciation, and are shown as a separate category of fixed asset since they are held for a different purpose. Income in respect of Operating lease assets and the depreciation charge for the period are both included within Other operating income.

Provisions for bad and doubtful debts

Specific provisions are made against loans and advances when, as a result of regular appraisals of the assets, it is considered that recovery is doubtful. A general provision is made against loans and advances to cover bad and doubtful debts which have not been separately identified but which are known from experience to be present in any portfolio of loans and advances. The specific and general provisions are deducted from loans and advances. Provisions made during the year, less amounts released and recoveries of amounts written off in previous years, are charged to the profit and loss account.

Securitisations

Certain Group undertakings have issued debt securities, or have entered into funding arrangements with lenders, in order to finance the purchase of certain portfolios of loan and investment assets. These obligations are secured on the assets of the undertakings. Where the Group has retained significant benefits and risks relating to the portfolios of assets, the assets and the related liabilities are presented within the relevant headings in the Group balance sheet.

Long term assurance business

The value of the long term assurance business represents the value of the shareholders' interest in the long term assurance funds, which consists of the present value of the surplus expected to emerge in the future from business currently in force, together with the Group's shareholders' interest in the surplus retained within the long term assurance funds.

In determining this value, assumptions relating to future mortality, persistency and levels of expenses are based on experience of the business concerned. Surplus expected to emerge in the future is discounted at a risk-adjusted discount rate after provision has been made for taxation. Changes in the value, which is determined on a post-tax basis, are included in the profit and loss account grossed up at the effective rate of tax. The post-tax increase in the value is treated as non-distributable until it emerges as part of the surplus arising during the year.

The values of the assets and liabilities of the long term assurance funds are based on the amounts included in the accounts of the Life Assurance companies. The values are determined in accordance with the terms of the Companies Act 1985 (Insurance Companies Accounts) Regulations 1993, adjusted for the purposes of inclusion in the Group accounts in order to be consistent with the Group's accounting policies and presentation, where a separate asset is established to account for the value of long term assurance business. See note 21.

Foreign currency translation

Income and expenses arising in foreign currencies are translated into sterling at the average rates of exchange over the accounting period unless they are hedged in which case the relevant hedge rate is applied. Dividends are translated at the rate prevailing on the date the dividend is receivable. Assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange current at the balance sheet date. In the Group accounts, exchange differences on the translation of the opening net assets of foreign Group undertakings to the closing rate of exchange are taken to reserves, as are those differences resulting from the restatement of the profits and losses of foreign Group undertakings from average to closing rates. Exchange differences arising on the translation of foreign currency borrowings used to hedge investments in overseas undertakings are taken directly to reserves and offset against the corresponding exchange differences arising on the translation of the investments. Other translation differences are dealt with through the profit and loss account.

Pensions

Where pensions are provided by means of a funded defined benefits scheme, annual contributions are based on actuarial advice. The expected cost of providing pensions is recognised on a systematic basis over the expected average remaining service lives of members of the scheme.

1. Segmental analysis	UK Retail Banking £m	Treasury & Wholesale Banking £m	Life Assurance £m	Finance House £m	General Insurance £m	Wealth Management £m	Continental Europe £m	Group Central Holdings £m	Group Total £m
1998									
Net interest income before exceptional items	**1,426**	**399**	**(11)**	**337**	**(5)**	**47**	**17**	**19**	**2,229**
Other income and charges	**360**	**67**	**211**	**8**	**147**	**38**	**18**	**40**	**889**
Total operating income	**1,786**	**466**	**200**	**345**	**142**	**85**	**35**	**59**	**3,118**
Profit (loss) before taxation and exceptional items	**900**	**361**	**190**	**120**	**98**	**26**	**–**	**(107)**	**1,588**
Year 2000 and EMU costs	**(41)**	**(2)**	**(7)**	**(1)**	**(4)**	**(1)**	**(4)**	**(8)**	**(68)**
Profit (loss) before taxation	**859**	**359**	**183**	**119**	**94**	**25**	**(4)**	**(115)**	**1,520**
Includes for:									
discontinued operations	**1**	**–**	**–**	**–**	**–**	**–**	**13**	**(9)**	**5**
Total assets	**62,244**	**84,943**	**14,360**	**9,503**	**137**	**4,225**	**1,289**	**1,078**	**177,779**
Net assets	**554**	**1,669**	**713**	**577**	**107**	**128**	**182**	**1,477**	**5,407**
1997									
Net interest income before exceptional items	1,335	282	(9)	305	(3)	23	16	73	2,022
Other income and charges	239	79	182	4	144	31	2	57	738
Total operating income	1,574	361	173	309	141	54	18	130	2,760
Profit (loss) before taxation and exceptional items	786	297	167	133	105	14	(26)	(24)	1,452
Year 2000 and EMU costs*	(21)	–	(2)	–	(1)	–	(4)	–	(28)
Finance lease adjustment	–	(133)	–	–	–	–	–	–	(133)
Adjustment to income from long term assurance business	–	–	(12)	–	–	–	–	–	(12)
Profit (loss) before taxation	765	164	153	133	104	14	(30)	(24)	1,279
Includes for:									
acquired operations	–	4	–	–	–	3	–	–	7
discontinued operations	–	–	–	–	–	–	(1)	–	(1)
Total assets	60,633	68,497	10,915	4,825	133	2,059	1,325	2,421	150,808
Net assets	472	1,331	563	406	244	24	288	1,550	4,878

*These costs were not treated as exceptional items in 1997, but are now separately disclosed for comparative purposes.

The segmental analysis has been revised to reflect more clearly the results of the Group's business segments, and to ensure improved comparability between segments. The following changes in classification between segments have been made:

a) Cost Allocations Further developments to the costing model have resulted in a more accurate allocation of costs from UK Retail Banking to Abbey National-branded unsecured lending (part of the Finance House segment) and to the Group's central support functions, included in the Group Central Holdings segment. 1997 comparatives have been restated accordingly.

b) Wealth Management A new Wealth Management segment is disclosed. This comprises the Group's offshore operations in Jersey, Isle of Man and Gibraltar, representative offices in Hong Kong and Dubai, and the onshore retail financial services operations of Cater Allen, Citydeal and Abbey National Independent Consulting Group (ANICG). Most of the elements of the Wealth Management segment were previously within the Treasury & Offshore segment (now renamed Treasury & Wholesale Banking). ANICG was formerly part of the UK Retail Banking segment.

Consistent with previous years, when arriving at the segmental analysis, various notional adjustments have been made.
They include an adjustment to reflect the capital notionally absorbed by each segment, based on the Group's Financial Services Authority regulatory requirements, and an allocation across the segments of the earnings on group reserves.

1. Segmental analysis continued

The effect on the results for the year ended 31 December 1998 is as follows:

	1998 Previously reported basis £m	Cost allocation £m	Wealth Management £m	1998 Revised basis £m
Profit before taxation and exceptional items:				
UK Retail Banking	**846**	**42**	**12**	**900**
Treasury & Wholesale Banking	**385**	**–**	**(24)**	**361**
Life Assurance	**190**	**–**	**–**	**190**
Finance House	**138**	**(18)**	**–**	**120**
General Insurance	**98**	**–**	**–**	**98**
Wealth Management	**–**	**–**	**26**	**26**
Continental Europe	**–**	**–**	**–**	**–**
Group Central Holdings	**(69)**	**(24)**	**(14)**	**(107)**
	1,588	–	–	**1,588**

The comparative segmental results for the year ended 31 December 1997 have been restated as follows:

	1997 Previously reported basis £m	Cost allocation £m	Wealth Management £m	Year 2000 and EMU costs £m	1997 Revised basis £m
Profit before taxation and exceptional items:					
UK Retail Banking	722	41	2	21	786
Treasury & Wholesale Banking	308	–	(11)	–	297
Life Assurance	165	–	–	2	167
Finance House	152	(19)	–	–	133
General Insurance	104	–	–	1	105
Wealth Management	–	–	14	–	14
Continental Europe	(30)	–	–	4	(26)
Group Central Holdings	3	(22)	(5)	–	(24)
	1,424	–	–	28	1,452

No separate geographical analysis is presented because the only significant non-UK businesses are shown in the Continental Europe and Wealth Management business segments and represents less than 5% of total assets.

2. Other interest receivable and similar income

	1998 £m	1997 £m
On secured advances	**5,128**	4,653
On unsecured advances	**582**	464
On finance leases (before leasing adjustment: see note 3)	**339**	309
On stock purchase and resale agreements	**286**	194
On other interest earning assets and investments	**132**	203
	6,467	5,823

Interest receivable on secured advances has been reduced by £207m (£227m) in respect of the charge for lending-related fees and discounts payable, which are charged against interest income over the period of time which the Group has the right to recover the incentives in the event of early redemption. The movements on such incentives are as follows:

	Group			Company		
	Interest rate discounts £m	Cashbacks £m	Total £m	Interest rate discounts £m	Cashbacks £m	Total £m
At 1 January 1998	98	352	450	98	351	449
Expenditure incurred in the year	125	180	305	125	178	303
Transfer to profit and loss account	(110)	(97)	(207)	(110)	(96)	(206)
At 31 December 1998	113	435	548	113	433	546

Interest due but not received on loans and advances in arrears has not been recognised in interest receivable where collectability is in doubt, but has been suspended. A table showing the movements on suspended interest is included in note 10.

3. Exceptional items

1998: Year 2000 and EMU costs

The costs incurred during the year ended 31 December 1998 in preparing the Group for Year 2000 and Economic and Monetary Union (EMU) have been treated as exceptional items but included within existing captions in the profit and loss account. These costs were not treated as exceptional items for 1997 reporting. An analysis of the expenditure incurred, including comparatives, is shown below:

Year ended 31 December 1998	Year 2000 £m	EMU £m	Total £m
Expenditure charged to the profit and loss account:			
Included within Other administrative expenses	**58**	**3**	**61**
Included within Income from long term assurance business	**7**	**–**	**7**
Capital expenditure (included within Tangible fixed assets)	**6**	**–**	**6**
Year ended 31 December 1997 (restated)	**Year 2000 £m**	**EMU £m**	**Total £m**
Expenditure charged to the profit and loss account:			
Included within Other administrative expenses	23	3	26
Included within Income from long term assurance business	2	–	2
Capital expenditure (included within Tangible fixed assets).	11	2	13

Comparative figures for 1997 have been restated to include internal costs allocated to Year 2000 and EMU projects.

Further information on Year 2000 and EMU, including a description of the associated risks and uncertainties, plans to address them and treatment of internal costs can be found on pages 32 to 33 of the Operating and Financial Review.

1997: Corporation tax changes

In 1997, the UK Government announced a package of measures which represented a significant change to the UK corporation tax regime. A number of these measures had an effect on the accounts of Abbey National. In particular, in the Finance (No. 2) Act 1997, the Government reduced the main rate of corporation tax from 33% to 31%, and abolished the reclaim of tax credits on dividends from UK equity investments by pension funds. In November 1997, the Government announced a further reduction in the main rate of corporation tax to 30% from April 1999, and announced proposals to change from annual to quarterly tax payment dates. These proposals were subsequently enacted.

Adjustment to net investment in finance leases

In common with the industry, the changes in corporation tax resulted in a reduction in value of the Group's net investment in finance leases. The effect for the Group was a reduction in interest receivable on finance leases of £133m. Tax variation clauses in the leases, which preserve the lessors' post-tax rate of return over the life of the leases, resulted in lower gross rental income when tax rates were reduced. A compensating reduction in the deferred tax liability was recognised (see note 37) and shown as a reduction in the tax charge. Group profit after tax and earnings per ordinary share were unaffected.

Adjustment to income from long term assurance business

As a result of the abolition of the reclaim of tax credits on dividends from UK equity investments by pension funds, a provision of £12m before tax (£8m after tax) was made against the embedded value profits for the Life Assurance subsidiaries in 1997 (see note 21).

4. Interest payable

	1998 £m	1997 £m
On retail customer accounts	**2,757**	2,402
On sale and repurchase agreements	**1,000**	280
On other deposits and loans	**3,277**	2,934
On subordinated liabilities	**215**	193
	7,249	5,809

5. Dividend income

	1998 £m	1997 £m
Income from equity shares and other variable yield securities	**4**	3

6. Other operating income	1998 £m	1997 £m
Deferred income release (see note 35)	**70**	24
Profits less losses on disposal of investment securities	**17**	10
Other	**85**	49
	172	83

7. Administrative expenses	1998 £m	1997 £m
Staff costs (1):		
Wages and salaries	**516**	455
Social security costs	**42**	39
Other pension costs	**53**	40
	611	534
Property and equipment expenses:		
Rents payable	**62**	60
Rates payable	**25**	26
Hire of equipment	**6**	6
Other property and equipment expenses	**77**	69
	170	161
Other administrative expenses (2)	**459**	401
	1,240	1,096

Notes:

(1) Excludes the following staff costs incurred by Life Assurance, which are charged to income from long term assurance business:

	1998 £m	1997 £m
Staff costs:		
Wages and salaries	**37**	36
Social security costs	**3**	3
Other pension costs	**4**	4
	44	43

(2) Includes the following amounts in respect of payments to the auditors, PricewaterhouseCoopers:

All amounts stated net of V.A.T.	1998 £m	1997 £m
Audit services	**2.9**	2.1
Reporting accountants and other regulatory reporting	**1.3**	2.2
Sub-total: Audit and similar services	**4.2**	4.3
Tax services	**0.6**	0.7
Consultancy and advisory services	**2.2**	1.9
Sub-total: Other services	**2.8**	2.6
	7.0	6.9

Included within the remuneration for audit services is the audit fee for the Company of £0.9m (£0.9m).

Of the fees payable to the Group's auditors for audit services £2.7m (£2.0m) related to the United Kingdom.

Non-audit fees of £2.8m for PricewaterhouseCoopers in 1998 include £2.7m paid to Coopers & Lybrand and £0.1m paid to Price Waterhouse prior to the date of appointment of PricewaterhouseCoopers as auditors. Non-audit fees in 1997 comprise solely amounts paid to the previous auditors Coopers & Lybrand.

Payments to PricewaterhouseCoopers for Consultancy and advisory services represents less than 5% (5%) of the Group's total consultancy expenditure.

8. Employees

The average number of staff employed by the Group during the year was as follows:

	1998	1997 (as restated)
UK Retail Banking	**17,047**	16,076
Treasury & Wholesale Banking	**677**	347
Life Assurance	**1,889**	1,736
Finance House	**2,672**	2,301
General Insurance	**904**	798
Wealth Management	**1,013**	672
Continental Europe	**413**	468
Group Central Holdings	**3,348**	3,066
	27,963	25,464

Comparatives have been restated to include the Wealth Management segment.

9. Depreciation and amortisation

	1998 £m	1997 £m
Amortisation of intangible fixed assets – purchased goodwill (see note 25)	**1**	–
Depreciation of tangible fixed assets (see note 26)	**105**	98
	106	98

10. Provisions for bad and doubtful debts

	On advances secured on residential properties £m	**On other secured advances £m**	**On unsecured advances £m**	**Total £m**
Group				
At 1 January 1998				
General	84	13	20	117
Specific	100	130	110	340
Exchange adjustments	1	4	–	5
Acquisitions of subsidiary undertakings/purchase of business	–	40	46	86
Disposals of subsidiary undertakings	(1)	(7)	–	(8)
Transfer from profit and loss account	60	4	137	201
Irrecoverable amounts written off	(29)	(43)	(108)	(180)
At 31 December 1998	215	141	205	561
Being for the Group:				
General	109	23	67	199
Specific	106	118	138	362
Including for the Company:				
At 1 January 1998				
General	49	1	11	61
Specific	61	3	81	145
At 31 December 1998				
General	62	–	12	74
Specific	57	1	101	159

10. Provisions for bad and doubtful debts continued

Capital provisions as a percentage of loans and advances to customers

	On advances secured on residential properties %	On other secured advances %	On unsecured advances %	Total %
Group				
At 31 December 1998				
UK	0.3	3.4	3.2	0.6
Non-UK	1.8	44.7	2.2	7.3
At 31 December 1997				
UK	0.3	13.6	3.5	0.5
Non-UK	1.8	38.7	1.3	7.7
Company				
At 31 December 1998	0.2	1.4	6.2	0.4
At 31 December 1997	0.2	3.1	5.8	0.3

Analysis of movements on suspended interest	£m	£m	£m	£m
Group				
At 1 January 1998	50	122	9	181
Exchange adjustments	1	4	–	5
Acquisitions of subsidiary undertakings/purchase of business	–	1	–	1
Amounts suspended in the period	30	7	10	47
Irrecoverable amounts written off	(20)	(56)	(8)	(84)
At 31 December 1998	61	78	11	150
Including for the Company:				
At 1 January 1998	34	3	6	43
At 31 December 1998	40	1	8	49
The value of loans and advances at 31 December 1998 on which interest is suspended is as follows:				
Group				
Loans and advances to customers	684	206	185	1,075
Provisions on these amounts	(106)	(118)	(46)	(270)
Company				
Loans and advances to customers	558	2	107	667
Provisions on these amounts	(57)	(1)	(78)	(136)

Analysis of Group non-performing loans and advances

The following table presents loans and advances which are classified as ‘non-performing’ in accordance with US disclosure requirements. Under this definition loans and advances are classified as ‘non-performing’ if they are either accounted for on a non-accruals basis, or in arrears for more than 90 days, irrespective of whether interest has been suspended or a specific provision made. No interest is suspended or provisions made in respect of such cases where the Group does not expect to incur losses.

	1998 £m	1997 £m
Loans and advances on which a proportion of interest has been suspended and/or on which specific provision has been made	**1,184**	892
Loans and advances 90 days overdue on which no interest has been suspended and on which no specific provision has been made	**1,335**	1,216
Non-accruing loans and advances	**170**	208
Total non-performing loans and advances	**2,689**	2,316
Non-performing loans and advances as a percentage of total loans and advances to customers	**3.69%**	3.44%
Provisions as a percentage of total non-performing loans and advances	**20.86%**	19.73%

11. Tax on profit on ordinary activities

	1998 £m	1997 £m
UK Corporation tax:		
Current at 31% (31.5%)	**387**	319
Prior years	**113**	(159)
Double tax relief	**(58)**	(18)
Deferred tax:		
Current year	**90**	10
Prior years	**(123)**	142
Tax on franked investment income	**–**	4
Overseas taxation	**53**	28
	462	326

The current year deferred tax charge for 1997 includes a credit of £137m in respect of the taxation effect of exceptional items as explained in note 3.

12. Profit on ordinary activities after tax

The profit after tax of the Company attributable to the shareholders is £544m (£555m). As permitted by section 230 of the Companies Act 1985, the Company's profit and loss account has not been presented in these accounts.

13. Dividends

	1998 Pence per share	1997 Pence per share	1998 £m	1997 £m
Ordinary shares				
Interim (paid)	**11.75**	10.20	**167**	144
Final (proposed)	**23.55**	20.50	**334**	290
	35.30	30.70	**501**	434
Preference shares (non-equity)			**34**	35
			535	469

Preference share dividends include an exchange loss of nil (1997: exchange loss of £4m) in respect of US dollar preference shares. See note 40 for further details of the terms of these shares.

14. Earnings per ordinary share

	1998	1997
Profit attributable to the shareholders of Abbey National plc (£m)	**1,058**	954
Preference dividends (£m)	**(34)**	(35)
Profit attributable to the ordinary shareholders of Abbey National plc (£m)	**1,024**	919
Weighted average number of ordinary shares in issue during the year – basic (million)	**1,414**	1,409
Basic earnings per ordinary share (pence)	**72.4**	65.2
Profit attributable to the ordinary shareholders of Abbey National plc (£m)	**1,024**	919
Weighted average number of ordinary shares in issue during the year – basic (million)	**1,414**	1,409
Weighted average effect of share options (million)	**13**	12
Weighted average number of ordinary shares in issue during the year – diluted (million)	**1,427**	1,421
Diluted earnings per ordinary share (pence)	**71.7**	64.7

15. Treasury bills and other eligible bills

	Group 1998		Group 1997	
	Book value £m	**Market value £m**	Book value £m	Market value £m
Investment securities				
Treasury bills and similar securities	**–**	**–**	9	9
Other securities				
Treasury bills and similar securities	**746**	**746**	388	388
Other eligible bills	**1,311**	**1,311**	1,231	1,231
Sub-total	**2,057**	**2,057**	1,619	1,619
Total	**2,057**	**2,057**	1,628	1,628

The movement on treasury bills and similar securities held for investment purposes was as follows:

	Group £m
At 1 January 1998	9
Disposals	(9)
At 31 December 1998	–

16. Loans and advances to banks

	Group		Company	
	1998 £m	1997 £m	**1998 £m**	1997 £m
Items in the course of collection	**216**	256	**214**	252
Amounts due from subsidiaries	**–**	–	**2,995**	315
Purchase and resale agreements	**4,983**	3,087	**–**	–
Other loans and advances	**2,229**	4,928	**152**	19
	7,428	8,271	**3,361**	586
Repayable:				
On demand	**3,711**	2,938	**744**	334
In not more than three months	**2,890**	4,803	**214**	252
In more than three months but not more than one year	**295**	64	**274**	–
In more than one year but not more than five years	**461**	437	**173**	–
In more than five years	**71**	29	**1,956**	–
	7,428	8,271	**3,361**	586

Following an accounting presentation change, assets under stock borrowing and lending agreements are reported under a separate heading in the balance sheet. The 1997 comparative amounts have therefore been reclassified to reflect this (Group £722m, Company nil).

The loans and advances to banks in the above table have the following interest rate structures:

	Group		Company	
	1998 £m	1997 £m	**1998 £m**	1997 £m
Fixed rate	**5,924**	6,956	**1,561**	8
Variable rate	**1,288**	1,059	**1,586**	326
Items in the course of collection (non-interest bearing)	**216**	256	**214**	252
	7,428	8,271	**3,361**	586

The Group's policy is to hedge all fixed rate loans and advances to banks to floating rates using derivative instruments, or by matching with other on-balance sheet interest rate exposures. See note 48, Derivatives, 'Non-trading derivatives' for further information.

17. Loans and advances to customers

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Advances secured on residential properties	**63,194**	61,864	**59,733**	58,333
Purchase and resale agreements	**749**	701	**–**	–
Other secured advances	**2,019**	495	**68**	114
Unsecured loans	**6,188**	3,651	**1,661**	1,480
Collateralised and guaranteed mortgage loans	**111**	167	**–**	–
Amounts due from subsidiaries	**–**	–	**707**	709
	72,261	66,878	**62,169**	60,636
Repayable:				
On demand or at short notice	**3,575**	3,477	**3,356**	2,910
In not more than three months	**2,482**	1,476	**537**	504
In more than three months but not more than one year	**2,697**	1,312	**905**	865
In more than one year but not more than five years	**7,006**	4,650	**3,985**	3,562
In more than five years	**57,062**	56,420	**53,619**	53,001
Less: provisions (see note 10)	**(561)**	(457)	**(233)**	(206)
	72,261	66,878	**62,169**	60,636

Included in Group loans and advances to customers are loans to associated undertakings of £7m (£1m).

Following an accounting presentation change, assets under stock borrowing and lending agreements are reported under a separate heading in the balance sheet. The 1997 comparative amounts have therefore been reclassified to reflect this (Group £5,956m, Company nil).

The loans and advances to customers included in the above table have the following interest rate structures:

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Fixed rate	**22,182**	14,263	**16,328**	12,571
Variable rate	**50,640**	53,072	**46,074**	48,271
Provisions	**(561)**	(457)	**(233)**	(206)
	72,261	66,878	**62,169**	60,636

The Group’s policy is to hedge all fixed rate loans and advances to customers using derivative instruments, or by matching with other on-balance sheet interest rate exposures. See note 48, Derivatives, ‘Non-trading derivatives’ for further information.

18. Net investment in finance leases

	Group 1998 £m	Group 1997 £m
Amounts receivable	**10,666**	10,316
Less: deferred income	**(5,326)**	(5,661)
Less: provisions for impairment (see below)	**(14)**	–
	5,326	4,655
Repayable:		
In not more than three months	**132**	54
In more than three months but not more than one year	**609**	106
In more than one year but not more than five years	**578**	270
In more than five years	**4,007**	4,225
	5,326	4,655
Cost of assets acquired for the purpose of letting under finance leases in the year	**268**	545
Gross rentals receivable	**472**	393
Commitments as lessor for the purchase of equipment for use in finance leases	**381**	160
Amounts outstanding subject to a sub-participation	**210**	216

Provisions for impairment relate to small ticket leasing assets acquired in the year.

19. Debt securities

	Group 1998		Group 1997		Company 1998		Company 1997	
	Book value £m	**Market value £m**	Book value £m	Market value £m	**Book value £m**	**Market value £m**	Book value £m	Market value £m
Investment securities								
Issued by public bodies:								
Government securities	**5,428**	**5,616**	7,924	8,315	**372**	**374**	1,655	1,661
Other public sector securities	**3,097**	**3,093**	2,490	2,521	**29**	**29**	29	29
	8,525	**8,709**	10,414	10,836	**401**	**403**	1,684	1,690
Issued by other issuers:								
Bank and building society certificates of deposit	**401**	**405**	257	257	**–**	**–**	–	–
Other debt securities	**29,666**	**29,718**	21,560	21,744	**1,090**	**1,090**	883	883
	30,067	**30,123**	21,817	22,001	**1,090**	**1,090**	883	883
Sub-total	**38,592**	**38,832**	32,231	32,837	**1,491**	**1,493**	2,567	2,573
Other securities								
Issued by public bodies:								
Government securities	**1,863**	**1,863**	635	635	**–**	**–**	–	–
	1,863	**1,863**	635	635	**–**	**–**	–	–
Issued by other issuers:								
Bank and building society certificates of deposit	**9,724**	**9,724**	6,429	6,429	**–**	**–**	–	–
Other debt securities	**4,024**	**4,024**	7,159	7,159	**–**	**–**	–	–
	13,748	**13,748**	13,588	13,588	**–**	**–**	–	–
Sub-total	**15,611**	**15,611**	14,223	14,223	**–**	**–**	–	–
Total	**54,203**	**54,443**	46,454	47,060	**1,491**	**1,493**	2,567	2,573

The investment securities held by the Company include subordinated investments in subsidiaries of £1,089m (£882m) and are included within Other debt securities.

	Group 1998		Group 1997		Company 1998		Company 1997	
	Book value £m	**Market value £m**	Book value £m	Market value £m	**Book value £m**	**Market value £m**	Book value £m	Market value £m
Analysed by listing status:								
Investment securities								
Listed in the UK	**4,538**	**4,640**	5,481	5,583	**372**	**374**	1,654	1,660
Listed or registered elsewhere	**31,169**	**31,289**	22,201	22,629	**–**	**–**	–	–
Unlisted	**2,885**	**2,903**	4,549	4,625	**1,119**	**1,119**	913	913
	38,592	**38,832**	32,231	32,837	**1,491**	**1,493**	2,567	2,573
Other securities								
Listed in the UK	**70**	**70**	66	66	**–**	**–**	–	–
Listed or registered elsewhere	**4,799**	**4,799**	7,110	7,110	**–**	**–**	–	–
Unlisted	**10,742**	**10,742**	7,047	7,047	**–**	**–**	–	–
	15,611	**15,611**	14,223	14,223	**–**	**–**	–	–
Total	**54,203**	**54,443**	46,454	47,060	**1,491**	**1,493**	2,567	2,573

19. Debt securities continued

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Book value				
Analysed by maturity:				
Due within one year	**13,886**	9,891	**395**	813
Due in more than one year but not more than five years	**17,197**	15,490	**–**	835
Due in more than five years but not more than ten years	**7,777**	9,111	**221**	191
Due in more than ten years	**15,343**	11,962	**875**	728
	54,203	46,454	**1,491**	2,567

The movement on debt securities held for investment purposes was as follows:

	Cost £m	Provisions £m	Net book value £m
Group			
At 1 January 1998	32,258	(27)	32,231
Exchange adjustments	505	–	505
Additions	26,278	–	26,278
Disposals	(11,418)	–	(11,418)
Redemptions and maturities	(8,102)	–	(8,102)
Transfers to other securities (net)	(865)	–	(865)
Transfer from profit and loss account	–	(18)	(18)
Amortisation of premiums	(19)	–	(19)
At 31 December 1998	38,637	(45)	38,592
Company			
At 1 January 1998	2,567	–	2,567
Additions	768	–	768
Disposals	(1,766)	–	(1,766)
Amortisation of premiums	(78)	–	(78)
At 31 December 1998	1,491	–	1,491

The total net book value of debt securities held for investment purposes at 31 December 1998 includes unamortised discounts of £262m (£196m) for the Group, and unamortised premiums of £6m (£80m) for the Company.

The Group enters into sale and repurchase agreements. The total nominal value of assets so transferred and which are included above is £7,078m (£2,560m) including, for the Company, nil (nil). Cash collateral associated with these transactions of £7,041m (£2,600m) for the Group and nil (nil) for the Company is included in Deposits by banks.

The Company has lent government securities of £360m (nil) on an unsecured basis under a gilt stock lending agreement to Abbey National Treasury Services Plc.

Market values of investment securities are based on market prices of securities where available. Where market prices are not available, valuations are stated at amortised cost less any provision for permanent diminution in value.

Included within investment securities are a number of securities held for hedging purposes. Some of these provide temporary hedging cover where permanent hedges are not immediately available.

There are hedges in place in respect of the majority of fixed rate investment securities whereby the rise or fall in their market value, due to interest rate movements, will be offset by a substantially equivalent reduction or increase in the value of the hedges.

20. Equity shares and other variable yield securities

	Group 1998		Group 1997		Company 1998		Company 1997	
	Book value £m	**Market value £m**	Book value £m	Market value £m	**Book value £m**	**Market value £m**	Book value £m	Market value £m
Listed in the UK	**31**	**87**	28	64	**–**	**–**	19	52
Listed elsewhere	**39**	**24**	41	26	**3**	**3**	3	3
Unlisted	**53**	**56**	14	14	**1**	**1**	1	1
	123	**167**	83	104	**4**	**4**	23	56

Included within unlisted securities of the Group are variable yield securities held for purposes other than investment, having book and market values of £3m (£5m). All other equity shares and variable yield securities are held for investment purposes.

The movement on equity shares and other variable yield securities held for investment purposes was as follows:

	Group Cost & Book value £m	**Company Cost & Book value £m**
At 1 January 1998	78	23
Additions	58	–
Disposals	(15)	(19)
Provisions made for permanent diminution in value	(1)	–
At 31 December 1998	120	4

21. Long term assurance business

The value of the long term assurance business is as follows:

	1998 £m	1997 £m
Value of shareholders' interest in the long term assurance funds	**760**	649

The value of the long term assurance business is calculated by discounting the proportion of surplus which is projected to accrue to shareholders in future years from business currently in force, and adding the shareholders' interest in the surplus retained within the long term assurance funds. The basis on which this value is determined is reviewed regularly in the light of the experience of the business and expectations regarding future economic conditions. The principal long term economic assumptions used are as follows:

	%	**%**
Risk adjusted discount rate (net of tax)	10.0	10.0
Return on equities (gross of tax – pension business)	8.5	9.0
Return on equities (gross of tax – life business)	9.0	9.0
Return on gilts (gross of tax)	6.5	7.5
Inflation	4.0	4.0

The lower equity return for pension business is to reflect the abolition of tax credits on dividend income brought in as part of the Budget in July 1997. In 1997 the cost of this reduction, at £12m, was held as a provision against embedded value profits (see below).

In view of the reduction in long term gilt yields that has taken place in the market over the past two years, the assumed return on gilts has been reduced from 7.5% to 6.5%. The effect of the change in assumptions was determined by calculating the value of the long term assurance business at the beginning of the year on both the old and new assumptions. Together with other changes in respect of persistency, mortality and expense assumptions, the combined financial effect of all basis changes is to increase the value of the long term assurance business by £12m before tax and £8m after tax. The net increase is included below in income from long term assurance business for the year ended 31 December 1998.

The assumed rates of return on investments above are applied to the value of investments adjusted by reference to the assumed long term rate of investment return.

Business in force is defined as all live policies where the first premium has been paid. Recurrent single premium policies are treated as single premium policies, with the exception of Department of Social Security rebate policies, which are treated as regular premium policies. Shareholders are entitled to 10% of the value of bonuses declared in any particular year derived from the Scottish Mutual with profits fund. The level of assumed future bonuses is calculated by projecting the portfolio of with profits business forward and applying reversionary and terminal bonus rates at such a level as to exhaust the level of projected surplus of assets over liabilities. For all other business the entire surplus is attributable to shareholders.

21. Long term assurance business continued

Income from long term assurance business, which is included as Other operating income in the consolidated profit and loss account, is calculated as follows:

	1998 £m	1997 £m
Value of shareholders' interest in the long term assurance funds at 31 December	**760**	649
Value of shareholders' interest in the long term assurance funds at 1 January	**649**	555
Increase in value of long term assurance business	**111**	94
Transfers into long term assurance funds	**(17)**	(14)
Net increase in value of long term assurance business	**94**	80
Surplus transferred from long term funds	**13**	12
Income after tax from long term assurance business	**107**	92
Income before tax from long term assurance business	**155**	135

Income before tax from long term assurance business comprises:

	£m	£m
Income from long term assurance business	**155**	147
Provision against income from long term assurance business	**–**	(12)
	155	135

The provision, as referred to above, was calculated as the discounted value of the loss of tax credits on dividends from UK equity investments. This was shown as an exceptional item in the Group profit and loss account in 1997 (see note 3).

The assets and liabilities of the long term assurance funds are presented separately from those of other businesses in order to reflect the different nature of the shareholders' interest in them. The amounts of these assets, which are valued at market value, and liabilities of the long term assurance funds included in the consolidated balance sheet are based on the Life Assurance balance sheets prepared under the Companies Act 1985 (Insurance Companies Accounts) Regulations 1993.

The assets and liabilities of the long term assurance funds are:

	1998 £m	1997 £m
Investments	**7,078**	5,690
Assets held to cover linked liabilities	**5,141**	3,839
Debtors and prepayments	**754**	214
Other assets	**410**	358
Assets of the long term assurance funds	**13,383**	10,101
Technical provisions	**5,270**	4,100
Technical provisions for linked liabilities	**5,147**	3,853
Fund for future appropriations	**961**	1,016
Other creditors	**2,005**	1,132
Liabilities of the long term assurance funds	**13,383**	10,101

22. Interests in associated undertakings

The movement in interests in associated undertakings was as follows:

	Group £m	Company £m
At 1 January 1998	21	24
Additions	2	2
Disposals	(3)	(15)
At 31 December 1998	20	11

On 30 December, Abbey National plc disposed of its interest in Travellers Exchange Corporation plc. The amount receivable for the issued share capital was £11m and was received in cash. The Group loss on disposal of £9m, calculated after transferring from reserves £14m of goodwill previously written off, is included within Amounts written off fixed asset investments.

The principal associated undertakings at 31 December 1998 are:

	Nature of business	Issued share capital	Group interest (%)	Group's share of results based on accounts for the year ended
Commercial Union Underwriting Ltd	Insurance underwriting services	100 £1 ordinary A shares	15	31 December
		50,000,000 £1 ordinary B shares	21	
DAH Holdings Ltd	Private banking	635,910 US$1 ordinary A shares	9.9	31 December
		364,090 US$1 ordinary convertible B shares	50	
Willis National Holdings Ltd	Personal finance	1,000 £1 ordinary shares	49	31 December

The United Kingdom is the principal area of operation of principal associated undertakings except for DAH Holdings Ltd, whose principal areas of operation are Hong Kong and the Channel Islands, and all are registered in England & Wales, except for DAH Holdings Ltd which is registered in Bermuda.

All associated undertakings are unlisted.

Abbey National plc has the right to increase its interests in Commercial Union Underwriting Ltd up to a maximum of 75% after the fifth anniversary of the commencement of the operation (July 2000), and to 100% in certain circumstances.

23. Shares in Group undertakings

	1998 Cost & Book value £m	1997 Cost & Book value £m
Subsidiary undertakings		
Banks	**260**	442
Others	**2,516**	1,993
	2,776	2,435

The movement in shares in Group undertakings was as follows:

	Company £m
At 1 January 1998	2,435
Exchange adjustments	10
Additions	516
Disposals	(185)
At 31 December 1998	2,776

Abbey National plc entered into the following transactions:
On 25 May, Abbey National plc disposed of Abbey National Bank SAE, its Spanish subsidiary. The amount received was PTA 31 bn and was received in cash. Further details can be found in note 49f.

On 28 May, following a Group restructure to create the Wealth Management Division, Abbey National plc acquired Cater Tyndall Ltd and Cater Allen Ltd, which were previously subsidiaries of Abbey National Treasury Services plc. The amount paid in consideration for the issued share capital was £177m and was payable in cash.

23. Shares in Group undertakings continued

On 30 December, Abbey National purchased the issued capital of Lombard Tricity Finance, Lombard Business Equipment Leasing and certain motor finance companies. The amount paid in consideration for the issued share capital was £63m and was payable in cash. In addition, £2m of acquisition costs were incurred.

Subscriptions for additional share capital in existing subsidiary undertakings during the year amounted to £274m.

Subsidiaries of Abbey National plc entered into the following transactions:

Date	Company purchased/business acquired	Purchaser	Consideration
1 February	Whitechapel Corporate Services Ltd	First National Vehicle Contracts Ltd	£1m cash
13 March	Duncan Lawrie Pension Consultants	Abbey National Independent Consulting Group	£1m cash
1 April	TSB Factors Ltd Cavendish Growth companies Nos 1, 2 and 3 plc	First National Bank plc Household Mortgage Corporation PLC	£7m cash £4m capitalisation of existing loans
3 April	Home Rent Companies 1–15 plc	N&P BES Loans	£57m of which: £56m capitalisation of existing loans £1m cash
1 May	State Securities Ltd	First National Bank plc	£19m of which: £11m cash £5m loan notes £3m deferred consideration
18 July	Fleet Management Services Ltd	First National Bank plc	£11m cash
29 October	Rea Brothers Trustees Ltd, Rea Brothers Ind. Trustee Ltd, Rea Brothers Actuarial & Trustee Services	Abbey National Independent Consulting Group	£1m cash
30 December	Business of Lombard Motor Finance	First National Bank plc	£268m cash

All of the above transactions are included in the consolidated accounts as acquisitions. Further disclosures relating to these transactions can be found in note 24, Summary of the effect of acquisitions and note 49, Consolidated cash flow statement.

23. Shares in Group undertakings continued

The principal subsidiaries of Abbey National plc at 31 December 1998 are listed below, all of which are directly held except where indicated.

	Nature of business	Country of incorporation or registration
Abbey National American Investments Ltd*	Investment	England & Wales
Abbey National General Insurance Services Ltd	General insurance	England & Wales
Abbey National Independent Consulting Group Ltd	Personal finance	England & Wales
Abbey National Leasing Companies* (25 companies)	Leasing	England & Wales
Abbey National Mortgages plc*	Personal finance	England & Wales
Abbey National Treasury Investments Ltd*	Investment	England & Wales
Abbey National Treasury Services plc	Treasury operations	England & Wales
Abbey National Treasury Services Investments Ltd*	Investment	England & Wales
Cater Allen International Ltd*	Money market & stockbroking	England & Wales
First National Bank plc*	Personal finance and commercial lending	England & Wales
First National Tricity Finance Ltd	Retail point of sale finance	England & Wales
HMC Group PLC*	Personal finance	England & Wales
Wagon Finance Ltd*	Personal finance	England & Wales
Abbey National France SA	Personal finance	France
Abbey National (Gibraltar) Ltd*	Personal finance	Gibraltar
Carfax Insurance Ltd	Insurance	Guernsey
Cater Allen Bank (Isle of Man) Ltd*	Treasury operations	Isle of Man
Abbey National Treasury International Ltd*	Personal finance and treasury operations	Jersey
Abbey National Financial and Investment Services plc	Service company	Scotland
Abbey National Life plc	Insurance	Scotland
Abbey National PEP Managers Ltd*	PEP management	Scotland
Abbey National Unit Trust Managers Ltd*	Unit trust management	Scotland
Scottish Mutual Assurance plc*	Insurance	Scotland
Abbey National North America Corporation	Funding	United States

*Subsidiary held indirectly through subsidiary companies.

All the above companies are included in the consolidated accounts. The Company holds directly or indirectly 100% of the issued ordinary share capital of its principal subsidiaries. All companies operate principally in their country of incorporation or registration. Abbey National Treasury Services plc also has branch offices in France and Jersey and a representative office in Hong Kong. Abbey National (Gibraltar) Ltd has a representative office in Portugal. Abbey National Treasury International Ltd has a representative office in Hong Kong and a branch in the Isle of Man and Abbey National plc has branches in Italy and France and representative offices in Spain and Dubai.

24. Summary of the effect of acquisitions

The following table summarises the effect of all acquisitions of subsidiary undertakings and purchases of businesses in the year ended 31 December 1998:

	Book value before acquisition £m	Accounting policy adjustments £m	Revaluation adjustments £m	Total fair value adjustments £m	Fair value at acquisition £m
Loans and advances to banks	4	–	–	–	4
Loans and advances to customers	3,406	–	(20)	(20)	3,386
Net investment in finance leases	691	–	–	–	691
Tangible fixed assets	68	–	–	–	68
Operating lease assets	90	–	(5)	(5)	85
Other assets	256	(1)	–	(1)	255
Total assets	4,515	(1)	(25)	(26)	4,489
Deposits by banks	3,990	2	–	2	3,992
Other liabilities	254	1	10	11	265
Total liabilities excluding shareholders’ funds	4,244	3	10	13	4,257
Net assets acquired	271	(4)	(35)	(39)	232
Total fair value of the consideration and cost of acquisitions					434
Goodwill on acquisition of subsidiary undertakings/purchase of business					202

The only significant undertaking included in the above table is Lombard Tricity Finance and its profit after tax for the period 1 January 1998 to 30 December 1998 was £4m, and the loss for the year ended 31 December 1997, £8m.

The subsidiary undertakings and business forming the Lombard acquisition were acquired on 30 December 1998, and accordingly fair values of the assets and liabilities have been estimated on a provisional basis. The purchase consideration is subject to the finalisation of the completion accounts for the entities purchased, and is also stated on a provisional basis. Adjustments to the purchase consideration, fair values and goodwill will be made as necessary during 1999.

24. Summary of the effect of acquisitions continued

The material fair value adjustments made to the book values before acquisition, as included above, and relating to the Lombard acquisition, are:

– £21m increase in provision balances against lending and operating assets;

– £5m revaluation of certain funding liabilities.

In 1997, revaluation adjustments to Other liabilities included provisions for litigation proceedings against certain Cater Allen operations and the estimated costs of resources required to address operational difficulties within City Deal Services Ltd which were in existence at the time of the acquisition. In accordance with FRS7, 'Fair values in acquisition accounting', these costs were provided on a provisional basis. In 1998, the extent of the potential liabilities has become clearer and consequently a further provision of £29m has been made against reserves as an adjustment to goodwill.

25. Intangible fixed assets	Purchased goodwill Group £m
Cost	
At 1 January 1998	–
Additions	202
At 31 December 1998	202
Amortisation	
At 1 January 1998	–
Charge for the year	1
At 31 December 1998	1
Net book value	
At 31 December 1998	201
At 31 December 1997	–

Intangible fixed assets comprises purchased goodwill arising on acquisitions of subsidiary and associated undertakings and purchases of businesses made since 1 January 1998. Previously, goodwill arising on acquisitions of subsidiary and associated undertakings and purchases of businesses was taken directly to reserves.

The cumulative amount of goodwill taken to profit and loss account reserve in previous periods by the Group and not subsequently recognised in the profit and loss account is £1,204m (£1,193m), and by the Company £528m (£528m).

Goodwill included above in respect of all material acquisitions is currently being amortised over a period of 20 years.

26. Tangible fixed assets	Group				Company		
	Investment properties £m	Other premises £m	Equipment £m	Total £m	Premises £m	Equipment £m	Total £m
Cost or valuation							
At 1 January 1998	–	451	835	1,286	403	753	1,156
Acquisitions of subsidiary undertakings	55	2	30	87	–	–	–
Disposal of subsidiary undertaking	–	–	(6)	(6)	–	–	–
Additions	–	13	98	111	–	75	75
Disposals	(3)	(30)	(22)	(55)	(31)	(10)	(41)
At 31 December 1998	52	436	935	1,423	372	818	1,190
Depreciation							
At 1 January 1998	–	68	520	588	65	480	545
Acquisition of subsidiary undertaking	–	–	17	17	–	–	–
Disposal of subsidiary undertaking	–	–	(1)	(1)	–	–	–
Charge for the year	–	9	96	105	8	82	90
Disposals	–	(2)	(15)	(17)	(2)	(7)	(9)
At 31 December 1998	–	75	617	692	71	555	626
Net book value							
At 31 December 1998	52	361	318	731	301	263	564
At 31 December 1997	–	383	315	698	338	273	611

As at 31 December 1998, investment properties are included in Tangible fixed assets at market values, calculated on an 'existing use' basis. No independent valuation was carried out at 31 December 1998 as the properties were consolidated at fair values at time of acquisition during the year, based on valuations provided by Colleys, an independent firm of professional valuers. Accordingly, the directors have placed reliance on these earlier valuations when arriving at the value as at 31 December 1998 and no revaluation has been recorded in the period.

26. Tangible fixed assets continued

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
The net book value of Other premises comprises:				
Freeholds	**292**	310	**243**	275
Long leaseholds	**26**	28	**15**	18
Short leaseholds	**43**	45	**43**	45
Land and buildings occupied for own activities:				
Net book value at 31 December	**252**	299	**234**	261
The net book value of equipment includes:				
Assets held under finance leases	**2**	2	**–**	–
Depreciation charge for the year on these assets	**1**	5	**–**	3
Capital expenditure which has been contracted, but has not been provided in the accounts	**10**	11	**9**	9

27. Operating lease assets

	Group £m
Cost	
At 1 January 1998	76
Acquisitions of subsidiary undertakings	110
Additions	114
Disposals	(32)
At 31 December 1998	268
Depreciation	
At 1 January 1998	9
Acquisitions of subsidiary undertakings	25
Charge for the year	21
Disposals	(10)
At 31 December 1998	45
Net book value	
At 31 December 1998	223
At 31 December 1997	67

	Group 1998 £m	Group 1997 £m
Capital expenditure which has been contracted, but has not been provided in the accounts	**10**	9

28. Other assets

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Foreign exchange and interest rate contracts (see note 48)	**1,030**	599	**201**	35
Debtors and other settlement balances	**1,752**	1,220	**138**	177
Introducer fees	**264**	118	**–**	–
Other	**286**	336	**225**	232
	3,332	2,273	**564**	444

The charge for the period in respect of introducer fees is £73m (£59m).

The amounts in respect of foreign exchange and interest rate contracts relate to translation differences arising from instruments which are used to hedge currency assets and liabilities, and to the revaluation of trading derivative contracts.

29. Prepayments and accrued income	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Accrued interest due from subsidiaries	**–**	–	**110**	25
Unamortised lending-related fees (see note 2)	**548**	450	**546**	449
Other accrued interest	**1,788**	1,541	**22**	61
Prepayments and other accruals	**40**	32	**16**	25
	2,376	2,023	**694**	560

30. Deposits by banks	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Items in the course of transmission	**277**	314	**269**	313
Amounts due to subsidiaries	**–**	–	**11,053**	7,791
Sale and repurchase agreements	**21,862**	7,252	**–**	–
Other deposits	**13,471**	16,248	**211**	220
	35,610	23,814	**11,533**	8,324
Repayable:				
On demand	**15,273**	3,422	**8,649**	7,763
In not more than three months	**14,533**	17,043	**270**	320
In more than three months but not more than one year	**4,452**	2,992	**274**	112
In more than one year but not more than five years	**143**	209	**173**	10
In more than five years	**1,209**	148	**2,167**	119
	35,610	23,814	**11,533**	8,324

Following an accounting presentation change, Liabilities under stock borrowing and lending agreements are reported under a separate heading in the balance sheet. The 1997 comparative amounts have therefore been reclassified to reflect this (Group £722m, Company nil).

31. Customer accounts	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Retail deposits	**49,258**	47,690	**45,750**	44,722
Amounts due to subsidiaries	**–**	–	**3,367**	4,732
Sale and repurchase agreements	**214**	3,303	**–**	–
Other customer accounts	**3,452**	4,726	**1,613**	1,557
	52,924	55,719	**50,730**	51,011
Repayable:				
On demand	**40,101**	41,168	**41,948**	42,981
In not more than three months	**10,245**	9,254	**7,823**	4,477
In more than three months but not more than one year	**1,064**	4,267	**52**	2,907
In more than one year but not more than five years	**210**	314	**4**	28
In more than five years	**1,304**	716	**903**	618
	52,924	55,719	**50,730**	51,011

Included in Group customer accounts are amounts due to associated undertakings of £16m (£6m).

Following an accounting presentation change, Liabilities under stock borrowing and lending agreements are reported under a separate heading in the balance sheet. The 1997 comparative amounts have therefore been reclassified to reflect this (Group £5,956m, Company nil).

32. Debt securities in issue

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Bonds and medium term notes	**26,162**	21,661	**–**	3
Other debt securities in issue	**16,827**	18,540	**23**	40
	42,989	40,201	**23**	43
Bonds and medium term notes are repayable:				
In not more than three months	**3,475**	1,588	**–**	–
In more than three months but not more than one year	**7,529**	5,518	**–**	3
In more than one year but not more than two years	**2,901**	4,012	**–**	–
In more than two years but not more than five years	**8,577**	6,063	**–**	–
In more than five years	**3,680**	4,480	**–**	–
	26,162	21,661	**–**	3
Other debt securities in issue are repayable:				
In not more than three months	**13,243**	14,971	**1**	5
In more than three months but not more than one year	**3,476**	3,515	**7**	20
In more than one year but not more than two years	**86**	32	**15**	15
In more than two years but not more than five years	**–**	–	**–**	–
In more than five years	**22**	22	**–**	–
	16,827	18,540	**23**	40

33. Other liabilities

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Creditors and accrued expenses	**1,870**	708	**380**	369
Short positions in government debt securities held for investment purposes	**1,199**	287	**–**	–
Income tax	**193**	207	**193**	207
Corporation tax	**370**	266	**167**	158
Foreign exchange and interest rate contracts (see note 48)	**930**	1,208	**–**	1
Obligations under finance leases (see note 34)	**2**	2	**–**	–
	4,564	2,678	**740**	735

The amounts in respect of foreign exchange and interest rate contracts relate to translation differences arising from instruments which are used to hedge currency assets and liabilities, and to the revaluation of trading derivative contracts.

34. Obligations under finance leases

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Amounts payable:				
In not more than one year	**2**	2	**–**	–
	2	2	**–**	–

35. Accruals and deferred income

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Accrued interest due to subsidiaries	**–**	–	**59**	113
Other accrued interest	**2,722**	2,561	**955**	919
Deferred income	**293**	281	**–**	–
	3,015	2,842	**1,014**	1,032

See Accounting policies, page 60, for a description of the accounting treatment of deferred income from certain residential mortgage lending. The balance of such deferred income included above is £279m (£276m). The amount taken to the profit and loss account during the year was £70m (£24m).

36. Provisions for liabilities and charges

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Deferred taxation (see note 37)	**1,074**	1,046	**2**	104
Other provisions for liabilities and charges (see note 38)	**120**	98	**70**	41
	1,194	1,144	**72**	145

37. Deferred taxation

	Group £m	Company £m
At 1 January 1998	1,046	104
Acquisitions of subsidiary undertakings	61	–
Transfer from profit and loss account	(33)	(102)
At 31 December 1998	1,074	2

The amounts provided and total potential liability are:

	Amount provided Group £m	Amount provided Company £m	Total potential liability Group £m	Total potential liability Company £m
Tax effect of timing differences due to:				
Excess of capital allowances over depreciation	13	12	13	12
Capital allowances on finance lease receivables	1,007	–	1,007	–
Other	54	(10)	54	(10)
	1,074	2	1,074	2

38. Other provisions for liabilities and charges

	Pension and other similar obligations (1) £m	Provisions for contingent liabilities and commitments £m	Other provisions (2) £m	Total £m
Group				
At 1 January 1998	12	56	30	98
Acquisitions of subsidiary undertakings	–	32	1	33
Transfer from profit and loss account	51	16	18	85
Pension contributions/provisions utilised	(64)	(25)	(7)	(96)
At 31 December 1998	(1)	79	42	120
Company				
At 1 January 1998	11	21	9	41
Transfer from profit and loss account	46	61	4	111
Pension contributions/provisions utilised	(59)	(21)	(2)	(82)
At 31 December 1998	(2)	61	11	70

(1) In addition to Pension and other similar obligations included in the above table, a balance in respect of the pension surplus acquired with the purchase of the business of N&P is included within Other assets. This balance, which was £25m (£26m) as at 31 December 1998, is being amortised over the remaining service lives of employees contributing to the scheme, and £1m (£2m) was charged to the profit and loss account in the year ended 31 December 1998.

(2) Other provisions include amounts in respect of compensation payable as a result of the review of business involving the transfers from occupational to personal pension schemes and the opting-out of and the non-joining of occupational pension schemes. The provisions for the Group excluding Life Assurance are included within Other provisions. Amounts provided in respect of Life Assurance are charged to Income from long term assurance business and carried against the asset long term assurance business in the balance sheet. In addition, provisions have been made for the administrative costs of carrying out the review, which are included within Provisions for contingent liabilities and commitments.

Aggregate amounts provided in respect of pension mis-selling compensation are as follows:

	Group excluding Life Assurance £m	Life Assurance £m	Group £m	Company £m
At 1 January 1998	12	10	22	7
Transfer from profit and loss account	18	3	21	3
Provisions utilised	(7)	(3)	(10)	(1)
At 31 December 1998	23	10	33	9

39. Subordinated liabilities including convertible debt

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Dated subordinated liabilities:				
4.513% Subordinated debt 1999 (US $340m)	**205**	–	**205**	–
Registered junior subordinated fixed rate note 1999 (US $81m)	**49**	49	**49**	49
Registered junior subordinated fixed rate note 1999 (US $26m)	**16**	16	**16**	16
Registered junior subordinated fixed rate note 1999 (US $7m)	**4**	5	**4**	5
9.00% Subordinated guaranteed bond 2002 (LUX Fr 1bn)	**17**	16	**–**	–
Subordinated loan stock 2002*	**–**	–	**17**	17
Subordinated guaranteed note 2002 (US $75m)	**45**	46	**–**	–
Subordinated floating rate note 2002 (US $75m)*	**–**	–	**45**	46
8.00% Subordinated guaranteed bond 2002 (NLG 200m)	**64**	60	**–**	–
Subordinated loan 2002 (US $112m)*	**–**	–	**68**	68
10.375% Subordinated guaranteed bond 2002	**100**	100	**–**	–
10.512% Subordinated loan stock 2001*	**–**	–	**100**	100
Subordinated floating rate note 2003 (US $100m)	**60**	61	**–**	–
Subordinated floating rate note 2003 (US $100m)*	**–**	–	**60**	61
Subordinated floating rate note 2004 (US $137m)	**83**	83	**–**	–
Subordinated floating rate note 2004*	**–**	–	**83**	83
Subordinated floating rate note 2004 (CAN $100m)	**39**	42	**–**	–
Subordinated floating rate note 2004 (US $74m)*	**–**	–	**45**	45
8.75% Subordinated guaranteed bond 2004	**151**	151	**–**	–
Subordinated floating rate note 2004*	**–**	–	**150**	150
8.2% Subordinated bond 2004 (US $500m)	**302**	304	**–**	–
Subordinated floating rate note 2004 (US $500m)*	**–**	–	**302**	304
6.69% Subordinated bond 2005 (US $750m)	**450**	454	**450**	454
10.75% Subordinated bond 2006	**101**	100	**101**	100
Subordinated guaranteed floating rate note 2009 (Swiss Fr 130m)	**57**	55	**–**	–
Subordinated floating rate note 2009 (US $102m)*	**–**	–	**62**	62
Subordinated floating rate note 2009 (DEM 1bn)	**355**	–	**355**	–
11.50% Subordinated guaranteed bond 2017	**152**	152	**–**	–
11.59% Subordinated loan stock 2017*	**–**	–	**150**	150
10.125% Subordinated guaranteed bond 2023	**152**	152	**–**	–
10.18% Subordinated loan stock 2023*	**–**	–	**150**	150
Undated subordinated liabilities:				
10.0625% Exchangeable subordinated capital securities	**199**	199	**199**	199
7.35% Subordinated step-up perpetual notes (US $500m)	**300**	302	**300**	302
6.70% Perpetual Subordinated Reset Capital Securities (US$ 500m)	**298**	–	**298**	–
5.56% Subordinated guaranteed bond (YEN 15bn)	**80**	70	**80**	70
5.50% Subordinated guaranteed notes (YEN 5bn)	**27**	23	**27**	23
4.00% Subordinated perpetual notes (YEN 5bn)	**27**	23	**27**	23
	3,333	2,463	**3,343**	2,477

The subordinated floating rate notes pay a rate of interest related to the LIBOR of the currency of denomination.

*These represent the on-lending to the Company, on a subordinated basis, of issues by subsidiary companies.

The 10.0625% Exchangeable subordinated capital securities are exchangeable into fully paid 10.375% non-cumulative non-redeemable sterling preference shares of £1 each, at the option of Abbey National. Exchange may take place on any interest payment date providing that between 30 and 60 days' notice has been given to the holders. The holders will receive one new sterling preference share for each £1 principal amount of capital securities held. The rights attaching to these preference shares would be the same as those detailed in note 40.

The 7.35% Subordinated step-up perpetual notes are redeemable at par, at the option of Abbey National, on 15 October 2006 and each fifth anniversary thereafter.

The 6.70% Perpetual Subordinated Reset Capital Securities are redeemable at par, at the option of Abbey National, on 15 June 2008 and each fifth anniversary thereafter.

The 4.00% Subordinated perpetual notes are redeemable at par, at the option of Abbey National, on 24 December 2016 and each fifth anniversary thereafter.

In common with other debt securities issued by Group companies, the capital securities are redeemable in whole at the option of Abbey National, on any interest payment date, in the event of certain tax changes affecting the treatment of payments of interest on the capital securities in the United Kingdom, at their principal amount together with any accrued interest.

40. Called up share capital and share premium account

	Ordinary shares of 10 pence each £m	Preference shares of £1 each £m	Preference shares of US$0.01 each £m	Total £m
Authorised share capital				
At 31 December 1997	175	1,000	6	1,181
At 31 December 1998	175	1,000	6	1,181
Issued and fully paid share capital				
At 1 January 1998	141	325	–	466
Issued under employee share option schemes	1	–	–	1
At 31 December 1998	142	325	–	467
Share premium account				
At 1 January 1998	1,335	9	116	1,460
Shares issued	16	–	–	16
Capitalisation of reserves in respect of shares issued via QUEST	17	–	–	17
At 31 December 1998	1,368	9	116	1,493

Under the Company's Executive, All Employee and Sharesave schemes, employees hold options to subscribe for 27,909,739 (25,903,757) ordinary shares at prices ranging from 232 to 1,195 pence per share, exercisable up to August 2008. During the year 4,751,490 (5,479,678) ordinary shares were issued on the exercise of options for a consideration of £34m (£15m).

The terms of the Group's Sharesave Schemes were amended during the year so that options maturing in the year may be subscribed for, at up to full market value, by a qualifying employee share ownership trust formed in the year (see below). The trust will then deliver the shares to the employees on payment of the option price.

During the year the Company established a qualifying employee share ownership trust (QUEST) to operate in conjunction with the Sharesave Scheme by acquiring shares in the Company and using them to satisfy Sharesave options.

The QUEST has subscribed at market value for ordinary shares at a total cost of £24m. The Company provided £17m to the QUEST for this purpose and £7m was received from Sharesave participants. The shares were all transferred by the QUEST to participants in the Group's Sharesave Scheme in satisfaction of their options. The price paid by option holders, including executive directors, was 322 pence per share (five year options) and 232 pence per share (seven year options).

The Company's contribution has been included in the Company's accounts as a capitalisation of reserves.

As of 31 December 1998 there were 2,209,127 shareholders. The following table shows an analysis of their holdings:

	Ordinary shares of 10 pence each		Preference shares of £1 each		Preference shares of US$0.01 each	
Size of shareholding	Shareholders	Shares	Shareholders	Shares	Shareholders	Shares
1–100	1,435,955	139,724,401	–	–	5	500
101–1,000	742,556	314,676,426	14	10,327	29	14,145
1,001+	29,630	962,998,059	930	324,989,673	8	7,985,355
	2,208,141	1,417,398,886	944	325,000,000	42	8,000,000

40. Called up share capital and share premium account continued

Sterling preference shares

Holders of the sterling preference shares are entitled to receive a biannual non-cumulative preferential dividend payable in sterling out of the distributable profits of the Company. The rate per annum will ensure that the sum of the dividend payable on such date and the Associated Tax Credit (as defined in the terms of the sterling preference shares) represents an annual rate of 8.625% per annum of the nominal amount of shares issued in 1998, and an annual rate of 10.375% for shares issued in 1995 and 1997.

On a return of capital or on a distribution of assets on a winding up, the sterling preference shares shall rank *pari passu* with any other shares that are expressed to rank *pari passu* therewith as regards participation in assets, and otherwise in priority to any other share capital of the Company. On such a return of capital or winding up, each sterling preference share shall, out of the surplus assets of the Company available for distribution amongst the members after payment of the Company's liabilities, carry the right to receive an amount equal to the amount paid up or credited as paid together with any premium paid on issue and the full amount of any dividend otherwise due for payment.

Other than as set out above, no sterling preference share confers any right to participate on a return of capital or a distribution of assets of the Company.

Holders of the sterling preference shares are not entitled to receive notice of or attend, speak and vote at general meetings of the Company unless the business of the meeting includes the consideration of a resolution to wind up the Company or any resolution varying, altering or abrogating any of the rights, privileges, limitations or restrictions attached to the sterling preference shares or if the dividend on the sterling preference shares has not been paid in full for the three consecutive dividend periods immediately prior to the relevant general meeting.

In any such case, the sterling preference shareholders are entitled to receive notice of and attend the general meeting at which such resolution is proposed and will be entitled to speak and vote on such a resolution but not on any other resolution.

US dollar preference shares

Holders of the US dollar preference shares are entitled to receive a quarterly non-cumulative preferential dividend payable in US dollars out of the distributable profits of the Company payable at a rate per annum which will ensure that the sum of the dividend payable on such date and the Associated Tax Credit represents an annual rate of 8.75% per annum of the Sterling value of the dollar amount issued, as fixed at issue.

The US dollar preference shares are redeemable, in whole or in part, at the option of Abbey National at any time and from time to time after five years and one day after the date of original issue, 15 November 1996. Redemption may occur only if the sterling dollar exchange rate is at or above its level at date of allotment, US$1.654:£1, or in the event of a tax or regulatory change. The redemption amount will be $25, unless redeemed in years five to ten in which instance a redemption premium will be payable.

On a return of capital or on a distribution of assets on a winding up, the US dollar preference shares shall rank *pari passu* with any other shares that are expressed to rank *pari passu* therewith as regards participation in assets, and otherwise in priority to any other share capital of the Company. On such a return of capital or winding up, each US dollar preference share shall, out of the surplus assets of the Company available for distribution amongst the members after payment of the Company's liabilities, carry the right to receive an amount equal to £22.67, payable in US dollars together with any accrued and unpaid dividends at that time.

Other than as set out above, no US dollar preference share confers any right to participate on a return of capital or a distribution of assets of the Company.

Holders of the US dollar preference shares are not entitled to receive notice of or attend, speak and vote at general meetings of the Company unless the business of the meeting includes the consideration of a resolution to wind up the Company or any resolution varying, altering or abrogating any of the rights, privileges, limitations or restrictions attached to the US dollar preference shares or if the dividend on the US dollar preference shares has not been paid in full for the six consecutive quarters immediately prior to the relevant general meeting.

In any such case, the US dollar preference shareholders are entitled to receive notice of and attend the general meeting at which such resolution is proposed and will be entitled to speak and vote on such a resolution but not on any other resolution.

41. Reserves and profit and loss account

	Profit and loss account		Non-distributable reserve	
	Group £m	Company £m	Group £m	Company £m
At 1 January 1998	2,644	2,218	308	–
Profit retained for the financial year	398	9	–	–
Goodwill taken to profit and loss account reserve during the year	(30)	–	–	–
Goodwill transferred to profit and loss account during the year	19	–	–	–
Exchange adjustments	–	(1)	–	–
Capitalised on exercise of share options issued via Quest	(17)	(17)	–	–
Transfer from profit and loss account	–	–	125	–
At 31 December 1998	3,014	2,209	433	–

The non-distributable reserve represents the value of the Group's shareholders' interest in the long term assurance funds of Life Assurance.

Exchange losses arising from foreign currency borrowings used to hedge investments in overseas Group undertakings of £11m (gain of £69m) have been taken to the reserves of the Group and Company. These exchange movements are matched by corresponding exchange movements on the investments in the accounts of the Company, and exchange movements on the net assets of overseas Group undertakings in the Group accounts.

Goodwill taken to profit and loss account reserve during the year represents an adjustment to goodwill on acquisitions of subsidiary undertakings in 1997 (see note 24).

42. Reconciliation of movements in shareholders' funds

	Group		Company	
	1998 £m	1997 £m	**1998 £m**	1997 £m
Profit attributable to the shareholders of Abbey National plc	**1,058**	954	**544**	555
Dividends (see note 13)	**(535)**	(469)	**(535)**	(469)
	523	485	**9**	86
Other recognised net gains and losses relating to the year	**–**	(5)	**(1)**	–
Increases in ordinary share capital including share premium	**34**	15	**34**	15
Increases in preference share capital including share premium	**–**	129	**–**	129
Capitalised reserves on exercise of share options	**(17)**	–	**(17)**	–
Goodwill transferred from (taken to) profit and loss account reserve during the year	**(11)**	(139)	**–**	(4)
Net addition to shareholders' funds	**529**	485	**25**	226
Shareholders' funds at 1 January	**4,878**	4,393	**4,144**	3,918
Shareholders' funds at 31 December	**5,407**	4,878	**4,169**	4,144
Equity shareholders' funds	**4,957**	4,428	**3,719**	3,694
Non-equity shareholders' funds	**450**	450	**450**	450
At 31 December	**5,407**	4,878	**4,169**	4,144

Equity shareholders' funds comprise called up ordinary share capital, ordinary share premium account, profit and loss account and reserves. Non-equity shareholders' funds comprise called-up preference share capital and preference share premium account.

43. Assets and liabilities denominated in foreign currency

The aggregate amounts of assets and liabilities denominated in currencies other than sterling were as follows:

	Group		Company	
	1998 £m	1997 £m	**1998 £m**	1997 £m
Assets	**43,364**	42,489	**3,902**	2,918
Liabilities	**46,921**	47,332	**3,375**	2,371

The above assets and liabilities denominated in foreign currencies do not indicate the Group's exposure to foreign exchange risk. The Group's foreign currency positions are substantially hedged by off-balance sheet hedging instruments, or by on-balance sheet assets and liabilities denominated in the same currency.

44. Memorandum items: Guarantees and assets pledged as collateral security

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Guarantees given by Abbey National plc of subsidiaries' liabilities	**–**	–	**107,613**	85,637
Guarantees given to third parties	**813**	913	**2**	2
Mortgaged assets granted to secure future obligations to third parties who have provided security to the leasing subsidiaries	**1,031**	1,002	**–**	–
	1,844	1,915	**107,615**	85,639

Guarantees given to third parties include amounts in respect of credit derivative contracts of £73m (£64m). Credit derivatives include contracts such as credit default swaps, spread put options and credit linked notes, whereby credit risk is taken on in respect of reference assets.

45. Memorandum items: Other contingent liabilities

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Other contingent liabilities	**552**	779	**10**	16

The principal other contingent liabilities are as follows:

Rediscounted commercial bills
Cater Allen International Limited has rediscounted commercial bills, including bills sold to the Bank of England under repurchase agreements, amounting to £419m (£656m).

Repayment of certain tax credits
Abbey National Treasury Services plc has received a demand from an overseas tax authority for an amount of £113m (at the balance sheet exchange rate) (£106m) relating to the repayment of certain tax credits received and related charges. As at 31 December 1998, additional interest in relation to the demand could amount to £10m (at the balance sheet exchange rate) (£5m). The subsidiary has received legal advice that it has strong grounds to challenge the validity of the demand and accordingly no specific provision has been made.

46. Memorandum items: Commitments

The table below shows the contract or principal amount of commitments other than those relating to derivatives (see note 48).

	Group 1998 £m	Group 1997 £m	Company 1998 £m	Company 1997 £m
Formal standby facilities, credit lines and other commitments to lend:				
Less than one year	**1,225**	1,088	**321**	255
One year and over	**1,474**	984	**–**	–
Other commitments	**111**	92	**17**	34
	2,810	2,164	**338**	289

Other commitments of the Group includes £5m (£24m) and nil (£2m) of expenditure committed to Year 2000 projects and EMU projects respectively.

47. Operating leases

	Group				Company			
	1998 Property £m	**1998 Equipment £m**	1997 Property £m	1997 Equipment £m	**1998 Property £m**	**1998 Equipment £m**	1997 Property £m	1997 Equipment £m
Further rental commitments under operating leases expiring:								
In not more than one year	**1**	**4**	1	3	**1**	**4**	1	3
In more than one year but not more than five years	**11**	**5**	6	8	**10**	**4**	6	7
In more than five years	**50**	**–**	44	1	**43**	**–**	39	–
	62	**9**	51	12	**54**	**8**	46	10

As at 31 December 1998 the Group held various leases on land and buildings, many for extended periods, and other leases for equipment, which require the following aggregate rental payments:

	Group 1998 £m	**Company 1998 £m**
Year ended 31 December		
1999	67	62
2000	64	58
2001	63	58
2002	61	56
2003	57	52
Total thereafter	426	386

	1998 £m	1997 £m
Group rental expense comprises:		
In respect of minimum rentals	**67**	56
Less sub-lease rentals	**(4)**	(3)
	63	53

48. Derivatives

Derivatives are contracts or agreements whose value is derived from one or more underlying indices or asset values inherent in the contract or agreement. Derivatives are used for trading and non-trading purposes. These terms are defined in Accounting policies: Derivatives on page 61.

Non-trading derivatives

The main non-trading derivatives are interest rate and cross-currency swaps, which are used to hedge the Group's exposures to interest rates and exchange rates inherent in non-trading assets, liabilities and positions, including fixed rate lending and structured savings products within UK Retail Banking, Finance House and Continental Europe, and medium term note issues, capital issues and fixed rate asset purchases within Treasury & Wholesale Banking.

The following table summarises activities undertaken by the Group, the related risks associated with such activities and the types of derivatives used in managing such risks. Such risks may also be managed using on-balance sheet instruments as part of an integrated approach to risk management.

Activity	**Risk**	**Type of Hedge**
Management of the return on variable rate assets funded by shareholders' funds and net non-interest bearing liabilities.	Reduced profitability due to falls in interest rates.	Receive fixed interest rate swaps. Purchase interest rate floors.
Fixed rate lending.	Sensitivity to increases in interest rates.	Pay fixed interest rate swaps. Purchase interest rate caps.
Fixed rate retail and wholesale funding.	Sensitivity to falls in interest rates.	Receive fixed interest rate swaps.
Equity-linked retail funding.	Sensitivity to increases in equity market indices.	Receive equity swaps.
Management of other net interest income on retail activities.	Sensitivity of returns to changes in interest rates.	Interest rate swaps and caps/floors according to the type of risk identified.

48. Derivatives continued

Activity	Risk	Type of Hedge
Fixed rate asset investments.	Sensitivity to increases in interest rates.	Pay fixed interest rate swaps.
Investment in foreign currency assets.	Sensitivity to strengthening of sterling against other currencies.	Cross-currency swaps. Foreign currency funding.
Profits earned in foreign currencies.	Sensitivity to strengthening of sterling against other currencies.	Forward foreign exchange contracts. Purchase options.
Investment in, and issuance of, products with embedded options.	Sensitivity to changes in underlying rate and rate volatility causing option exercise.	Interest rate swaps plus caps/floors, and other matched options.
Investment in, and issuance of, bonds with put/call features.	Sensitivity to changes in rates causing option exercise.	Swaptions*.
Firm commitments (e.g. asset purchases, issues arranged).	Sensitivity to changes in rates between arranging a transaction and completion.	Hedges are arranged at the time of commitments if there is exposure to rate movements.

*A swaption is an option on a swap which gives the holder the right but not the obligation to buy or sell a swap.

Derivative products which are combinations of more basic derivatives (such as swaps with embedded option features), or which have leverage features, may be used in circumstances where the underlying position being hedged contains the same risk features. In such cases the derivative used will be structured to match the risks of the underlying asset or liability. Exposure to market risk on such contracts is therefore hedged.

Derivatives used for non-trading activities are accounted for on an accruals basis consistent with the assets, liabilities or positions being hedged.

Trading derivatives

Abbey National Financial Products (ANFP) is the only business within the Abbey National Group actively trading derivative products and is additionally responsible for implementing Group hedging activities involving derivative contracts with the external market. ANFP's objective is to gain margin value by marketing derivatives to end-users and hedging the resulting exposures efficiently. Products offered by ANFP include interest rate and cross-currency swaps, caps, floors and swaptions and variations on these products. ANFP has established clear guidelines for staff to ensure that end-users are aware of the potential risk of entering into complex derivative transactions.

A comprehensive limit structure has been established for ANFP which includes exposures to interest rates, yield curve shape, volatility and spreads. In addition to the normal limits, additional limits covering sensitivity to large changes in the underlying variables have been imposed. Substantially no foreign exchange risk is currently run within ANFP, other than that accruing through profits earned in currencies other than sterling. These exposures are monitored and hedged on a regular basis. Direct interest rate exposure is also maintained at low levels, but exact hedges are often not available in the market and this will give rise to a combination of yield curve, volatility and spread risk within the established limits. The overall management and control policy framework at ANFP is consistent with 'The Derivatives Practices and Principles' issued by the Group of 30 Global Derivatives Study Group regarding derivatives.

ANTS additionally holds trading derivatives to hedge interest rate exposures created within trading portfolios of asset backed and other securities.

Derivatives used in trading activities are stated at fair value.

Quantitative disclosures

The table below shows the contract or underlying principal amounts, and positive and negative fair values of non-trading and trading derivatives analysed by type of contract. Contract or underlying principal amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The fair value represents the amount at which a contract could be exchanged in an arm's length transaction, calculated at market rates current at the balance sheet date.

48. Derivatives continued	**Contract or underlying principal amounts 1998 £m**	**Positive fair values 1998 £m**	**Negative fair values 1998 £m** **Group**	Contract or underlying principal amounts 1997 £m	Positive fair values 1997 £m	Negative fair values 1997 £m Group
Non-trading derivatives:						
Exchange rate contracts:						
Cross-currency swaps	**13,704**	**636**	**626**	13,173	256	718
Forward foreign exchange	**5,525**	**33**	**194**	6,891	58	59
	19,229	**669**	**820**	20,064	314	777
Interest rate contracts:						
Interest rate swaps	**75,157**	**2,438**	**1,893**	58,847	857	1,044
Caps, floors and swaptions	**5,854**	**10**	**17**	5,790	4	–
Futures (exchange traded)	**7,097**	**1**	**2**	5,283	11	–
Forward rate agreements	**295**	**–**	**–**	575	–	–
	88,403	**2,449**	**1,912**	70,495	872	1,044
Equity contracts:						
Caps, floors and swaptions	**281**	**39**	**19**	155	46	1
Equity index options	**202**	**–**	**1**	62	–	–
	483	**39**	**20**	217	46	1
Total	**108,115**	**3,157**	**2,752**	90,776	1,232	1,822

Included in the above analysis of non-trading derivatives are exchange rate contracts and interest rate contracts with underlying principal amounts of £1,427m (£1,540m) and £39,419m (£25,243m) respectively, which were undertaken by Group entities with ANFP. The total net negative fair value of such contracts amounted to £151m (net positive £173m).

Associated contracts which ANFP has transacted with external counterparties are included in the analysis of trading derivatives. Net positive fair values of £151m (net negative £173m) on all contracts held by ANFP with other Group entities are included within Other liabilities, as shown in the following table:

	Contract or underlying principal amounts 1998 £m	**Positive fair values 1998 £m**	**Negative fair values 1998 £m** **Group**	Contract or underlying principal amounts 1997 £m	Positive fair values 1997 £m	Negative fair values 1997 £m Group
Trading derivatives:						
Exchange rate contracts:						
Cross-currency swaps	**3,148**	**98**	**117**	1,238	98	135
Forward foreign exchange	**71**	**–**	**8**	94	–	9
	3,219	**98**	**125**	1,332	98	144
Interest rate contracts:						
Interest rate swaps	**94,288**	**2,136**	**2,459**	55,435	1,024	1,043
Caps, floors and swaptions	**29,266**	**329**	**200**	7,492	55	61
Futures (exchange traded)	**20,677**	**–**	**–**	10,391	–	–
Forward rate agreements	**13,747**	**16**	**14**	7,730	2	2
	157,978	**2,481**	**2,673**	81,048	1,081	1,106
Equity contracts:						
Futures	**–**	**–**	**–**	4	–	–
	–	**–**	**–**	4	–	–
Total	**161,197**	**2,579**	**2,798**	82,384	1,179	1,250
Effect of netting		**(2,338)**	**(2,338)**		(1,029)	(1,029)
Translation differences on foreign exchange derivatives used for hedging purposes		**366**	**413**		332	804
Unamortised premiums		**272**	**57**		117	10
Fair values of contracts between ANFP and other Group entities		**151**	**–**		–	173
Amount included in Other assets/Other liabilities		**1,030**	**930**		599	1,208

48. Derivatives continued

Positive fair values arise where gross positive fair values exceed gross negative fair values on a contract by contract basis. This equates to net replacement cost. Negative fair values arise where gross negative fair values exceed gross positive fair values on a contract by contract basis. The totals of positive and negative fair values arising on trading derivatives as at 31 December 1998 have been netted where the Group has a legal right of offset with the relevant counterparty.

As at the balance sheet date, the Company held non-trading interest rate swaps, forward foreign exchange contracts, cross currency swaps and equity contracts with underlying principal amounts of £31,871m (£25,432m), nil (£4,174m), £453m (nil) and £203m (£156m) respectively. The net replacement cost of these contracts was £1,202m (£441m), nil (nil), £36m (nil) and £1m (£35m) respectively at 31 December 1998.

Substantially all of the Group's derivatives activity is contracted with financial institutions.

All exchange traded instruments are subject to cash requirements under the standard margin arrangements applied by the individual exchanges. Such instruments are not subject to significant credit risk. Other derivative contracts are not subject to these cash requirements.

The following table analyses over-the-counter (OTC) and other non-exchange traded derivatives held for non-trading purposes by remaining maturity:

	Contract or underlying principal amounts 1998 £m	**Net replacement cost 1998 £m**	Contract or underlying principal amounts 1997 £m	Net replacement cost 1997 £m
Derivatives maturing:				
In not more than one year	**30,913**	**318**	31,380	225
In more than one year but not more than five years	**54,254**	**1,733**	42,109	576
In more than five years	**15,851**	**1,105**	12,004	420
	101,018	**3,156**	85,493	1,221

The following table analyses OTC and other non-exchange traded derivatives held for trading purposes by remaining maturity:

	Contract or underlying principal amounts 1998 £m	**Net replacement cost 1998 £m**	Contract or underlying principal amounts 1997 £m	Net replacement cost 1997 £m
Trading derivatives maturing (before netting):				
In not more than one year	**38,882**	**683**	20,930	152
In more than one year but not more than five years	**73,342**	**1,078**	37,771	654
In more than five years	**28,296**	**818**	13,292	373
	140,520	**2,579**	71,993	1,179

For a discussion of risk management of derivatives within the trading and non-trading portfolios see pages 29 to 31 of the Operating and Financial Review.

49. Consolidated cash flow statement

a) Reconciliation of profit before tax to net cash inflow from operating activities

	1998 £m	1997 £m
Profit on ordinary activities before tax	**1,520**	1,279
Increase in interest receivable and prepaid expenses	**(1,157)**	(181)
Increase in interest payable and accrued expenses	**245**	265
Provisions for bad and doubtful debts	**201**	121
Provisions for contingent liabilities and commitments	**16**	16
Net advances written off	**(176)**	(186)
Increase in the value of long term assurance business	**(155)**	(129)
Depreciation	**126**	106
Profit on sale of tangible fixed assets and investments	**(30)**	(18)
Exceptional items	**–**	145
Effect of other deferrals and accruals of cash flows from operating activities	**16**	32
Net cash inflow from trading activities	**606**	1,450

49. Consolidated cash flow statement continued

a) Reconciliation of profit before tax to net cash inflow from operating activities continued

	1998 £m	1997 £m
Net increase in loans and advances	**(1,811)**	(1,372)
Net decrease (increase) in investment in finance leases	**20**	(480)
Net decrease (increase) in bills and securities	**(2,678)**	3,197
Net increase (decrease) in deposits and customer accounts	**5,616**	(169)
Net increase in debt securities in issue	**3,005**	4,784
Net increase (decrease) in other liabilities less assets	**487**	(127)
Exchange movements	**(557)**	375
Net cash inflow from operating activities	**4,688**	7,658

Exchange movements represent exchange movements on cash balances and investing and financing activities. The movements are not indicative of the Group's exposure to foreign exchange risk on these items, because foreign currency positions in such balances are substantially hedged by other on-balance sheet and off-balance sheet foreign currency amounts. All other exchange movements, including movements on hedges, are included in the relevant captions in the above reconciliation.

b) Analysis of the balances of cash as shown in the balance sheet

Included in the balance sheet are the following amounts of cash:

	Cash & balances with central banks 1998 £m	Loans & advances to other banks repayable on demand 1998 £m	Total 1998 £m	Cash & balances with central banks 1997 £m	Loans & advances to other banks repayable on demand 1997 £m	Total 1997 £m
At 1 January	**329**	**1,034**	**1,363**	228	568	796
Net cash inflow	**–**	**303**	**303**	101	466	567
At 31 December	**329**	**1,337**	**1,666**	329	1,034	1,363

Loans and advances to other banks repayable on demand excludes £2,374m (£1,894m) of loans and advances relating to stock lending and sale and repurchase business, which are repayable on demand, but matched by corresponding balances in deposits by banks. Such balances have not been classified as cash for the purposes of the cash flow statement.

The Group is required to maintain balances with the Bank of England which at 31 December 1998 amounted to £101m (£240m). These are shown in loans and advances to banks, and are not included in cash for the purposes of the cash flow statement.

c) Analysis of changes in financing during the year

	Share capital inc. Share premium 1998 £m	Subordinated liabilities 1998 £m	Total 1998 £m	Share capital inc. Share premium 1997 £m	Subordinated liabilities 1997 £m	Total 1997 £m
At 1 January	**1,926**	**2,463**	**4,389**	1,782	2,374	4,156
Net cash inflow from financing	**17**	**857**	**874**	140	62	202
Effect of foreign exchange rate changes	**–**	**13**	**13**	4	27	31
Capitalised on exercise of share options	**17**	**–**	**17**	–	–	–
At 31 December	**1,960**	**3,333**	**5,293**	1,926	2,463	4,389

49. Consolidated cash flow statement continued

d) Acquisitions of subsidiary and associated undertakings/purchase of business

	1998 £m	1997 £m
Net assets acquired:		
Treasury bills and other eligible bills	**–**	542
Loans and advances to banks	**4**	5,813
Loans and advances to customers	**3,386**	7,029
Net investment in finance leases	**691**	–
Debt securities	**–**	5,540
Tangible fixed assets	**68**	4
Operating lease assets	**85**	–
Other assets	**255**	185
Deposits by banks	**(3,992)**	(8,250)
Customer accounts	**–**	(10,569)
Other liabilities	**(265)**	(184)
Goodwill on acquisitions	**202**	129
	434	239
Satisfied by:		
Unsecured interest bearing loan notes	**5**	2
Cash	**364**	237
Deferred consideration	**4**	–
Loan capitalisation	**61**	–
	434	239

e) Analysis of the net outflow of cash in respect of acquisitions of subsidiary and associated undertakings/purchase of business

	1998 £m	1997 £m
Cash consideration	**364**	237
Cash acquired	**(7)**	(1)
Net outflow of cash in respect of acquisitions of subsidiary and associated undertakings/purchase of business	**357**	236

f) Sale of subsidiary and associated undertakings

	1998 £m	1997 £m
Net assets disposed of:		
Tangible fixed assets	**5**	1
Loans and advances	**327**	–
Other assets	**8**	9
Cash at bank and in hand	**4**	1
Deposits by banks and customer accounts	**(214)**	(5)
Other liabilities	**(5)**	(4)
Provisions for liabilities and charges	**(1)**	–
Goodwill written back	**19**	–
	143	2
Profit on disposal	**4**	2
Consideration received	**147**	4
Satisfied by:		
Cash	**147**	–
Other assets	**–**	4
	147	4

g) Analysis of the net inflow (outflow) of cash in respect of the sale of subsidiary and associated undertakings

	1998 £m	1997 £m
Cash received as consideration	**147**	–
Cash disposed of	**(4)**	(1)
Net inflow (outflow) of cash in respect of sale of subsidiary undertakings	**143**	(1)

50. Retirement benefits

The Abbey National Amalgamated Pension Fund, Abbey National Group Pension Scheme and National and Provincial Building Society Pension Fund are the principal pension schemes within the Group, covering 76% (78%) of the Group's employees, and are all funded defined benefits schemes.

The latest formal actuarial valuation carried out by an independent professionally qualified actuary was made as at 31 March 1996 for the Amalgamated Scheme and 31 March 1997 for the National and Provincial Building Society Pension Fund. The Abbey National Group Pension scheme was first established in 1996 and a formal actuarial valuation carried out as at 31 March 1998.

The main long term financial assumptions used in this valuation were:

	% Nominal per annum
Investment return	8.5
Equity dividend growth	5.0
Pension increases	3.75
General salary increases	6.0
General price inflation	4.0

Formal actuarial valuations of the assets and liabilities of the schemes are carried out on a triennial basis and, in addition, there is an annual review by the appointed actuary. The results of these reviews are included in the accounts.

Including the results of the reviews of pension schemes, carried out as at 31 March 1998 by the appointed actuary, the combined market value of the schemes' assets was £1,446m, and the funding level 107%. The review was carried out using the same actuarial method and long term financial assumptions as in the formal valuation of the Abbey National Group Pension Scheme as shown above.

The pension cost of £46m (£33m) reflects the regular contribution rate less an amount in respect of the surplus being recognised over the expected remaining service lives of the members of the respective funds in accordance with SSAP 24 'Accounting for Pension Costs'. Contributions of £57m (£52m) were made to the fund in 1998 and a provision of nil (£11m) has been included in the balance sheet.

In addition, included in Other assets as at 31 December 1998 was an amount of £25m (£26m) in respect of the unamortised pension scheme surplus assessed at the date the business of N&P was purchased. This was based on an actuarial assessment of the scheme at that date and is included in the balance sheet in accordance with FRS7. This balance is being amortised over the average remaining service lives of employees in the scheme, and £1m (£2m) was charged to the profit and loss account in the year ended 31 December 1998.

51. Directors' emoluments and interests

Further details of directors' emoluments and interests are included in the Report of the Personnel and Remuneration Committee on pages 46 to 53. These details include an analysis, by director, of salary and other payments and benefits on page 49, an analysis of directors' share interests and share options on pages 50 to 53 and details of the directors' conditional rights over the Company's shares under the Long Term Incentive Plan on page 53.

Ex gratia pensions paid to former directors of Abbey National plc in 1998, which have been provided for previously, amounted to £154,633 (£160,300). The Board has determined that it will no longer award any new such ex gratia pensions and accordingly, no charge (nil) to the profit and loss account has been made in respect of them.

Details of loans, quasi loans and credit transactions entered into or agreed by the Company or its subsidiaries with persons who are or were directors and connected persons and officers of the Company during the year were as follows:

	Number of persons	Aggregate amount outstanding £000
Directors		
Loans	9	1,210
Quasi loans	4	4
Credit transactions	–	–
Officers		
Loans	31	3,134
Quasi loans	9	8
Credit transactions	22	397

No director had a material interest in any contract of significance, other than a service contract, with the Company or any of its subsidiaries at any time during the year. The directors did not have any interests in shares or debentures of subsidiaries.

Further disclosures relating to these transactions, as required under FRS 8, 'Related party disclosures' are given in note 52.

52. Related party disclosures

a) Transactions with directors, executive officers and their close family members

Directors, executive officers and members of their close families have undertaken the following transactions with the Abbey National Group in the course of normal banking and life assurance business. These transactions were made on the same terms and conditions as applicable to other employees within the Group, or on normal commercial terms.

	1998		1997	
	No. of directors and executive officers (1)	**Amounts in respect of directors, executive officers (1) and their close family members £000**	No. of directors and executive officers (1)	Amounts in respect of directors, executive officers (1) and their close family members £000
Secured loans, unsecured loans and overdrafts				
Net movements in the year	**15**	**191**	16	308
Balances outstanding as at 31 December 1998	**12**	**1,259**	13	1,068
Deposit, investment, bank and instant access accounts				
Net movements in the year	**16**	**1,269**	14	1,114
Balances outstanding as at 31 December 1998	**16**	**2,935**	16	1,666
Life assurance policies and investments				
Net movements in the year	**2**	**(37)**	1	18
Total sum insured/value of investment	**3**	**176**	3	213

(1) Executive officers are defined as those officers who report directly to the Group Chief Executive.

One director has also undertaken sharedealing transactions through a subsidiary company of an aggregate net value of £408,010. The transactions were on normal business terms and standard commission rates were payable.

Secured and unsecured loans are made to directors, executive officers and their close family members on the same terms and conditions as applicable to other employees within the Group.

Amounts deposited by directors, executive officers and their close family members earn interest at the same rates as those offered to the market or on the same terms and conditions applicable to other employees within the Group.

Life assurance policies and investments are entered into by directors, executive officers and their close family members on normal market terms and conditions, or on the same terms and conditions as applicable to other employees within the Group.

b) Transactions with associated undertakings

Abbey National plc acts as agent for Commercial Union Underwriting Ltd (CUUL), under which it passes insurance premiums to CUUL and earns an agent's margin. The agency margin amounted to £130m (£120m) for the year ended 31 December 1998.

Abbey National Independent Consulting Group Ltd holds a 49% share in Willis National Holdings Ltd, a company offering independent financial advice. The Group earns a commission on insurance premiums, for which it pays professional service fees. The net income from such fees amounted to nil (£1m).

Abbey National plc has a joint venture agreement with Safeway plc which includes the Direct Savings Account and an in-store banking network. Customer accounts are all managed by Abbey National plc, with a share of profits being paid to Safeway. During the year ended 31 December 1998, nil (nil) was paid to Safeway plc.

Balances outstanding between the Group and associated companies as at 31 December 1998 are detailed in note 17 and note 31.

c) Transactions with long term assurance funds

The long term assurance funds are related parties for the purposes of this disclosure because the assets and liabilities of the long term assurance funds are included in the balance sheet.

As at 31 December 1998, Group entities owed £206m (£258m) to, and were owed £41m (£27m) by the long term assurance funds. Of these respective amounts £204m (£257m) relates to amounts deposited by the long term assurance funds with Abbey National plc or Abbey National Treasury Services plc, and £5m (£2m) relates to amounts owed by the long term assurance funds to Abbey National plc. The remaining amounts represent balances between the long term assurance funds and the shareholders' funds of the life assurance businesses within the Group. In addition, the long term assurance funds have lent £645m (£194m) of investment assets to a subsidiary of Abbey National Treasury Services plc under stock lending agreements as at 31 December 1998.

Included in fees and commissions receivable in the year is an amount of £26m (£21m) receivable from the long term assurance fund of Abbey National Life in respect of life assurance products sold through the retail branch network.

During the year Abbey National Financial Investment Services plc incurred costs amounting to £90m (£86m) on behalf of the long term assurance funds. All such costs were recharged to the long term assurance funds.

Details of transfers of funds between shareholders' funds and long term assurance funds are provided in note 21.

Included within Assets of long term assurance funds and Liabilities of long term assurance funds are amounts owing between the long term assurance funds of £11m (£11m).

The value of the funds' holdings in internally managed unit trusts amounted to £798m (£632m) at 31 December 1998.

The unit trusts are managed by Abbey National Unit Trust Management Ltd, Scottish Mutual International Fund Managers Ltd and Scottish Mutual International Managers Ltd.

Group financial summary – Profit and loss accounts

	Before exceptional items 1998 £m	Exceptional items 1998 £m	Total 1998 £m	Total 1997 £m	Total 1996 £m	Total 1995 £m	Total 1994 £m
Net interest income	**2,229**		**2,229**	1,889	1,794	1,584	1,394
Commissions, fees and other income	**889**	**(7)**	**882**	724	555	399	365
Operating expenses	**(1,285)**	**(61)**	**(1,346)**	(1,194)	(1,038)	(870)	(755)
Provisions for bad and doubtful debts	**(201)**		**(201)**	(121)	(127)	(72)	(74)
Provisions for contingent liabilities and commitments	**(16)**		**(16)**	(16)	(4)	(7)	–
Amounts written off fixed asset investments	**(28)**		**(28)**	(3)	(13)	(8)	2
Profit on ordinary activities before tax	**1,588**	**(68)**	**1,520**	1,279	1,167	1,026	932
Tax on profit on ordinary activities	**(483)**	**21**	**(462)**	(326)	(403)	(344)	(322)
Profit on ordinary activities after tax	**1,105**	**(47)**	**1,058**	953	764	682	610
Minority interests – equity	**–**		**–**	1	3	1	–
Profit attributable to the shareholders of Abbey National plc	**1,105**	**(47)**	**1,058**	954	767	683	610
Transfer to non-distributable reserve	**(125)**		**(125)**	(78)	(67)	(59)	(65)
Dividends – ordinary and preference shares	**(535)**		**(535)**	(469)	(373)	(290)	(233)
Profit retained for the financial year	**445**	**(47)**	**398**	407	327	334	312
Profit on ordinary activities before tax includes for:							
operations discontinued in 1998 (with prior year comparative)			**5**	(1)	–	–	–
operations acquired in the year excluding integrated businesses			**–**	7	8	9	22
operations discontinued in 1995 (with prior year comparatives)			**–**	–	–	(8)	(9)
Earnings per ordinary share (pence)							
– basic			**72.4p**	65.2p	56.5p	51.7p	46.5p
– diluted			**71.7p**	64.7p	56.0p	51.3p	46.0p
Dividends per ordinary share (pence)							
Net			**35.30p**	30.70p	26.10p	21.75p	17.75p
Gross equivalent			**44.13p**	38.38p	32.63p	27.19p	22.19p
Dividend cover (times)			**2.00**	2.10	2.10	2.40	2.60

The Group financial summary is based on the audited consolidated financial statements of the Abbey National Group for the five years ended 31 December 1998, and has been derived from the consolidated financial statements for each of the relevant years.

For a description of exceptional items in 1998 and 1997 see note 3 to the accounts. Operating expenses in 1996 include exceptional costs of £61m incurred in the integration of the business of the National and Provincial Building Society (N&P).

The figure disclosed in respect of Profit on ordinary activities before tax resulting from operations acquired in 1996 excludes the results of the business transferred from N&P.

The calculation of the gross equivalent dividend per ordinary share applies a tax rate of 20% for grossing-up purposes for dividends.

Group financial summary – Balance sheets

	1998 £m	1997 £m	1996 £m	1995 £m	1994 £m
Assets					
Cash, treasury bills and other eligible bills	**2,386**	1,957	339	391	598
Loans and advances to banks	**7,428**	8,271	2,825	3,579	2,906
Loans and advances to customers	**72,261**	66,878	64,227	51,090	48,484
Net investment in finance leases	**5,326**	4,655	4,310	2,844	2,278
Securities and investments	**54,326**	46,537	39,774	35,297	32,374
Assets under stock borrowing and lending agreements	**15,026**	6,678	–	–	–
Long term assurance business	**760**	649	555	425	352
Intangible fixed assets	**201**	–	–	–	–
Tangible fixed assets	**731**	698	689	585	534
Operating lease assets	**223**	67	26	–	–
Other assets	**5,728**	4,317	3,397	3,403	2,701
Assets of long term assurance funds	**13,383**	10,101	7,869	5,518	4,230
Total assets	**177,779**	150,808	124,011	103,132	94,457
Liabilities					
Deposits by banks	**35,610**	23,814	17,718	19,393	17,826
Customer accounts	**52,924**	55,719	49,678	40,962	38,056
Debt securities in issue	**42,989**	40,201	35,193	26,095	23,852
Liabilities under stock borrowing and lending agreements	**15,026**	6,678	–	–	–
Other liabilities	**9,107**	6,954	6,786	5,096	5,269
Subordinated liabilities including convertible debt	**3,333**	2,463	2,374	2,127	1,520
Liabilities of long term assurance funds	**13,383**	10,101	7,869	5,518	4,230
	172,372	145,930	119,618	99,191	90,753
Non-equity shareholders' funds	**450**	450	321	101	–
Equity shareholders' funds	**4,957**	4,428	4,072	3,840	3,704
Total liabilities	**177,779**	150,808	124,011	103,132	94,457

Supplementary financial information for the year ended 31 December 1998

The Annual Report on Form 20-F (Form 20-F) is filed with the Securities and Exchange Commission in accordance with US legislation. The Form 20-F is available for public inspection, and a copy may be obtained from Abbey National plc, registered office: Abbey House, Baker Street, London NW1 6XL.

The Form 20-F contains certain additional information which is prepared in accordance with generally accepted accounting principles applicable in the United States (US GAAP) which differ in certain respects from those used in the UK (UK GAAP). Extracts from the Form 20-F are presented in the following pages, including an average balance sheet prepared under UK GAAP and a reconciliation of profit after tax and shareholders' funds between US and UK GAAP with a description of the relevant principal differences.

Throughout this section, references to UK and Non-UK refer to the location of the office where the transaction is recorded.

			1998			1997			1996
Average Balance Sheet	**Average balance £m**	**Interest £m**	**Average rate %**	Average balance £m	Interest £m	Average rate %	Average balance £m	Interest £m	Average rate %
Assets									
Treasury bills and other eligible bills									
UK	**2,074**	**107**	**5.18**	811	28	3.51	77	–	0.44
Non-UK	**5**	**–**	**5.91**	21	2	7.02	11	1	6.79
Loans and advances to banks									
UK	**9,194**	**511**	**5.56**	3,997	230	5.75	3,968	217	5.48
Non-UK	**316**	**25**	**7.85**	308	23	7.39	337	25	7.30
Loans and advances to customers									
UK	**67,260**	**5,714**	**8.50**	65,126	5,097	7.83	55,712	3,968	7.12
Non-UK	**1,368**	**85**	**6.23**	1,273	82	6.50	1,347	108	7.98
Lease receivables									
UK	**4,679**	**339**	**7.24**	4,500	306	6.81	3,663	243	6.62
Non-UK	**29**	**1**	**4.19**	31	1	2.81	42	2	4.58
Debt securities									
UK	**46,374**	**2,859**	**6.16**	40,200	2,707	6.73	35,720	2,337	6.54
Non-UK	**3,818**	**244**	**6.38**	2,833	182	6.42	2,219	145	6.55
Total average interest earning assets and interest income	**135,117**	**9,885**	**7.32**	119,100	8,658	7.27	103,096	7,046	6.83
Allowance for loan losses	**(614)**	**–**	**–**	(663)	–	–	(682)	–	–
Non-interest earning assets									
Assets under stock borrowing and lending agreements	**13,536**	**–**	**–**	2,341	–	–	–	–	–
Long term assurance fund assets	**11,264**	**–**	**–**	8,737	–	–	6,409	–	–
Other	**8,554**	**–**	**–**	6,372	–	–	5,348	–	–
Total average assets and interest income	**167,857**	**9,885**	**5.89**	135,887	8,658	6.37	114,171	7,046	6.17
Non-UK assets as a percentage of total	**3.52%**	**–**	**–**	3.50%	–	–	3.46%	–	–
Total average interest earning assets and net interest income	**135,117**	**2,182**	**1.61**	119,100	2,038	1.71	103,096	1,815	1.76
Net interest (income) expense allocated to dealing profits	**–**	**47**	**–**	–	(16)	–	–	(21)	–
Net interest income before exceptional items (Consolidated Profit and Loss Account)	**–**	**2,229**	**–**	–	2,022	–	–	1,794	–

Average Balance Sheet	1998 Average balance £m	1998 Interest £m	1998 Average rate %	1997 Average balance £m	1997 Interest £m	1997 Average rate %	1996 Average balance £m	1996 Interest £m	1996 Average rate %
Liabilities and shareholders' funds									
Deposits by banks									
UK	**29,507**	**1,856**	**6.29**	19,105	1,178	6.16	20,114	1,197	5.95
Non-UK	**748**	**25**	**3.27**	650	39	5.94	493	28	5.69
Customer accounts – retail demand deposits									
UK	**23,234**	**997**	**4.29**	24,559	961	3.91	23,798	809	3.40
Non-UK	**848**	**46**	**5.37**	445	22	4.94	175	8	4.70
Customer accounts – retail time deposits									
UK	**22,420**	**1,577**	**7.03**	19,353	1,328	6.86	15,112	883	5.85
Non-UK	**2,000**	**138**	**6.88**	1,552	96	6.22	1,114	67	6.03
Customer accounts – wholesale deposits									
UK	**5,017**	**353**	**7.04**	5,871	370	6.30	4,080	229	5.62
Non-UK	**210**	**9**	**4.45**	181	11	6.28	282	17	5.85
Bond and medium term notes									
UK	**24,361**	**1,474**	**6.05**	21,176	1,432	6.76	16,965	1,106	6.52
Non-UK	**270**	**17**	**6.38**	253	14	5.44	233	15	6.31
Other debt securities in issue									
UK	**12,142**	**790**	**6.50**	11,595	745	6.43	8,968	549	6.13
Non-UK	**4,221**	**221**	**5.24**	4,869	245	5.04	3,287	169	5.12
Dated and undated loan capital and other subordinated liabilities									
UK	**2,036**	**158**	**7.77**	1,779	136	7.63	1,476	107	7.25
Non-UK	**635**	**42**	**6.58**	668	43	6.42	726	47	6.41
Total average interest bearing liabilities and interest expense	**127,649**	**7,703**	**6.03**	112,056	6,620	5.91	96,823	5,231	5.40
Non-interest bearing liabilities									
Liabilities under stock borrowing and lending agreements	**13,536**	**–**	**–**	2,341	–	–	–	–	–
Long term assurance fund liabilities	**11,264**	**–**	**–**	8,737	–	–	6,409	–	–
Other	**10,097**	**–**	**–**	7,959	–	–	6,656	–	–
Shareholders' funds	**5,311**	**–**	**–**	4,794	–	–	4,283	–	–
Total average liabilities, shareholders' funds and interest expense	**167,857**	**7,703**	**4.59**	135,887	6,620	4.87	114,171	5,231	4.58
Non-UK liabilities as a percentage of total	**6.45%**	**–**	**–**	7.50%	–	–	5.53%	–	–
Interest income as a percentage of average interest earning assets			**7.32**			7.27			6.83
Interest expense as a percentage of average interest bearing liabilities			**6.03**			5.91			5.40
Interest spread			**1.29**			1.36			1.43
Net interest margin			**1.61**			1.71			1.76

For the purposes of the average balance sheet, interest income and interest expense have been stated after allocation of interest on instruments entered into for hedging purposes.

Following an accounting presentation change, Assets and Liabilities under stock borrowing and lending agreements are reported under separate headings in the average balance sheet and have been reclassified as non-interest earning assets and non-interest bearing liabilities respectively. Accordingly, the related average balances, yields, spreads and margins have been restated for the average balance sheet for 1997. Amounts so restated are £253m within Loans and advances to banks and £2,088m within Loans and advances to customers with corresponding balances in Deposits by banks and Customer accounts-wholesale respectively.

Differences between UK GAAP and US GAAP

The significant differences applicable to Abbey National's accounts are summarised below.

Goodwill/core deposit intangible

UK GAAP Goodwill arising on consolidation as a result of the acquisitions of subsidiary and associated undertakings after 1 January 1998, and goodwill arising on the purchase of businesses after 1 January 1998, is capitalised under the heading, Intangible fixed assets, and amortised over its expected useful economic life. Such goodwill is subject to review for impairment in accordance with FRS 11, 'Impairment of fixed assets and goodwill'. The useful economic life is calculated using a valuation model which determines the period of time over which returns are expected to exceed its cost of capital, subject to a maximum period of 20 years.

Goodwill arising on consolidation as a result of the acquisitions of subsidiary and associated undertakings prior to 1 January 1998, and goodwill which arose on the purchase of businesses prior to 1 January 1998, has previously been taken to reserves. On disposal of subsidiary and associated undertakings and businesses, such goodwill is charged to the profit and loss account balanced by an equal credit to reserves. Where such goodwill in continuing businesses has suffered a permanent diminution in value, a similar charge to the profit and loss account and credit to reserves is made.

US GAAP Goodwill is capitalised and amortised in the consolidated statement of income over the period in which the benefits are estimated to accrue. In Abbey National's case, a period of 20 years has been used. Goodwill is written off when judged to be irrecoverable.

The element of goodwill relating to the value of retail depositor relationships associated with an acquisition of a savings entity, termed the core deposit intangible, is capitalised separately and amortised in the consolidated statement of income over the estimated average life of the retail customer relationships.

Pension costs

UK GAAP Where pensions are provided by means of a funded defined benefits scheme, annual contributions are based on actuarial advice. The expected cost of providing pensions is recognised on a systematic basis over the expected average remaining service lives of the members of the scheme. Variations from regular cost are spread over the average remaining service lives of current employees on a straight line basis.

US GAAP Under Statement of Financial Accounting Standards (SFAS) No. 87, the same basic actuarial method is used as under UK GAAP, but certain assumptions differ, assets are assessed at fair value and liabilities are assessed at current settlement rates. Certain variations from regular cost are allocated in equal amounts over the average remaining services lives of current employees.

Leasing

UK GAAP Income from finance leases, including benefits from declining tax rates, is credited to the profit and loss account using the actuarial after tax method to give a constant periodic rate of return on the net cash investment.

US GAAP Application of SFAS No. 13 gives rise to a level rate of return on the investment in the lease, but without taking into account tax payments and receipts. This results in income being recognised in different periods than under UK GAAP.

Loan origination fees

UK GAAP Loan origination fees received in respect of services provided are recognised in the profit and loss account as the services are performed. Where loan origination fees are in the nature of interest, they are recognised in the profit and loss account over the life of the loan.

US GAAP Under SFAS No. 91, to the extent that loan origination fees are not offset by related direct costs, they are deferred and amortised through the profit and loss account over the life of the loan.

Shareholders' interest in long term assurance business

UK GAAP The shareholders' interest in the long term assurance funds is valued at the net present value of the surplus expected to emerge in the future from business currently in force, together with the Group's interest in the surplus retained within the long term assurance funds.

US GAAP The net present value of the profits inherent in the long term assurance business is not recognised under US GAAP.

For contracts valued in accordance with SFAS No. 60, which covers conventional products such as endowment and term assurance policies, premiums are recognised as revenue when due from the policyholders. Costs of claims are recognised when insured events occur. A liability for future policy benefits to be paid to or on behalf of policyholders is established based upon the present value of future benefits less the present value of future net premiums. Acquisition costs are charged to the profit and loss account in proportion to premium revenue recognised.

For contracts valued under SFAS No. 97, which covers unit-linked products, premiums and front-end load type charges receivable from customers and acquisition costs relating to the acquisition of new contracts are capitalised and amortised in proportion to the present value of estimated gross profits. Estimated gross profits are projected on best estimate assumptions with no provisions for adverse deviation. The liability for policy benefits is set equal to the nominal policyholders' account balance. Costs of claims are recognised when insured events occur.

Fees from Personal Equity Plans and Unit Trust Business

UK GAAP Initial fees receivable from customers are recognised on a receivable basis. Acquisition expenses are expensed as incurred. Provision is made for the estimated cost of the liability that may arise from the loyalty bonus terms contained in certain contracts in determining the extent of the provision required to be made, consideration is given to future management fee income that may be received on those contracts.

US GAAP Under SFAS No. 97, initial fees receivable from customers and acquisition costs relating to the acquisition of new business are capitalised and amortised in proportion to the present value of estimated gross profits. Provision is made against the estimated cost of the liability that may arise from the loyalty bonus terms contained in certain contracts by equal instalment over the term of loyalty bonus earning period.

Stock-Based Compensation

UK GAAP Following the issuance of UITF Abstract 17, 'Employee share option schemes', costs of equity-based instruments, such as share options, issued to employees under compensation schemes (except Inland Revenue approved Save as You Earn ('SAYE') schemes), must be recognised through the profit and loss account over the vesting period. For Inland Revenue approved SAYE schemes, equity-based instruments are accounted for within the called-up share capital and share premium accounts on the balance sheet when exercised.

US GAAP SFAS No. 123, 'Accounting for Stock-Based Compensation', encourages companies to account for equity-based instruments issued under compensation plans at their fair value, measured at the date at which the instruments are granted. However, the statement also permits the intrinsic value-based method of accounting, under which the compensation cost, being the excess, if any, of the quoted market price of the stock at grant date over the exercise price, must be recognised in the profit and loss account over the vesting period. On the balance sheet this is offset by a corresponding adjustment to share premium. Abbey National has chosen to continue to adopt the intrinsic value-based method for the purposes of the reconciliation between UK and US GAAP. Pro forma disclosures of the effects of implementing the fair value method under SFAS No. 123 are available in the annual Form 20-F.

Dividend payable

UK GAAP Dividends declared after the period end are recorded in the period to which they relate.

US GAAP Dividends are recorded in the period in which they are declared.

Investments in securities

UK GAAP Securities held for investment purposes are stated at cost adjusted for any amortisation of premium or discount. All securities not held for investment purposes are stated at market value and profits and losses arising from this revaluation are taken to the profit and loss account.

US GAAP Securities are classified as trading securities, available for sale securities, and held to maturity securities in accordance with SFAS No. 115. Held to maturity securities are accounted for in the same way as securities held for investment purposes under UK GAAP. Trading securities are accounted for in the same way as securities not held for investment purposes under UK GAAP. Available for sale securities are reported at market value, with unrealised gains and losses excluded from earnings, but reported in a separate component of shareholders' funds. Unrealised gains and losses on derivative financial instruments hedging available for sale securities are also reported in the separate component of shareholders' funds.

Prior year comparatives for the unrealised deficit on derivatives hedging securities available for sale have been restated for the inclusion of the fair value of non-trading derivatives entered into by Group entities with ANFP, unamortised swap fees and certain clerical items (1997: £30m; 1996: £15m).

Deferred tax

UK GAAP Deferred taxation is accounted for only where it is probable that a liability or asset will arise. Provision is calculated at rates expected to be applicable when the liability or asset crystallises. No deferred tax asset is created in respect of general allowances for lending losses which are not deductible in arriving at UK taxable profits.

US GAAP Provision for deferred tax under the liability method is required in full for all timing differences, including general allowances for loan losses and tax loss carry forwards. Deferred tax assets are recognised subject to any adjustment for valuation allowances.

Provisions against lending losses

UK GAAP Specific provisions, determined using statistical techniques or by individual assessment, are made against loans and advances when, as a result of regular appraisals of the assets, it is considered that recovery is doubtful. Statistical techniques are used for large groups of small balance homogenous loans. General provisions are made against loans and advances to cover bad and doubtful debts which have not been separately identified but are known from experience to be present in any portfolio of loans and advances.

Provisions against lending losses continued

US GAAP The approach described under UK GAAP also applies under US GAAP for almost all of the Group's loan balances. However, for loans within the scope of SFAS No. 114, allowances for lending losses are determined based on the present value of expected future cash flows discounted at the loan's effective rate, or as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Leases and large groups of smaller balance homogenous loans that are collectively evaluated for impairment, such as residential mortgage loans, are outside the scope of SFAS No. 114. Abbey National has reviewed SFAS No. 114 and concludes that it has no material effect on the reconciliation of net income and shareholders' funds between UK and US GAAP.

Future developments

UK GAAP In 1998, the Accounting Standards Board issued FRS 12, 'Provisions, Contingent Liabilities and Contingent Assets', and FRS 13, 'Derivatives and Other Financial Instruments: Disclosures'.

FRS 12 sets out principles, recognition criteria and measurement bases of accounting for provisions, contingent liabilities and contingent assets and is effective for accounting periods ending on or after 23 March 1999. Under FRS 12, a provision should be recognised only when an entity has a present obligation, whether legal or constructive, as a result of a past event, that is likely to result in a transfer of economic benefits, an estimate of which can be measured with sufficient reliability. Abbey National is currently reviewing the standard to determine its impact on the reconciliation of net income and shareholders' funds between UK and US GAAP.

FRS 13 requires narrative disclosures about an entity's objectives, policies and strategies in respect of financial instruments. These are supplemented by a range of numerical disclosures. FRS 13 is effective for accounting periods ending on or after 23 March 1999. Abbey National is currently reviewing the standard to determine what effect it may have on the level of additional disclosure provided.

US GAAP In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133, 'Accounting for Derivatives Instruments and Hedging Activities' (SFAS 133). SFAS 133 is effective for all fiscal quarters of all fiscal years beginning after 15 June 1999 (1 January 2000 for the Group). SFAS 133 requires that all derivatives instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. For fair-value hedge transactions in which the Group is hedging changes in the fair value of an asset, liability, or firm commitment, changes in the fair value of the derivative will generally be offset in the income statement by changes in the hedged item's fair value. For cash flow hedge transactions, in which the Group is hedging the variability of cash flows related to a variable-rate asset, liability, or a forecasted transaction, changes in the fair value of the derivative instrument will be reported in other comprehensive income. The gains and losses on the derivative instrument that are reported in other comprehensive income will be reclassified as earnings in the periods in which earnings are impacted by the variability of the cash flows of the hedged item. The ineffective portion of all hedges will be recognised in current-period earnings.

Abbey National has not yet determined the impact that the adoption of SFAS 133 will have on its earnings or statement of financial position.

SFAS 134, 'Accounting for Mortgage-Backed Securities Retained after the Securitisation of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise' revises the disclosure requirements of SFAS 65 relating to the classification of mortgage-backed securities resulting after securitization of mortgage loans held for sale. SFAS 134 is required to be adopted in respect of accounting periods beginning after 15 December 1998. Abbey National is currently reviewing the standard to determine the effect of the Group's disclosure.

Differences between UK and US accounting principles	1998 £m	1997 £m	1996 £m
Profit attributable to the shareholders of Abbey National plc	**1,058**	954	767
Preference dividends	**(34)**	(35)	(13)
Consolidated Net Income of Abbey National plc (UK GAAP)	**1,024**	919	754
Goodwill	**(44)**	(44)	(33)
Core deposit intangible	**(45)**	(45)	(19)
Pensions cost	**2**	(26)	(6)
Leasing	**10**	(13)	(12)
Loan origination fees	**2**	(9)	(17)
Shareholders' interest in long term assurance business	**(195)**	(35)	(59)
Fees from Personal Equity Plans and Unit Trust Business	**(10)**	–	–
Stock-based compensation costs	**(5)**	(3)	(8)
Deferred tax effect of the above US/UK GAAP adjustments	**53**	23	33
Deferred tax	**33**	14	3
Consolidated Net Income of Abbey National plc (US GAAP)	**825**	781	636
per 10 pence ordinary share	**58.4p**	55.4p	47.6p

	1998 £m	1997 £m	1996 £m
Shareholders' funds including non-equity interests (UK GAAP)	**5,407**	4,878	4,393
Goodwill	**761**	794	735
Core deposit intangible	**208**	253	298
Net assets of businesses acquired	**(49)**	(49)	(85)
Pensions cost	**(62)**	(64)	(38)
Leasing	**(71)**	(81)	(68)
Loan origination fees	**(24)**	(26)	(17)
Shareholders' interest in long term assurance business	**(315)**	(157)	(178)
Fees from Personal Equity Plans and Unit Trust Business	**(10)**	–	–
Stock-based compensation costs	**(16)**	(11)	(8)
Share premium	**16**	11	8
Dividend payable	**334**	290	245
Unrealised surplus on securities available for sale	**285**	627	783
Unrealised deficit on derivatives hedging securities available for sale	**(336)**	(596)	(730)
Deferred tax effect of US/UK GAAP adjustments to net income	**202**	149	126
Deferred tax effect of US/UK GAAP adjustments charged directly to shareholders' funds	**5**	(17)	(37)
Deferred tax	**76**	43	29
Shareholders' funds including non-equity interests (US GAAP)	**6,411**	6,044	5,456

Designed by Addison

The Abbey National Group of companies comprises Abbey National plc and its subsidiary companies.

Abbey National plc Registered Office:
Baker Street, London NW1 6XL
Reg. No. 2294747.
Registered in England

Contact information

Abbey National
Shareholder Services
Carbrook House
5 Carbrook Hall Road
Sheffield S9 2EG

Shareholder analysis – 1998 figures as at 31 December 1998

	Ordinary shares of 10p		Preference shares	
Size of shareholding	Shareholders	Shares	Shareholders	Shares
1-100	1,435,955	139,724,401	5	500
101-1,000	742,556	314,676,426	43	24,472
1,001+	29,630	962,998,059	938	332,975,028
	2,208,141	1,417,398,866	986	333,000,000

Financial calendar

1 March 1999	Ex-dividend date
5 March 1999	Record date
22 April 1999	Annual General Meeting, Barbican Centre, London
30 April 1999	Final dividend payment
28 July 1999	Interim results announced
13 August 1999	Record date for interim dividend
4 October 1999	Interim dividend payment

10 years plc

1999 marks the tenth anniversary of Abbey National's conversion to plc status. When we first converted, we had more than five-and-a-half million shareholders – today we have around 2.2 million. To all those shareholders who have been with us from the outset, and those more recent investors, we'd like to thank you for the past ten years and wish you a very profitable decade ahead.

Dividend mandates

Shareholders who receive payment of the dividend by cheque may wish to have the money paid directly into a nominated bank account. If you do this, you will still be sent a tax voucher at your home address, giving full details of the dividend paid. Shareholder Services can send you all the necessary forms to arrange this.

Amalgamating your shares

If you were mailed with more than one copy of this Directors' Report and Accounts, it may be because Abbey National has more than one record of shareholdings in your name. To ensure that you do not receive duplicate mailings in the future, you can choose to have all your shares amalgamated into one account by contacting Shareholder Services at the address above.

Shareholder rewards

Abbey National offers shareholders a discount on Abbey National Direct Motor Insurance. You can still take advantage of the offer until May 1999 by calling Abbey National Direct on 0800 783 0100. Details of further incentives will be sent to you with May's edition of Shareholder News.

Single company ISAs

For investors wishing to take advantage of preferential tax treatment in relation to their shareholdings, Abbey National intends to offer a single company Individual Savings Account (ISA) in the ordinary shares of the Company from 6 April 1999.
For further information contact Abbey National ISA Administration, Telephone helpline 08705 501151.

Abbey National plc is regulated by the Personal Investment Authority. The value of shares may fall as well as rise. The value of any tax benefit depends on your personal financial circumstances and may be affected by future legislative changes.

Abbey National Share Dealing Service
0870 609 2333
Abbey National share price information
0891 222 333 (calls cost 50p/min)
Abbey National Shareholder Services
Carbrook House
5 Carbrook Hall Road
Sheffield S9 2EG
0870 532 9430
www.abbeynational.plc.uk

An audio version of Abbey National's Annual Review is available from Shareholder Services.

The Abbey National Group