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Independent Auditors' Report to the Members of Alliance & Leicester plc

We have audited the Group and parent Company financial statements (the 'financial statements') of Alliance & Leicester plc for the year ended 31 December 2008, which comprise the Consolidated Income Statement, the Consolidated and Company Balance Sheets, the Consolidated and Company Statement of Total Recognised Income and Expenses, the Consolidated and Company Cash Flow Statement, the Accounting Policies and the related Notes 1 to 45. These financial statements have been prepared under the Accounting Policies set out therein.

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

Respective responsibilities of Directors and Auditors

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

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes specific information presented in the Business and Financial Review that is cross referred from Principal Activities and Business Review section of the Directors' Report.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

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

Basis of audit opinion

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

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

Opinion

In our opinion:

> the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its loss for the year then ended;

> the parent Company's financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent Company's affairs as at 31 December 2008;

> the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation; and

> the information given in the Directors' Report is consistent with the financial statements.

Separate opinion in relation to IFRSs

As explained in the Accounting Policies section of the Group financial statements, the Group in addition to complying with its legal obligations to comply with IFRSs as adopted by the European Union, has also complied with the IFRSs as issued by the International Accounting Standards Board.

In our opinion the Group financial statements give a true and fair view, in accordance with IFRSs, of the state of the Group's affairs as at 31 December 2008 and of its loss for the year then ended.

Deloitte LLP
Chartered Accountants and Registered Auditors
London, United Kingdom
19 March 2009

Consolidated Income Statement

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007 £m
Interest and similar income	2	**4,032**	4,167
Interest expense and similar charges	2	**(3,648)**	(3,366)
Net interest income		**384**	801
Fee and commission income	3	**471**	517
Fee and commission expense	3	**(79)**	(33)
Net fee and commission income		**392**	484
Net trading and other income	4	**48**	141
Total operating income		**824**	1,426
Administration expenses	5	**(927)**	(643)
Depreciation and amortisation	6	**(114)**	(131)
Total operating expenses excluding provisions and charges		**(1,041)**	(774)
Impairment losses on loans and advances to customers	8	**(607)**	(100)
Impairment losses on treasury investment securities and loans to banks	8	**(426)**	(153)
Provisions for other liabilities and charges	32	**(38)**	–
Total operating provisions and charges		**(1,071)**	(253)
(Loss)/profit before tax		**(1,288)**	399
Tax credit/(charge)	9	**370**	(103)
(Loss)/profit for the year from continuing operations		**(918)**	296
Attributable to:			
Equity holders of the parent		**(954)**	256
Innovative tier 1 holders	35	**17**	17
Preference shareholders	36	**19**	19
Minority interest	37	**–**	4

The Notes on pages 66 to 101 are an integral part of these Consolidated Financial Statements.

Consolidated Balance Sheet

As at 31 December 2008 and 2007

	Notes	2008 £m	2007[1] £m
Assets			
Cash and balances at central banks	11	**1,553**	3,471
Trading assets	12	**-**	1,439
Derivative financial instruments	13	**2,876**	970
Financial assets designated at fair value	14	**63**	891
Loans and advances to banks	15	**1,239**	2,885
Loans and advances to customers	16	**51,402**	55,056
Available-for-sale securities	18	**1,658**	12,773
Held-to-maturity securities		**-**	213
Loan and receivable securities	18	**14,250**	210
Macro hedge of interest rate risk		**713**	38
Intangible assets	21	**17**	116
Property, plant and equipment	22	**223**	252
Operating lease assets	23	**348**	284
Current tax assets		**17**	-
Deferred tax assets	24	**626**	5
Other assets	25	**259**	299
Retirement benefit obligations	33	**4**	53
Total assets		**75,248**	78,955
Liabilities			
Deposits by banks	26	**11,516**	18,512
Deposits by customers	27	**39,765**	29,976
Derivative financial instruments	13	**1,533**	791
Financial liabilities designated at fair value	28	**728**	4,027
Debt securities in issue	29	**17,477**	21,879
Subordinated liabilities	30	**1,436**	711
Other liabilities	31	**631**	702
Provisions	32	**34**	-
Current tax liabilities		**1**	5
Deferred tax liabilities	24	**278**	-
Retirement benefit obligations	33	**21**	28
Total liabilities		**73,420**	76,631
Equity			
Innovative tier 1	35	**311**	311
Preference shares	36	**294**	294
Minority interest	37	**-**	4
		605	609
Share capital	36	**328**	210
Share premium account	36	**724**	125
Capital redemption reserve	37	**90**	90
Reserve for share based payments	37	**-**	26
Available-for-sale reserve	37	**(293)**	(143)
Cash flow hedging reserve	37	**164**	(14)
Retained earnings	37	**210**	1,421
Total ordinary shareholders' equity		**1,223**	1,715
Total liabilities and equity		**75,248**	78,955

(1) The 2007 Balance Sheet has been reclassified as described in the accounting policies on page 50.

The Notes on pages 66 to 101 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 45 to 101 were approved by the Board on 19 March 2009 and signed on its behalf by:

Nathan Bostock
Chief Financial Officer

Consolidated Statement of Recognised Income and Expense

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007 £m
Actuarial (losses)/gains on retirement benefit obligations	33	**(60)**	56
Losses on available-for-sale securities	37	**(241)**	(220)
Gains on cash flow hedges taken directly to equity		**259**	15
Tax on items taken directly to equity		**2**	46
Net loss recognised directly in equity		**(40)**	(103)
Losses/(gains) on available-for-sale securities transferred to profit or loss on sale	37	**14**	(1)
Impairment loss transferred to profit or loss	37	**18**	11
Cash flow hedges transferred to profit or loss		**(11)**	(7)
Net transfers to profit		**21**	3
(Loss)/profit for the year		**(918)**	296
Total recognised income and expense for the year		**(937)**	196
Attributable to:			
Equity holders of the parent		**(973)**	156
Innovative tier 1 holders		**17**	17
Preference shareholders		**19**	19
Minority interest		**-**	4

Consolidated Cash Flow Statement

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007[(1)] £m
Net cash flow from operating activities			
(Loss)/Profit for the year		**(918)**	296
Adjustments for:			
Non-cash items included in net profit		**901**	430
Change in operating assets		**(411)**	(7,496)
Change in operating liabilities		**4,059**	9,119
Income taxes received/(paid)		**21**	(54)
Net cash flow from operating activities	38	**3,652**	2,295
Net cash flows from/(used in) investing activities			
Acquisition of subsidiaries, net of cash acquired		**(19)**	(173)
Disposal of subsidiaries, net of cash disposed		**-**	94
Purchase of tangible and intangible fixed assets		**(241)**	(186)
Proceeds from sale of tangible and intangible fixed assets		**48**	31
Purchase of non-trading securities		**(743)**	(4,219)
Proceeds from sale of non-trading securities		**2,660**	2,215
Net cash flow from/(used in) investing activities		**1,705**	(2,238)
Net cash flow (used in)/from financing activities			
Issue of debt securities		**4,066**	9,210
Repayment of debt securities		**(11,346)**	(7,581)
Issue of ordinary shares		**701**	18
Repurchase of ordinary shares		**-**	(194)
Preference dividend paid		**(19)**	(19)
Interest paid on innovative tier 1		**(17)**	(17)
Dividends paid		**(229)**	(241)
Net cash flow (used in)/ from financing activities		**(6,844)**	1,176
Net (decrease)/increase in cash and cash equivalents		**(1,487)**	1,233
Cash and cash equivalents at beginning of the year		**3,856**	2,623
Cash and cash equivalents at the end of the year		**2,369**	3,856

(1) The 2007 Cash Flow Statement has been reclassified as described in the accounting policies on page 51.

The Notes on pages 66 to 101 are an integral part of these Consolidated Financial Statements.

Company Balance Sheet

As at 31 December 2008 and 2007

	Notes	2008 £m	2007[1] £m
Assets			
Cash and balances at central banks	11	**1,553**	3,471
Trading assets	12	**-**	1,439
Derivative financial instruments	13	**2,190**	904
Financial assets designated at fair value	14	**63**	36
Loans and advances to banks	15	**1,236**	2,864
Loans and advances to customers	16	**52,604**	55,625
Available-for-sale securities	18	**1,654**	12,761
Held-to-maturity securities		**-**	213
Loan and receivable securities	18	**14,321**	13
Macro hedge of interest rate risk		**557**	52
Investment in subsidiary undertakings	19	**1,091**	1,091
Intangible assets	21	**16**	107
Property, plant and equipment	22	**148**	174
Current tax assets		**58**	75
Deferred tax assets	24	**358**	-
Other assets	25	**1,431**	368
Retirement benefit obligations	33	**4**	53
Total assets		**77,284**	79,246
Liabilities			
Deposits by banks	26	**13,585**	21,073
Deposits by customers	27	**41,222**	29,151
Derivative financial instruments	13	**1,671**	868
Financial liabilities designated at fair value	28	**728**	4,027
Debt securities in issue	29	**12,084**	16,609
Subordinated liabilities	30	**1,436**	711
Other liabilities	31	**4,649**	5,081
Deferred tax liabilities	24	**73**	8
Retirement benefit obligations	33	**21**	28
Total liabilities		**75,469**	77,556
Equity			
Innovative tier 1	35	**311**	311
Preference shares	36	**294**	294
		605	605
Share capital	36	**328**	210
Share premium account	36	**724**	125
Capital redemption reserve	37	**90**	90
Reserve for share based payments	37	**-**	26
Available-for-sale reserve	37	**(293)**	(143)
Cash flow hedging reserve	37	**141**	(11)
Retained earnings	37	**220**	788
Total ordinary shareholders' equity		**1,210**	1,085
Total liabilities and equity		**77,284**	79,246

(1) The 2007 Balance Sheet has been reclassified as described in the accounting policies on page 50.

The Notes on pages 66 to 101 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 45 to 101 were approved by the Board on 19 March 2009 and signed on its behalf by:

Nathan Bostock
Chief Financial Officer

Company Statement of Recognised Income and Expense

For the years ended 31 December 2008 and 2007

Notes	Notes	2008 £m	2007 £m
Actuarial (losses)/gains on retirement benefit obligations	33	**(60)**	56
Losses on available-for-sale securities	37	**(241)**	(220)
Gains on cash flow hedges taken directly to equity		**235**	11
Tax on items taken directly to equity		**14**	48
Net loss recognised directly in equity		**(52)**	(105)
Losses/(gains) on available-for-sale securities transferred to profit or loss on sale	37	**14**	(1)
Impairment loss transferred to profit or loss	37	**18**	11
Cash flow hedges transferred to profit or loss		**(24)**	(11)
Net transfers to profit		**8**	(1)
(Loss)/profit for the year		**(275)**	171
Total recognised income and expense for the year		**(319)**	65
Attributable to:			
Equity holders of the parent		**(355)**	29
Innovative tier 1 holders		**17**	17
Preference shareholders		**19**	19

Company Cash Flow Statement

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007[1] £m
Net cash flow from operating activities			
(Loss)/profit for the year		**(275)**	171
Adjustments for:			
Non-cash items included in net profit		**619**	274
Change in operating assets		**(1,937)**	(7,912)
Change in operating liabilities		**4,488**	11,847
Income taxes received/(paid)		**32**	(64)
Net cash flow from operating activities	38	**2,927**	4,316
Cash flows from/(used) in investing activities			
Increase in investment in subsidiaries		**(5)**	-
Disposal of subsidiaries, net of cash disposed		**-**	3
Purchase of tangible and intangible fixed assets		**(86)**	(102)
Proceeds from sale of tangible and intangible fixed assets		**1**	3
Purchase of non-trading securities		**(822)**	(4,022)
Proceeds from sale of non-trading securities		**2,463**	2,065
Net cash flow from/(used in) investing activities		**1,551**	(2,053)
Cash flows used in financing activities			
Issue of debt securities		**3,676**	6,722
Repayment of debt securities		**(10,058)**	(7,317)
Issue of ordinary shares		**701**	18
Repurchase of ordinary shares		**-**	(194)
Preference dividend paid		**(19)**	(19)
Interest paid on innovative tier 1		**(17)**	(17)
Dividends paid		**(229)**	(241)
Net cash flows used in financing activities		**(5,946)**	(1,048)
Net (decrease)/increase in cash and cash equivalents		**(1,468)**	1,215
Cash and cash equivalents at beginning of the year		**3,835**	2,620
Cash and cash equivalents at the end of the year		**2,367**	3,835

(1) The 2007 Cash Flow Statement has been reclassified as described in the accounting policies on page 51.

The Notes on pages 66 to 101 are an integral part of these Consolidated Financial Statements.

Accounting Policies

International Financial Reporting Standards

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards ('IFRS') as approved by the International Accounting Standards Board ('IASB'), and interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') of the IASB that, under European Regulations, are effective and available for early adoption at the Group's reporting date. The Group has complied with IFRS as issued by the IASB in addition to complying with its legal obligation to comply with IFRS as adopted for use in the European Union.

Disclosures required by IFRS 7 'Financial Instruments: Disclosure' relating to the nature and extent of risks arising from financial instruments can be found in the 'Risk Management' section on pages 16 to 33 which forms part of these Consolidated Financial Statements.

Recent Developments

In 2008, the Group adopted the following new or revised IFRS:

a) IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'. On 13 October 2008, the IASB issued amendments to IAS 39 and IFRS 7 regarding the reclassification of financial instruments. The changes to IAS 39 permit an entity to reclassify, in limited circumstances, certain non-derivative financial assets out of the 'fair value through profit and loss' and 'available-for-sale' categories into 'loans and receivable securities', 'available-for-sale' and 'held-to-maturity'. In addition, the amendments to IFRS 7 require expanded disclosures about these assets. The amendments became effective on 1 July 2008. The impact of the adoption of the amendments to IAS 39 and IFRS can be found in Note 18 on page 78.

b) 'Amendment to IFRS2: Share based payments - vesting conditions and cancellations'. The amendment requires share option awards lapsing due to a failure to meet the service condition to be treated as cancellations rather than forfeitures. The impact on the Group's results has been immaterial.

In addition, the Group applied IFRIC 11 'IFRS 2 - Group and Treasury Share Transactions'. On 30 November 2006 IFRIC issued IFRIC 11 which requires that treasury share transactions are treated as equity-settled, and share-based payments involving equity instruments of the parent should be treated as equity-settled where the obligation is from the parent to the employee and cash-settled when the obligation is from the subsidiary to the employee. This is consistent with the Group's previous practice and therefore the application of IFRIC 11 did not have a material impact on the Group's profit or loss or financial position.

Future Developments

The Group has not yet adopted the following new or revised IFRS or IFRIC Interpretations, which have been issued but which are not yet effective for the Group:

a) IAS 23 'Borrowing Costs' – On 29 March 2007, the IASB issued an amendment to IAS 23 'Borrowing costs' which removes the option to expense borrowing costs incurred during the acquisition, construction or production of a qualifying asset. The Group does not expect the adoption of the amendment to IAS 23 to have a material impact on the Group's profit or loss or financial position. The amendment to IAS 23 is effective for periods beginning on or after 1 January 2009.

b) IAS 1 'Presentation of Financial Statements' – On 6 September 2007, the IASB issued an amendment to IAS 1 'Presentation of Financial Statements' which changes the way in which non-owner changes in equity are required to be presented. It also changes the titles of primary financial statements as they will be referred to in IFRS but does not require that these be renamed in an entity's financial statements. The Group does not expect the adoption of the amendment to IAS 1 to have an impact on the financial statements. The amendment to IAS 1 is effective for periods beginning on or after 1 January 2009.

c) IFRS 3 'Business Combinations' – On 10 January 2008, the IASB issued an amendment to IFRS 3 'Business Combinations' which clarifies and changes certain elements of accounting for a business combination, including measurement of contingent consideration, step acquisition and intangible assets and also widens the scope of this standard. There are also associated amendments to IAS 27, IAS 28 and IAS 31. The amendment to IFRS 3 is effective for periods beginning on or after 1 July 2009.

Basis of preparation

The Financial Statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, financial assets and financial liabilities held at fair value through profit or loss, financial assets and liabilities in fair value hedges, and all derivative contracts, and on the going concern basis as disclosed in the Directors' statement of going concern set out in the Directors' Report on pages 36 to 37.

Certain balances in the 2007 Consolidated and Company Balance Sheets have been reclassified. This has resulted in the following changes:

a) Amounts previously shown as 'Net investment in finance leases and hire purchase contracts' are now included within 'Loans and advances to customers'.

b) Amounts previously shown as 'Prepayments and accrued income' are now included within 'Other assets'.

c) Amounts previously shown as 'Accruals and deferred income' are now included within 'Other liabilities'.

d) 'Financial liabilities designated at fair value' are now shown as a separate balance sheet heading. Previously, these amounts were included within 'Deposits by banks', 'Deposits by customers' and 'Debt securities in issue'.

Such reclassifications do not impact Total Assets, Total Liabilities or Equity and align the presentation of the balance sheet with the other UK businesses owned by Banco Santander, S.A.

Certain items in the 2007 Consolidated and Company Cash Flow Statements have been reclassified. This has resulted in the following changes:

a) Issue and repayment of debt securities moved from net cash flow used in operating activities to financing activities;
b) Additions and disposals of investment securities fair valued through profit or loss moved from net cash flow used in investing activities to net cash flow used in operating activities.

The consequence of these changes was that, for the Group, net cash flow from operating activities decreased from £3,442m to £2,295m, net cash flow used in investing activities increased from £1,757m to £2,238m and net cash outflow used in financing activities of £452m changed to net cash inflow from financing activities of £1,176m.

The consequence of these changes was that, for the Company, net cash flow from operating activities decreased from £3,240m to £4,316m, net cash flow used in investing activities increased from £1,573m to £2,053m and net cash flow used in financing activities increased from £452m to £1,048m.

The Group believes that both the presentation adopted in the prior period, and the presentation adopted in the current period are acceptable alternatives under IAS 7. The Group considers that the current presentation is preferable as it is more reflective of the manner in which the business is monitored by new management and is consistent with the presentation adopted by the other UK businesses owned by Banco Santander, S.A.

Consolidation

a) Subsidiaries

Subsidiaries, which are those companies and other entities (including Special Purpose Entities) over which the Group, directly or indirectly, has power to govern the financial and operating policies, are consolidated. The existence and effect of potential voting rights that are presently exercisable or presently convertible are considered when assessing whether the Group controls another entity. The Company recognises investments in subsidiaries at cost less impairment.

Subsidiaries are consolidated from the date on which control is transferred to the Group and are no longer consolidated from the date that control ceases. The purchase method of accounting is used to account for the acquisition of subsidiaries. The cost of an acquisition is measured at the fair value of the assets given up, shares issued or liabilities undertaken at the date of acquisition, plus directly attributable acquisition costs. The excess of the cost of acquisition over the fair value of the tangible and intangible net assets of the subsidiary acquired is recorded as goodwill. Inter-company transactions, balances and unrealised gains on transactions between Group companies are eliminated; unrealised losses are also eliminated unless the cost cannot be recovered. The accounting reference date of the Company and its subsidiary undertakings is 31 December, with the exception of those leasing and investment companies which, because of commercial considerations, have various accounting reference dates. The Financial Statements of these subsidiaries have been consolidated on the basis of interim Financial Statements for the period to 31 December.

b) Jointly controlled entities

Jointly controlled entities are entities over which the Group has joint control established by contractual agreement with other parties. Interests in joint ventures through which the Group carries on its business are classified as jointly controlled entities and accounted for using the equity method. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

Foreign currency translation

Items included in the Financial Statements of each entity of the Group are measured using the currency that best reflects the economic substance of the underlying events and circumstances relevant to that entity ('the functional currency'). The Consolidated Financial Statements are presented in pounds sterling, which is the functional currency of the parent.

Income statements and cash flows of foreign entities are translated into the Group's reporting currency at average exchange rates for the year and their balance sheets are translated at the exchange rates ruling on 31 December. Exchange differences arising from the translation of the net investment in foreign entities are taken to shareholders' equity. When a foreign entity is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

Foreign currency transactions are translated into the functional currency of the Company at the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement unless deferred in equity under the cash flow hedge.

Revenue recognition

(a) Interest income and expense

Income on financial assets that are classified as loans and receivables or available-for-sale, and interest expense on financial liabilities other than those at fair value through profit and loss are determined using the effective interest method. The effective interest rate is the rate that discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the future cash flows are estimated after considering all the contractual terms of the instrument excluding future credit losses. The calculation includes all amounts paid or received by the Group that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of the financial instrument and all other premiums or discounts. Interest income on assets classified as loans and receivables or available-for-sale, interest expense on liabilities classified at amortised cost and interest income and expense on hedging derivatives are recognised in net interest income in the income statement.

Accounting Policies continued

(b) Fee and commissions income
Fees and commissions that are not an integral part of the effective interest rate are recognised when the service has been provided. For retail products, fee and commission income consists principally of collection services fees, commission on foreign currencies, and fees for non-banking financial products. Revenue from these income streams are recognised as earned when the service is provided.
(c) Net trading and other income
Net trading and other income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends. It also includes income from operating lease assets, and profits/(losses) on the sales of fixed assets and subsidiary undertakings.
(d) Financial assets and liabilities held at fair value through profit or loss
Financial assets and liabilities held for trading, and financial assets and financial liabilities designated as fair value through profit or loss are recorded at fair value. Changes in fair value of trading assets and liabilities including trading derivatives are recognised in the income statement as net trading and other income together with dividends and interest receivable and payable. Changes in fair value of assets and liabilities designated as fair value through profit or loss are recognised in net trading and other income together with dividends, interest receivable and payable and changes in fair value of derivatives managed in conjunction with these assets and liabilities. Changes in fair value of derivatives in a designated hedging relationship are recognised in net trading and other income along with the fair value of the hedged item.

Pensions and other post retirement benefits

Group companies have various pension schemes. The schemes are generally funded through payments to trustee-administered funds as determined by periodic actuarial calculations. A defined benefit plan is a pension plan that defines an amount of pension benefit to be provided, usually as a function of one or more factors such as age, years of service or compensation. A defined contribution plan is a pension plan under which the Group pays fixed contributions as they fall due into a separate entity (a fund) and will have no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

The liability recognised in respect of defined benefit pension plans is the present value of the defined benefit obligation at the balance sheet date, less the fair value of plan assets. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. Full actuarial valuations of the Group's principal defined benefit schemes are carried out every year. The Group is responsible for the actuarial valuations and in doing so considers or relies in part on a report of a third party expert. The present value of the defined benefit obligation is determined by the estimated future cash outflows using interest rates of high quality corporate bonds, which have terms to maturity approximating the terms of the related liability. The Group's consolidated income statement includes the current service cost of providing pension benefits, the expected return on schemes' assets net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are taken directly to reserves and recognised in the statement of recognised income and expense. Past-service costs are charged immediately to the income statement, unless the changes are conditional on the employees remaining in service for a specified period of time, known as the vesting period. In this case, the past-service costs are amortised on a straight-line basis over the average period until the benefits become vested.

For defined contribution plans, the Group pays contributions to trustee-administered funds as they fall due. Once the contributions have been paid, the Group has no further payment obligations. The regular contributions constitute net periodic costs for the year in which they are due and as such are included in staff costs.

Post-retirement medical benefit liabilities are determined using the Projected Unit Credit Method, with actuarial valuations updated at each year-end. The expected benefit costs are accrued over the period of employment using an accounting methodology similar to that for the defined benefit pension scheme.

Share-based payments

Prior to the acquisition of Alliance & Leicester by Banco Santander, S.A., share options were satisfied by the issue of new Alliance & Leicester shares. The Group engaged in equity-settled share-based payment transactions in respect of services received from certain of its employees. Shares of the Company were allotted by the Company for the share option plan, the ShareSave plan, the restricted share plan, the share incentive plan, awards granted under the Long Term Incentive Plan and deferred bonus plans to satisfy share options as they vested. All awards granted under the Alliance & Leicester share plans were accounted for as equity-settled share-based payment transactions. The fair value of the services received was measured by reference to the fair value of the shares or share options initially on the date of the grant. The cost of the employee services received in respect of the shares or share options granted was recognised in the income statement within administration expenses, over the period that the services are received, which is the vesting period. The fair value of the options granted under the Share Option Plan, the Restricted Share plan, awards granted under the Long Term Incentive Plan and senior manager Deferred Bonus Plan were determined using option pricing models, which take into account the exercise price of the option, the current share price, the risk free interest rate, the expected volatility of the Company's share price over the life of the option, the dividend growth rate and other relevant factors.

Non-market vesting conditions are taken into account by adjusting the number of shares or share options included in the measurement of the cost of employee service so that ultimately, the amount recognised in the income statement reflects the number of vested shares or share options.

Upon acquisition of the Company by Banco Santander, S.A., share options vested and the charge was accelerated through the profit or loss. Further details on the impact of the acquisition on the Schemes can be found in Notes 40 and 42.

Goodwill and other intangible assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary, associate, or business at the date of acquisition. Goodwill on the acquisition of subsidiaries and businesses is included in Intangible assets. Goodwill on acquisitions of associates is included as part of Investment in associates. Goodwill is tested for impairment at each balance sheet date, or more frequently when events or changes in circumstances dictate. It is carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Negative goodwill is recognised immediately in the income statement.

Goodwill arising on acquisitions before the date of transition to IFRS has been retained at the previous UK GAAP amounts, subject to being tested for impairment at 31 December 2003. Goodwill written off to reserves under UK GAAP prior to the introduction of FRS 10 'Goodwill and Intangible Assets' in 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

Software development costs are capitalised when they are associated with identifiable and unique software products that are expected to provide future economic benefits and the cost of these products can be measured reliably. Internally developed software meeting these criteria and externally purchased software are classified in intangible assets on the balance sheet, unless the software is an integral part of the related computer hardware, in which case it is treated as property, plant and equipment as described below. Computer software is amortised over 1 to 5 years. Costs associated with maintaining software programmes are expensed as incurred.

Property, plant and equipment

Property, plant and equipment include owner-occupied properties, office fixtures and equipment. Property, plant and equipment are carried at cost less accumulated depreciation and accumulated impairment losses. A review for indications of impairment is carried out at each reporting date. Gains and losses on disposal are determined by reference to the carrying amount and are reported in net trading and other income. Repairs and renewals are charged to the income statement when the expenditure is incurred.

Software development costs are capitalised when they are associated with identifiable and unique software products that are expected to provide future economic benefits and the cost of these products can be measured reliably. Internally developed software meeting these criteria and externally purchased software are classified in property, plant and equipment on the balance sheet where the software is an integral part of the related computer hardware. Costs associated with maintaining software programmes are expensed as incurred. Classes of property, plant and equipment are depreciated on a straight-line basis over their useful life as follows:

Owner-occupied properties	Not exceeding 75 years
Office fixtures and equipment	3 to 15 years

Depreciation is not charged on freehold land and assets under construction.

Financial assets

The Group classifies its financial assets as: financial assets at fair value through profit or loss, loans and receivables, available-for-sale and held-to-maturity financial assets. Management determines the classification of its investments at initial recognition. Financial assets that are classified at fair value through profit or loss, which have not been designated as such or are not accounted for as derivatives or assets classified as 'available-for-sale', may subsequently in rare circumstances, be reclassified to the available-for-sale, loans and receivables or held to maturity categories. In order to meet the criteria for reclassification, the asset must no longer be held for the purpose of selling or repurchasing in the near term and must also meet the definition of the category into which it is to be reclassified had it not been required to classify it at fair value through profit or loss at initial recognition. The reclassified value is the fair value of the asset at the date of reclassification.

(a) Financial assets at fair value through profit or loss

Financial assets are classified at fair value through profit or loss if they are either held for trading or otherwise designated at fair value through profit or loss on initial recognition. A financial asset is classified as held for trading if it is a derivative or it is acquired principally for the purpose of selling in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking.

In certain circumstances financial assets other than those that are held for trading are designated at fair value through profit or loss where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring assets or recognising the gains or losses on them on a different basis, where the assets are managed and their performance evaluated on a fair value basis, or where a financial asset contains one or more embedded derivatives which are not closely related to the host contract.

Trading assets, derivative financial instruments and financial assets designated at fair value are classified at fair value through profit or loss, except where in a hedging relationship. They are derecognised when the rights to receive cash flows from the asset have expired or when the Group has transferred substantially all the risks and rewards of ownership.

(b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments, that are not quoted in an active market, and which are not classified as available-for-sale or fair value through profit or loss. They arise when the Group provides money or services directly to a customer with no intention of trading the loan. Loans and receivables are initially recognised at fair value including direct and incremental transaction costs. They are subsequently valued at amortised cost, using the effective

interest method. They are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all of the risks and rewards of ownership. Loans and receivables includes Loans and advances to banks, Loans and advances to customers and Loan and receivable securities.

(c) Available-for-sale

Available-for-sale investments are non-derivative financial investments that are designated as available-for-sale and are not categorised into any of the other categories described. They are initially recognised at fair value including direct and incremental transaction costs. They are subsequently held at fair value. Gains and losses arising from changes in fair value are included as a separate component of equity until sale when the cumulative gain or loss is transferred to the income statement. Interest is determined using the effective interest method. Gains and losses arising on securities prior to reclassification in the available-for-sale reserve is being recognised on a straight-line basis over the period to maturity of the assets, which is considered to be immaterially different to using the effective interest rate basis.

Income on investments in equity shares and other similar interests is recognised in the income statement as and when dividends are declared and interest is accrued. Impairment losses and foreign exchange translation differences on monetary items are recognised in the income statement. The investments are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all the risks and rewards of ownership.

(d) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity. Held-to-maturity investments are initially recognised at fair value including direct and incremental transaction costs. They are subsequently valued at amortised cost, using the effective interest method. They are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all of the risks and rewards of ownership. Were the Group to sell, other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and reclassified as available-for-sale.

The Group has adopted the amendment to IAS39 published on 13 October 2008, and where permitted, has reclassified financial assets held-for-trading and available-for-sale assets to loans and receivables with effect from 1 July 2008 (see Note 18).

Offsetting financial assets and liabilities

Financial assets and liabilities including derivatives are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Sale and repurchase agreements (including stock borrowing and lending)

Securities sold subject to a linked repurchase agreement ('repos') are retained in the Financial Statements as trading assets and the counterparty liability is included in amounts 'Deposits by banks' or 'Deposits by customers' within trading liabilities as appropriate. Securities purchased under agreements to resell ('reverse repos') are recorded as 'Loans and advances to banks' or 'Loans and advances to customers' within trading assets as appropriate. The difference between the sale and repurchase price is treated as trading income in the income statement. Securities lent to counterparties that are collateralised by cash are also retained in the balance sheet. Securities borrowing and lending transactions collateralised with other securities are not recognised in the balance sheet.

Derivative financial instruments

Transactions are undertaken in derivative financial instruments ('derivatives'), which include interest rate, cross currency, other index-related swaps, forwards, caps, floors and swaptions, as well as credit default and total return swaps. Derivatives are contracts or agreements whose value is derived from one or more underlying indices or asset values inherent in the contract or agreement, which require no or little initial net investment and are settled at a future date.

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and valuation techniques, including discounted cash flow models and option pricing models as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative, except where netting is permitted.

Certain derivatives embedded in other financial instruments, are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the hybrid contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. Contracts containing embedded derivatives are not subsequently reassessed for separation unless there has been a change in the terms of the contract which significantly modifies the cash flows, or where assets have been reclassified where they are reassessed at the time of reclassification.

Hedge accounting

The Group designates certain derivatives as hedging instruments of the fair value of recognised assets or liabilities or firm commitments (fair value hedge). The Group also designates cash flow hedges to hedge exposures to variability in cash flows, such as variable rate financial assets and liabilities. Hedge accounting is used for derivatives designated in this way provided certain criteria are met.

At the time a financial instrument is designated as a hedge, the Group formally documents the relationship between the hedging instrument(s) and hedged item(s). Documentation includes risk management objectives and the strategy in undertaking the hedge transaction, together with the methods that will be used to assess the effectiveness of the hedging

relationship. Accordingly, the Group formally assesses, both at the inception of the hedge and on an ongoing basis, whether the hedging derivatives have been and will be highly effective in offsetting changes in the fair value of the hedged items. A hedge is normally regarded as highly effective if, at inception and throughout its life, the Group can expect, and actual results indicate, that changes in the fair value of the hedged items are effectively offset by changes in the fair value of the hedging instrument, and actual results are within a range of 80% to 125%.

The Group discontinues hedge accounting when it is determined that: a derivative is not, or has ceased to be, highly effective as a hedge; when the derivative expires, or is sold, terminated, or exercised; or when the hedged item matures or is sold or repaid. On discontinuance of hedge accounting amortisation of the adjustment to the hedged item is included in net trading and other income.

The hedge adjustment for fair value hedges is classified in the balance sheet in the same category as the hedged item, unless it relates to a macro hedging relationship where the hedge adjustment is recognised as a macro hedge on the face of the balance sheet.

For fair value hedges, changes in the fair value of the hedged risk and hedged item are recognised in net trading and other income. For cash flow hedges the effective portion of change in the fair value of the hedging instrument is recognised in equity, and recycled to profit or loss in the periods when the hedged item will affect profit or loss. Hedge ineffectiveness represents the amount by which the changes in the fair value of the hedging derivative differ from changes in the fair value of the hedged item. Such gains and losses are recorded in current period earnings within net trading and other income. Gains and losses on components of a hedging derivative that are excluded from assessing hedge effectiveness are also included in net trading and other income.

Securitisation transactions

The Group has entered into certain arrangements where undertakings have issued mortgage-backed securities or have entered into funding arrangements with lenders in order to finance specific loans and advances to customers. As the Group has retained substantially all the risks and rewards of the underlying assets, all such financial instruments continue to be held on the Group balance sheet, and a liability recognised for the proceeds of the funding transaction.

Impairment of financial assets

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition, there is objective evidence that a financial asset or group of financial assets classified as available-for-sale or loans and receivables have become impaired. Evidence of impairment may include indications that the borrower or group of borrowers have defaulted, are experiencing significant financial difficulty, or the debt has been restructured to reduce the burden to the borrower.

(a) Retail assets carried at amortised cost

Impairment losses are assessed individually for the financial assets that are individually significant and individually or collectively for assets that are not individually significant. Balance sheet provisions are maintained at the level that management deems sufficient to absorb probable incurred losses in the Group's loan portfolio from homogeneous portfolios of assets and individually identified loans.

A provision for observed losses is established for all past due loans after a specified period of repayment default where it is probable that some of the capital will not be repaid or recovered through enforcement of any applicable security. Once a loan misses a payment (breach of contractual terms) an assessment of the likelihood of collecting the principal and overdue payments is made. This assessment is generally made using statistical techniques based on historic experience. These determinations are supplemented by various formulaic calculations and the application of management judgement.

For individually assessed assets, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of the estimated future cash flows from the asset or group of assets discounted at the original effective interest rate of the asset.

In making collective assessment for impairment, financial assets are assessed for each portfolio segmented by similar risk characteristics. For each risk segment, future cash flows from these portfolios are estimated through the use of historical loss experience. The historical loss experience is adjusted for current observable data, to reflect the effects of current conditions not affecting the period of historical experience, based on observable data. The loss is discounted at the effective interest rate, except where portfolios meet the criteria for short term receivables.

Loans that are part of a homogeneous pool of similar loans are placed on default status based on the number of months in arrears, which is determined through the number of missed payments or the number of months in collection. Loans that are not part of a homogeneous pool of similar loans are analysed based on the number of months in arrears on a case-by-case basis and are placed on default status when the probability of default is likely.

Generally, the length of time before an asset is placed on default status for provisioning is when one payment is missed. However, for assessing the level of non-performing asset repayment default depends on the nature of the collateral that secures the advances. On advances secured by residential property, the default period is three months.

On unsecured advances, such as personal term loans, the default period is generally four missed payments (three months in arrears). Exceptions to the general rule exist with respect to revolving facilities, such as bank overdrafts, which are placed on default upon a breach of the contractual terms governing the applicable account.

A provision for inherent losses is made for loan losses that have been incurred but have not been separately identified at the balance sheet date because the loan is not yet past due. An example of this situation is where a borrower is experiencing financial difficulties at the reporting date, e.g. due to loss of employment, although the borrower has not yet missed a payment. In these circumstances, an impairment loss had been incurred at the reporting date. The provision for inherent losses is determined on a portfolio basis based on management's best estimate of the current position based on past experience adjusted

by current trends. These statistical techniques involve the following (i) estimation of a period of time called the emergence period, which is discussed below, (ii) assessment of the number of accounts that go into arrears over the emergence period, and (iii) application of the provision methodology outlined for observed provisions to these accounts identified as impaired as a result of this exercise. Accounts that suffered credit deterioration after the reporting date are accordingly excluded from the statistical analysis.

The emergence period
This is the period which the Group's statistical analysis shows to be the period in which losses that had been incurred but have not been separately identified at the balance sheet date, become evident as the loans turn into past due. Based on the Group's statistical analysis at 31 December 2008, the emergence period was two months for unsecured lending, three months for current accounts and 12 months for secured lending. The longer emergence period for secured lending reflects the fact that a customer is more likely to default on unsecured debt before defaulting on secured lending. The factors considered in determining the length of the emergence period for unsecured lending are recent changes in customers' debit/credit payment profiles and credit scores. The factors considered for secured lending are the frequency and duration of exceptions from adherence to the contractual payment schedule.

Once a financial asset or a group of financial assets has been written down as a result of an impairment loss, subsequent interest income continues to be recognised on an effective interest rate basis, though on the asset value after provisions have been deducted.

Impairment losses are recognised in the income statement and the carrying amount of the financial asset or group of financial assets is reduced by establishing an allowance for impairment losses. If in a subsequent period the amount of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance. A write-off is made when all collection procedures have been completed and is charged against previously established provisions for impairment.

Recoveries of loan losses are not included in the loan loss allowance, but are taken to income and offset against charges for loan losses. Loan loss recoveries are classified in the income statement as Impairment losses on loans and advances to customers.

(b) Corporate assets
Impairments for these assets are assessed on both an individual and a collective basis. For individual assets impairment reviews are conducted monthly for those assets on the Bank's Watchlist, with a particular focus on the following scenarios: (1) where an asset has a payment default which has been outstanding for 90 days or more; (2) where non-payment defaults have occurred and/or where it has become evident that some sort of workout or rescheduling exercise is to be undertaken; or (3) where, for example with Real Estate Finance, it has become evident that the value of the Bank's security is no longer considered adequate.

In such situations a full review of the expected future cash flows in relation to the relevant asset, appropriately discounted, will be undertaken with the result compared with the current net book value of the asset. Any shortfall evidenced as a result of such a review, particularly where the shortfall is likely to be permanent, will lead to a suitable impairment recommendation.

Collective impairments are also looked at for portfolios where it is felt that market events, either specific or general, are likely to determine that losses are already inherent in a portfolio notwithstanding that these events may not have manifested themselves in specific defaults or other triggers that would lead to an individual impairment assessment. The amount of any such collective impairment will, for each portfolio concerned, represent management's best estimate of likely loss levels and will take into account *inter alia* estimates of future actual default rates and likely recovery levels.

(c) Treasury assets
Treasury assets (including derivative financial instruments, financial assets designated at fair value, loans and advances to banks, available-for-sale securities and loan and receivable securities) are assessed individually for impairment. A provision is made when management obtains information that suggests losses in the underlying portfolios will prevent the assets making payments in accordance with their contractual terms.

For available-for-sale assets, the cumulative loss is measured as the difference between the acquisition cost and the current fair value, less any impairment loss previously reported in the income statement. If in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase is due to an event occurring after the impairment loss was recognised in the income statement (with objective evidence to support this), the impairment loss is reversed through the income statement.

For assets carried at amortised cost, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of the estimated future cash flows from the asset or group of assets discounted at the original effective interest rate of the assets.

Impairment of non-financial assets

At each balance sheet date, or more frequently when events or changes in circumstances dictate, property, plant and equipment and intangible assets (including goodwill) are assessed for indicators of impairment. If indications are present, these assets are subject to an impairment review. The impairment review comprises a comparison of the carrying amount of the asset or cash generating unit with its recoverable amount: the higher of the asset's or cash-generating unit's fair value less costs to sell and its value in use. Net selling price is calculated by reference to the amount at which the asset could be disposed of in a binding sale agreement in an arm's length transaction evidenced by an active market or recent transactions for similar assets, less costs to sell. Value in use is calculated by discounting the expected future cash flows obtainable as a result of the asset's continued use, including those resulting from its ultimate disposal, at a market based discount rate on a pre-tax basis.

The carrying values of fixed assets and goodwill are written down by the amount of any impairment and the loss is recognised in the income statement in the period in which it occurs. Impairment of a cash generating unit is allocated first to goodwill and then to other assets held within the unit on a pro-rata basis. An impairment loss recognised in an interim period is not reversed at the balance sheet date. A previously recognised impairment loss relating to a fixed asset may be reversed in part or in full when a change in circumstances leads to a change in the estimates used to determine the fixed asset's recoverable amount. The carrying amount of the fixed asset will only be increased up to the amount that it would have been had the original impairment not been recognised. Impairment losses on goodwill are not reversed. For conducting impairment reviews, cash generating units are the lowest level at which management monitors the return on investment on assets.

Leases

The Group as lessor - Operating lease assets are recorded at deemed cost and depreciated over the life of the asset after taking into account anticipated residual values. Operating lease rental income and depreciation is recognised on a straight-line basis over the life of the asset. Amounts due from lessees under finance leases and hire purchase contracts are recorded as receivables at the amount of the Group's net investment in the leases. Finance lease income is allocated to accounting periods so as to reflect a constant periodic rate of return on the Group's net investment outstanding in respect of the leases and hire purchase contracts.

The Group as lessee - The Group enters into operating leases for the rental of equipment or real estate. Payments made under such leases are charged to the income statement on a straight-line basis over the period of the lease. When an operating lease is terminated before the lease period has expired, any payment to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

If the lease agreement transfers the risk and rewards of the asset, the lease is recorded as a finance lease and the related asset is capitalised. At inception, the asset is recorded at the lower of the present value of the minimum lease payments or fair value and depreciated over the estimated useful life. The corresponding rental obligations are recorded as borrowings. The aggregate benefit of incentives, if any, is recognised as a reduction of rental expense over the lease term on a straight-line basis.

Income taxes, including deferred taxes

The tax expense represents the sum of the income tax currently payable and deferred income tax.

Income tax payable on profits, based on the applicable tax law in each jurisdiction, is recognised as an expense in the period in which profits arise. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date. Deferred income tax is provided in full, using the liability method, on income tax losses available to carry forward and on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the Financial Statements. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which the assets may be utilised as they reverse. Such deferred tax assets and liabilities are not recognised if the temporary difference arises from goodwill and the initial recognition of other assets (other than in a business combination) and liabilities in a transaction that affects neither the taxable profit nor the accounting profit. Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised, based on rates enacted or substantially enacted at the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity. Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries except where the Group is able to control reversal of the temporary difference and it is probable that it will not reverse in the foreseeable future.

The Group reviews the carrying amount of deferred tax assets at each balance sheet date and reduces it to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

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

Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including cash and non-restricted balances with central banks, treasury bills and other eligible bills, loans and advances to banks, and short-term investments in securities.

Financial liabilities

Financial liabilities are initially recognised when the Group becomes contractually bound to the transfer of economic benefits in the future. Financial liabilities are classified at fair value through profit or loss if they are either held for trading or otherwise designated at fair value through profit or loss on initial recognition. A financial liability is classified as held for trading if it is a derivative or it is incurred principally for the purpose of selling or being unwound in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking.

In certain circumstances financial liabilities other than those that are held for trading are designated at fair value through profit or loss where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring assets and liabilities or recognising the gains or losses on them on a different basis, or where a financial liability contains one or more embedded derivatives which are not closely related to the host

contract. These liabilities are initially recognised at fair value and transaction costs are taken directly to the income statement. Gains and losses arising from changes in fair value are included directly in the income statement. All other financial liabilities are initially recognised at fair value net of transaction costs incurred. They are subsequently stated at amortised cost and the redemption value recognised in the income statement over the period of the liability using the effective interest method.
Derivative financial instruments and Financial liabilities designated at fair value are classified as fair value through profit or loss, unless in a hedge relationship. Deposits by banks, Deposits by customers, Debt securities in issue (unless designated at fair value). Subordinated liabilities are classified as amortised cost.

Borrowings

Borrowings, including subordinated liabilities, are recognised initially at fair value, being the proceeds (fair value of consideration received) net of transaction costs incurred. Borrowings are subsequently stated at amortised cost or fair value dependent on designation at initial recognition.

Share capital

Incremental external costs directly attributable to the issue of new shares are deducted from equity net of related income taxes.

Provisions

Provisions are recognised for present obligations arising as consequences of past events where it is more likely than not that a transfer of economic benefits will be necessary to settle the obligation, and it can be reliably estimated. When a leasehold property ceases to be used in the business, provision is made where the unavoidable costs of the future obligations relating to the lease are expected to exceed anticipated rental income. The net costs are discounted using market rates of interest to reflect the long-term nature of the cash flows.

Contingent liabilities are possible obligations whose existence will be confirmed only by certain future events or present obligations where the transfer of economic benefit is uncertain or cannot be reliably measured. Contingent liabilities are not recognised but are disclosed unless they are remote.

Financial guarantee contracts

The Group accounts for guarantees that meet the definition of a financial guarantee contract at fair value on initial recognition. In subsequent periods, these guarantees are measured at the higher of the initial fair value less cumulative amortisation and the amount that would be recognised as a provision as described in the Accounting Policies above.

Dividends

Dividends on ordinary shares are recognised in equity in the period in which the right to receive payment is established.

Critical accounting policies and areas of significant management judgement

The preparation of the Group's Consolidated Financial Statements requires management to make estimates and judgements that affect the reported amount of assets and liabilities at the date of the Financial Statements and the reported amount of income and expenses during the reporting period. Management evaluates its estimates and judgements on an ongoing basis. Management bases its estimates and judgements on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The following estimates and judgements are considered important to the portrayal of the Group's financial condition.

(a) Provisions for loans and advances

The Group estimates provisions for loans and advances to customers, treasury investment securities and loans and advances to banks with the objective of maintaining balance sheet provisions at the level believed by management to be sufficient to absorb actual losses ('observed provisions') and inherent losses ('incurred but not yet observed provisions') in the Group's loan portfolio from homogeneous portfolios of assets and individually identified loans in connection with loans and advances to banks and loans and advances to customers. The calculation of provisions on impaired loans and advances is based on the likelihood of the asset being written off (or repossessed in the case of mortgage loans) and the estimated loss on such a write-off. These assessments are made using statistical techniques based on historic experience. These determinations are supplemented by various formulaic calculations and the application of management judgement.

The Group considers accounting estimates related to provisions for loans and advances 'critical accounting estimates' because: (i) they are highly susceptible to change from period to period as the assumptions about future default rates and valuation of potential losses relating to impaired loans and advances are based on recent performance experience, and (ii) any significant difference between the Group's estimated losses (as reflected in the provisions) and actual losses will require the Group to take provisions which, if significantly different, could have a material impact on its future income statement and its balance sheet. The Group's assumptions about estimated losses are based on past performance, past customer behaviour, the credit quality of recent underwritten business and general economic conditions, which are not necessarily an indication of future losses.

Provisions for loans and advances, less amounts released and recoveries of amounts written off in previous years are charged to the line item 'Impairment losses' in the income statement. The provisions are deducted from the 'Loans and advances to banks', 'Loan and receivable securities' and the 'Loans and advances to customers' line items on the balance sheet. If the Group believes that additions to the provisions for such credit losses are required, then the Group records additional provisions

for credit losses, which would be treated as a charge in the line item 'Impairment losses on loans and advances to customers' in the income statement.

The Consolidated Financial Statements for the year ended 31 December 2008 include a provision charge for loans and advances in connection with retail lending for an amount equal to £274m and commercial lending for an amount equal to £275m. The provision for retail lending increased reflecting higher default rates in the unsecured portfolios and increased reserving due to a further general deterioration in economic conditions. The provision for commercial lending reflected the current economic down turn and the impact this is having on the corporate sector. In calculating the retail and commercial lending provisions, within the Retail Banking and Corporate Banking segments, a range of outcomes was calculated based principally on management's conclusions regarding the current economic outlook relative to historic experience. Had management used different assumptions regarding the current economic outlook, a larger or smaller provision for loans and advances would have resulted that could have had a material impact on the Group's reported loss on continuing operations before tax in 2008. Specifically, if management's conclusions as to the current economic outlook were different, but within the range of what management deemed to be reasonably possible economic outlooks, the provision charge for loans and advances in the Retail Banking segment could have decreased in 2008 from an actual provision charge of £274m by up to £22m, with a potential corresponding reduction in the Group's loss before tax on continuing operations in 2008 of up to 2%, or increased by up to £29m, with a potential corresponding increase in the Group's loss before tax on continuing operations in 2008 of up to 2%. The range within Retail Banking is based on differing assumptions of the loss per case and loss factor per case. In Corporate Banking the provision charge for loans and advances in the Corporate Banking segment could have decreased in 2008 from an actual provision charge of £275m by up to £51m, with a potential corresponding reduction in the Group's loss before tax on continuing operations in 2008 of up to 4%, or increased by up to £29m, with a potential corresponding increase in the Group's loss before tax on continuing operations in 2008 of up to 2%.

The actual provision charge for retail lending of £274m (2007: £85m) and commercial lending of £275m (2007: £15m) in 2008 was based on what management estimated to be the most probable economic outlook within the range of reasonably possible assumptions.

The provision charge for Treasury assets (investment securities, loans and advances to banks and the Conduit shown in loans and advances to customers) of £485m (2007: £153m) was based on management's assessment of impairment of each individual asset based on data available at 31 December 2008. A detailed analysis of Treasury assets by type of instrument, credit structure, credit rating and geography can be found in the Risk Management Report on pages 27 to 30.

(b) Valuation of financial instruments

Financial instruments that are classified at fair value through profit or loss (including those held for trading purposes) or available-for-sale, and all derivatives, are stated at fair value. The fair value of such financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing, knowledgeable parties, other than in a forced or liquidation sale.

Initial measurement

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the instrument is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include significant data from observable markets. Any difference between the transaction price and the value based on a valuation technique where the inputs are not based on data from observable current markets is not recognised in profit or loss on initial recognition. Subsequent gains or losses are only recognised to the extent that they arise from a change in a factor that market participants would consider in setting a price.

Subsequent measurement

Fair value hierarchy

The Group applies the following fair value hierarchy that prioritises the inputs to valuation techniques used in measuring fair value. The hierarchy establishes three categories for valuing Financial Instruments, giving the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The three categories are: quoted prices in active markets (Level 1), internal models based on observable market data (Level 2) and internal models based on other than observable market data (Level 3). If the inputs used to measure an asset or a liability fall to different levels within the hierarchy, the classification of the entire asset or liability will be based on the lowest level input that is significant to the overall fair value measurement of the asset or liability. The Group categorises assets and liabilities measured at fair value within the fair value hierarchy based on the inputs to the valuation techniques as follows:

Level 1: Unadjusted quoted prices for identical assets or liabilities in an active market that the Group has the ability to access at the measurement date. Level 1 measurements include equity securities and debt securities.

Level 2: Quoted prices in markets that are not active, quoted prices for similar assets or liabilities, inputs other than quoted market prices for the asset or liability that are observable either directly or indirectly for substantially the full term, and inputs to valuation techniques that are derived principally from or corroborated by observable market data through correlation or other statistical means for substantially the full term of the asset or liability. Level 2 measurements include, debt securities, exchange rate derivatives, interest rate derivatives, equity and credit derivatives.

Level 3: Inputs to the pricing or valuation techniques that are significant to the overall fair value measurement of the asset or liability are unobservable. The Group has no Level 3 assets and liabilities.

The Group assesses active markets for equity instruments based on the average daily trading volume both in absolute terms and relative to the market capitalisation for the instrument. The Group assesses active markets for debt instruments based on both

the average daily trading volume and the number of days with trading activity. The Group assesses active markets for exchange traded derivatives based on the average daily trading volume both in absolute terms and relative to the market capitalisation for the instrument. Market activity and liquidity is discussed in the relevant monthly Risk Forum as well as being part of the daily update given by each business at the start of the trading day. This information, together with the observation of active trading and the magnitude of the bid-offer spreads allow consideration of the liquidity of a financial instrument. All underlying assets and liabilities are reviewed to consider the appropriate adjustment to mark the mid price reported in the trading systems to a realisable value. This process takes into account the liquidity of the position in the size of the adjustment required. These liquidity adjustments are presented and discussed at the monthly Risk Forum.

In determining the appropriate measurement levels, the Group performs regular analyses on the assets and liabilities. All underlying assets and liabilities are regularly reviewed to determine whether a position should be regarded as illiquid; the most important practical consideration being the observability of trading. Where the bid/offer spread is observable, this is tested against actual trades. If trades are not observed, the bid/offer spread is disregarded as a sign of liquidity and the position is regarded as illiquid.

Changes in the observability of significant valuation inputs during the reporting period may result in a reclassification of certain assets and liabilities within the fair value hierarchy.

Financial instruments valued using observable market prices

If a quoted market price in an active market is available for an instrument, the fair value is calculated based on the market price.

Financial instruments valued using a valuation technique

In the absence of a quoted market price in an active market, management uses internal models to make its best estimate of the price that the market would set for that financial instrument. In order to make these estimations, various techniques are employed, including extrapolation from observable market data and observation of similar financial instruments with similar characteristics. Wherever possible, valuation parameters for each product are based on prices directly observable in active markets or that can be derived from directly observable market prices. Valuation parameters for each type of financial instrument are discussed below.

The Group did not make any material changes to the valuation techniques or internal models it used during the years ended 31 December 2008 and 2007. The Group developed a discounted cash flow model during 2008 for credit default swaps the effect of which was immaterial.

The following table summarises the fair values at 31 December 2008 and 2007 of the asset and liability classes accounted for at fair value, by the valuation methodology used by the Group to determine their fair value. The table also discloses the percentages that the recorded fair values of financial assets and liabilities represent of the total assets and liabilities, respectively, that are recorded at fair value in the balance sheet:

At 31 December 2008

Balance sheet category		Quoted prices in active markets £m	%	Internal models based on market observable data £m	%	Total £m	%	Valuation technique
Assets								
Derivative assets	Exchange rate contracts	-	-	1,818	40	1,818	40	A
	Interest rate contracts	-	-	1,058	23	1,058	23	A&B
	Equity & credit contracts	-	-	-	-	-	-	
Financial assets at FVTPL	Debt securities	-	-	63	1	63	1	A
Available-for-sale financial assets	Debt securities	1,648	36	-	-	1,648	36	-
	Equity securities	-	-	10	-	10	-	B
Total assets at fair value		1,648	36	2,949	64	4,597	100	
Liabilities								
Derivative liabilities	Exchange rate contracts	-	-	357	16	357	16	A
	Interest rate contracts	-	-	1,164	51	1,164	51	A&B
	Equity & credit contracts	-	-	12	1	12	1	A
Financial liabilities at FVTPL	Debt securities in issue	-	-	728	32	728	32	A
Total liabilities at fair value		-	-	2,261	100	2,261	100	

Accounting Policies continued

At 31 December 2007

Balance sheet category		Quoted prices in active markets £m	%	Internal models based on market observable data £m	%	Total £m	%	Valuation technique
Assets								
Trading assets	Debt securities	1,439	9	-	-	1,439	9	-
Derivative assets	Exchange rate contracts	-	-	273	2	273	2	A
	Interest rate contracts	-	-	697	4	697	4	A&B
Financial assets at FVTPL	Debt securities	-	-	891	6	891	6	A
Available-for-sale financial assets	Debt securities	-	-	12,770	79	12,770	79	A
	Equity securities	-	-	3	-	3	-	B
Total assets at fair value		1,439	9	14,634	91	16,073	100	
Liabilities								
Derivative liabilities	Exchange rate contracts	-	-	309	6	309	6	A
	Interest rate contracts	-	-	482	10	482	10	A&B
Financial liabilities at FVTPL	Debt securities in issue	-	-	4,027	84	4,027	84	A
Total liabilities at fair value		-	-	4,818	100	4,818	100	

Valuation techniques

The main valuation techniques employed in the Group's internal models to measure the fair value of the financial instruments disclosed above at 31 December 2008 and 2007 are set out below. In substantially all cases, the principal inputs into these models are derived from observable market data.

a) In the valuation of financial instruments requiring static hedging (for example interest rate and currency derivatives), the 'present value' method is used. Expected future cash flows are discounted using the interest rate curves of the applicable currencies. The interest rate curves are generally observable market data and reference yield curves derived from quoted interest rates in appropriate time bandings, which match the timings of the cash flows and maturities of the instruments.

b) In the valuation of financial instruments exposed to interest rate risk that require either static or dynamic hedging (such as interest rate futures, caps and floors, and options), the present value method (futures), Black/Scholes model (caps/floors) and the Hull/White model (Bermudan options) are used. These types of model are widely accepted in the financial services industry. The significant inputs used in these models are observable market data, including appropriate interest rate curves, volatilities, correlations and exchange rates. In the valuation of equity financial instruments requiring dynamic hedging (principally equity securities, options and other structured instruments), proprietary stochastic volatility models are used. These types of models are widely accepted in the financial services industry. Observable market inputs are used in these models to generate variables such as the bid/offer spread, foreign currency exchange rates, credit risk, volatility, correlation between indices and market liquidity as appropriate.

The fair values of the financial instruments arising from the Group's internal models take into account, among other things, contract terms and observable market data, which include such factors as bid-offer spread, interest rates, credit risk, exchange rates, the quoted market price of raw materials and equity securities, volatility and prepayments. The main assumptions taken into account when internal models use information other than market data can be found in the table below.

In all cases, when it is not possible to derive a valuation for a particular feature of an instrument, management uses judgement to determine the fair value of the particular feature. In exercising this judgement, a variety of tools are used including proxy observable data, historical data and extrapolation techniques. Extrapolation techniques take into account behavioural characteristics of equity markets that have been observed over time, and for which there is a strong case to support an expectation of a continuing trend in the future. Estimates are calibrated to observable market prices when they become available.

The estimates thus obtained could vary if other valuation methods or assumptions were used. The Group believes its valuation methods are appropriate and consistent with other market participants. Nevertheless, the use of different valuation methods or assumptions, including imprecision in estimating unobservable market inputs, to determine the fair value of certain financial instruments could result in different estimates of fair value at the reporting date and the amount of gain or loss recorded for a particular instrument. Most of the valuation models are not significantly subjective, because they can be tested and, if necessary, recalibrated by the internal calculation of and subsequent comparison to market prices of actively traded securities, where available.

The Group considers that the accounting estimate related to the valuation of financial assets and financial liabilities including derivatives where quoted market prices are not available is a 'critical accounting estimate' because: (i) it is highly susceptible to change from period to period because it requires management to make assumptions about interest rates, volatility, exchange rates, the credit rating of the counterparty, valuation adjustments and specific features of the transactions and (ii) the impact that recognising a change in the valuations would have on the assets reported on its balance sheet as well as its net profit/(loss) could be material.

Changes in the valuation of financial assets and financial liabilities including derivatives where quoted market prices are not available are accounted for in the line item 'Net trading and other income' in the income statement and the Trading assets, Financial assets designated at fair value, Financial liabilities designated at fair value and Derivative financial instruments line items in the Group's balance sheet.

The Group trades in a wide variety of financial instruments in the major financial markets and therefore considers a range of interest rates, volatility, exchange rates, counterparty credit ratings, valuation adjustments and other similar inputs, all of which vary across maturity bands. These are chosen to best reflect the particular characteristics of each transaction. Had management used different assumptions regarding the interest rates, volatility, exchange rates, the credit rating of the counterparty, and valuation adjustments, a larger or smaller change in the valuation of financial assets and financial liabilities including derivatives where quoted market prices are not available would have resulted that could have had a material impact on the Group's reported profit on continuing operations before tax in 2008. Due to the individual nature of these contracts, the Group does not believe generally it is appropriate to apply a global adjustment to management's estimates, as it would not give a meaningful sensitivity with respect to financial instrument fair values based on data other than market prices. Sensitivities have been given with respect to key management estimates where they can be separately identified. Further information about sensitivities (including value-at-risk) to market risk arising from financial instrument trading activities can be found in the Risk Management Report on page 31.

(c) Provisions for misselling

The Group estimates provisions for misselling with the objective of maintaining reserve levels believed by management to be sufficient to absorb current estimated probable losses in connection with compensation from customers who claim reimbursement of payment protection insurance ('PPI'). The calculation of provisions for misselling is based on the estimated number of claims that may be received, of those, the number that will be upheld, and the estimated average settlement per case. These assessments are based on management's estimate for each of these three factors. In certain instances, the extent to which the Group is required to uphold claims is driven by binding legal decisions or precedents, as described in Note 34 Contingent liabilities and commitments.

The Group considers accounting estimates related to misselling provisions 'critical accounting estimates' because: (i) they are highly susceptible to change from period to period per the three factors above, and (ii) any significant difference between the Group's estimated losses as reflected in the provisions and actual losses will require the Group to take provisions which, if significantly different, could have a material impact on its future income statement and its balance sheet. The Group's assumptions about estimated losses are based on our own experience following a customer mailing exercise in 2008.

Provisions for misselling are charged to the line item 'Provisions for other liabilities and charges' in the income statement. The provision is included in the 'Provisions' line item on the balance sheet. If the Group believes that additions to the misselling provision are required, then the Group records additional provisions, which would be treated as a charge in the line item 'Provisions for other liabilities and charges' in the income statement.

The Consolidated Financial Statements for the year ended 31 December 2008 include a provision charge for misselling in the Retail Banking segment for an amount equal to £38m (2007: £nil). The balance sheet provision increased from £nil in 2007 to £34m in 2008, reflecting the PPI provision. In calculating the misselling provision within the Retail Banking segment, management's best estimate of the provision was calculated based on conclusions regarding the number of claims that may be received, of those, the number that will be upheld, and the estimated average settlement per case. Had management used different assumptions regarding these factors, a larger or smaller provision for misselling would have resulted in the Retail Banking segment that could have had a material impact on the Group's reported profit before tax in 2008.

Specifically, if management's conclusions as to the number of claims that will be received, of those, the number that will be upheld, and the estimated average settlement per case were different, but within the range of what management deemed to be reasonably possible, the provision charge for misselling (excluding bank charges) in the Retail Banking segment could have decreased in 2008 by up to £25m, with a potential corresponding decrease in the Group's loss before tax in 2008 of up to 2%, or increased by up to £16m, with a potential corresponding increase in the Group's loss before tax in 2008 of up to 1%. The actual charge in 2008 was based on what management estimated to be the most probable number of claims that will be received, of those, the number that will be upheld, and the estimated average settlement per case within the range of reasonably possible outcomes. With respect to the reimbursement of bank charges, the legal and regulatory position continues to evolve and remains unclear, as described in Note 34 Contingent liabilities and commitments. As a result, management remain unable to quantify reliably a meaningful sensitivity or range of possible outcomes.

(d) Pensions

The Group operates a funded and an unfunded defined benefit pension scheme as described in Note 33 to the Consolidated Financial Statements. The assets of the funded scheme are measured at their fair values at the balance sheet date. The liabilities of the schemes are estimated by projecting forward the growth in current accrued pension benefits to reflect inflation and salary growth to the date of pension payment, discounted to present value using the interest rate applicable to high quality AA rated corporate bonds of the same currency and term as the scheme liabilities. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme. In determining the value of scheme liabilities, assumptions are made by management as to mortality, price inflation, discount rates, pension increases, and earnings growth. Financial assumptions are based on market conditions at the balance sheet date and can generally be derived objectively. Demographic assumptions require a greater degree of estimation and judgement to be applied to externally derived data.

The Group considers accounting estimates related to pension provisions 'critical accounting estimates' because: (i) they are highly susceptible to change from period to period, and (ii) any significant difference between the Group's estimates of the scheme liabilities and actual liabilities could significantly alter the amount of the surplus or deficit recognised in the balance sheet and the pension cost charged to the income statement. The Group's assumptions principally about mortality, but also about price inflation, discount rates, pension increases, and earnings growth, are based on past experience and current economic trends, which are not necessarily an indication of future experience.

Pension service costs are charged to the line item 'Administration expenses', with the interest cost on liabilities and the expected return on scheme assets included within 'Net trading and other income' in the income statement. The provision is included in the 'Retirement benefit obligations' line item in the balance sheet. If the Group believes that increases to the pensions cost are required, then the Group records additional costs that would be treated as a charge in the line item Administration expenses or Net trading and other income in the income statement.

The Consolidated Financial Statements for the year ended 31 December 2008 include current year defined benefit service cost of £19m (2007: £20m) and a pension scheme deficit of £7m (2007: £42m surplus). The changes compared to the prior year reflect reductions in scheme membership, salary reviews, changes in pension increases, changes in mortality assumptions, changes in price inflation assumptions and changes in discount rates. In calculating the current year service cost and deficit, a range of outcomes was calculated based principally on management's estimates regarding mortality, price inflation, discount rates, pension increases, and earnings growth. Had management used different assumptions principally regarding mortality, but also price inflation, discount rate, pensions increases and earnings growth, a larger or smaller charge for pension costs would have resulted that could have had a material impact on the Group's reported profit on continuing operations before tax in 2008. Specifically, if management's conclusions as to mortality, price inflation, discount rates, pensions increases and earnings growth were different, but within the range of what management deemed to be reasonably possible conclusions, the charge for pension costs could have decreased in 2008 from an actual pension charge of £10m (2007: £9m) by up to £10m (2007: £9m), with a potential corresponding decrease in the Group's loss before tax in 2008 of up to 1% (2007: 2% increase in profit), or increased by up to £5m (2007: £5m), with a potential corresponding increase in the Group's loss before tax in 2008 of up to 0% (2007: 1% decrease in profit). The actual current year service pension charge of £19m (2007: £20m) in 2008 was based on what management estimated to be the most probable mortality, price inflation, discount rates, pensions increases and earnings growth within the range of reasonably possible values. In addition, if management's conclusions as to mortality, price inflation, discount rates, pensions increases and earnings growth were different, but within the range of what management deemed to be reasonably possible conclusions, the value of the deficit at the year end could have moved in 2008 from an actual deficit of £7m (2007: £42m surplus) to a surplus of up to £117m (2007: surplus of up to £207m), or increased to a deficit of up to £90m (2007: deficit of up to £67m).

(e) Deferred tax

The Group recognises deferred tax assets with respect to tax losses carried forward to the extent that it is probable that future taxable profits will be available against which the unused tax losses and unused tax credits can be utilised. At 31 December 2008 the Group has recognised such deferred tax assets in full. As at 31 December 2008 this amounted to £368m (2007: £nil). The value of the deferred tax asset is based on management's best estimate of the amount that will be recoverable in the foreseeable future. This estimate is based on management's assessment of future taxable profits that are expected to arise over this period.

The Group considers accounting estimates related to deferred tax assets 'critical accounting estimates' because: (i) they are highly susceptible to change from period to period as the assumptions about future taxable profits represent forward-looking estimates which are inherently vulnerable to changes in economic and market conditions, and (ii) any significant shortfall between the Group's estimated taxable profits and actual taxable profits could require the Group to take charges which, if significant, could have a material impact on its future income statement and its balance sheet. The Group's assumptions about estimated future taxable profits are based on assumptions about future performance within the Abbey National plc group, of which Alliance & Leicester plc has become a part, and general economic conditions, which are not necessarily an indication of future performance.

Changes to the value of deferred tax assets are charged to the line item 'Tax credit/(charge)' in the income statement. The changes in deferred tax assets are deducted from the 'Deferred tax assets' line item on the balance sheet.

The Consolidated Financial Statements for the year ended 31 December 2008 include a charge for changes in the value of deferred tax assets arising in connection with the non recoverability of taxable losses of £nil. If management estimates of future tax profits were not met, it is possible that the deferred tax asset would still be recovered, but over a longer period, therefore it is not possible to quantify reliably a meaningful sensitivity or range of possible outcomes. Under current UK tax legislation, the tax losses in respect of which deferred tax assets have been recognised do not expire.

Notes to the Financial Statements

1. Segments

The principal activity of the Group is financial services. The Group's business is managed and reported on the basis of the following segments:

- Retail Banking
- Corporate Banking
- Treasury & Group Items

In 2008, the Commercial Bank business was renamed Corporate Banking, and the Treasury business was combined with Group items for segmental reporting purposes. The segmental analysis for 2007 has been amended to reflect these changes.

The Group's segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. The Group has three segments. Retail Banking offers a range of personal banking, savings and mortgage products and services. Corporate Banking offers business banking services principally to small and medium-sized UK companies and commercial loans to larger Corporate customers. It also contains operations in run down. Treasury & Group Items consist of assets and liabilities required to support the liquidity and funding requirements of the Group, Asset and Liability Management activities, Group Capital and shared services.

The segment information below is presented on the basis used by the Company's Board to evaluate performance, in accordance with IFRS 8. The Company's Board reviews discrete financial information for each of its segments, including measures of operating results and assets. The segments are managed primarily on the basis of their results, which are measured on a 'trading' basis. The trading basis differs from the statutory basis (described in the Accounting Policies section on pages 50 to 65) as a result of the application of various adjustments. Management considers that the trading basis provides the most appropriate way of reviewing the performance of the business.

The segmental analysis for 2007 has been amended to reflect this basis of reporting, to ensure a relevant comparison can be made. The adjustments are:

- **Reorganisation and other items** – Comprise implementation costs in relation to the strategic change cost reduction projects, costs arising from the acquisition by Banco Santander S.A., refinement of the credit provisioning methodology and effective interest rate assumptions described in Note 2 and 8 respectively, as well as certain other costs and income of a one-off nature. Management needs to understand the underlying drivers of the cost base that will remain after these exercises are complete, and does not want this view to be clouded by these costs, which are managed independently.
- **Depreciation of operating lease assets** – The operating lease businesses are managed as financing businesses and, therefore, management needs to see the margin earned on the businesses. Residual value risk is separately managed. As a result the depreciation is netted against the related income.
- **Hedging and certain other mark-to-market variances** – The balance sheet and income statement are subject to mark-to-market volatility including that arising from the accounting for elements of derivatives deemed under IFRS to be ineffective as hedges. Where appropriate, such volatility is separately identified to enable management to view the underlying performance of the business.
- **Treasury impairment losses** – During 2008, Alliance & Leicester incurred significant losses on its investment securities. These are managed separately and are considered exceptional due to their size and the current global credit crisis. Investments in structured investment vehicles were written off during 2008 and losses were incurred on some investments in bank floating rate notes.

Transactions between the business segments are on normal commercial terms and conditions. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Internal charges and transfer pricing adjustments have been reflected in the performance of each business. Revenue sharing agreements are used to allocate external customer revenues to a business segment on a reasonable basis. Funds are ordinarily reallocated between segments, resulting in funding cost transfers disclosed in total trading income. Interest charged for these funds is based on the Group's cost of capital.

Interest receivable and interest payable have not been reported separately. The majority of the revenues from the segments presented below are from interest and the Company's Board relies primarily on net interest revenues to both assess the performance of the segment and to make decisions regarding allocation of segmental resources.

Segment assets and liabilities comprise operating assets and liabilities, being the majority of the balance sheet.

a) Segmental information

2008	Retail Banking £m	Corporate Banking £m	Treasury & Group £m	Total £m	Adjustments £m	Group Total £m
Net interest income	570	195	(112)	653	(269)	384
Non-interest income	215	252	(19)	448	(8)	440
Total trading income	785	447	(131)	1,101	(277)	824
Administration expenses	(216)	(253)	(203)	(672)	(255)	(927)
Depreciation/amortisation	(26)	(20)	(2)	(48)	(66)	(114)
Total trading expenses	(242)	(273)	(205)	(720)	(321)	(1,041)
Impairment losses	(129)	(51)	–	(180)	(853)	(1,033)
Provisions for other liabilities and charges	–	–	–	–	(38)	(38)
Trading profit/(loss) before tax	414	123	(336)	201	(1,489)	(1,288)
Adjust for:						
Reorganisation and other items	(366)	(202)	(322)	(890)		
Hedging and certain other mark-to-market variances	–	–	(114)	(114)		
Treasury losses and impairment	–	–	(485)	(485)		
Profit/(loss) before tax	48	(79)	(1,257)	(1,288)		
Average number of staff	2,937	813	3,184	6,934	-	6,934
Total assets	40,898	9,954	24,396	75,248	–	75,248

Adjustments comprise:	Net interest income £m	Non interest income £m	Administration expenses £m	Depreciation and amortisation £m	Impairment losses on loans and advances £m	Provisions for other liabilities and charges £m	Adjustments before tax £m
Reorganisation and other items	(269)	40	(255)	–	(368)	(38)	(890)
Depreciation on operating lease assets	–	66	–	(66)	–	–	–
Hedging and certain other mark-to-market variances	–	(114)	–	–	–	–	(114)
Treasury losses and impairment	–	–	–	–	(485)	–	(485)
	(269)	(8)	(255)	(66)	(853)	(38)	(1,489)

Changes in interest and exchange rates mean that period on period comparisons of gross interest and other trading income and expense are not meaningful and therefore management only considers these items on a net basis. Similarly, management considers the trading income generated by each segment on the basis of the margin earned on the customer relationship. There is therefore no split that is meaningful of trading income between external customers and intra-Group. No analysis of total trading income from external customers and intra-Group is therefore presented.

2007	Retail Banking £m	Corporate Banking £m	Treasury & Group £m	Total £m	Adjustments £m	Group Total £m
Net interest income	599	169	36	804	(3)	801
Non-interest income	276	253	(1)	528	97	625
Total trading income	875	422	35	1,332	94	1,426
Administration expenses	(220)	(252)	(171)	(643)	–	(643)
Depreciation/amortisation	(22)	(21)	(14)	(57)	(74)	(131)
Total trading expenses	(242)	(273)	(185)	(700)	(74)	(774)
Impairment losses	(85)	(15)	–	(100)	(153)	253
Trading profit/(loss) before tax	548	134	(150)	532	(133)	399
Adjust for:						
Reorganisation and other items	31	48	(17)	62		
Hedging and certain other mark-to-market variances	–	–	(42)	(42)		
Treasury losses and impairment	–	–	(153)	(153)		
Profit/(loss) before tax	579	182	(362)	399		
Average number of staff	3,261	726	3,236	7,223	-	7,223
Total assets	46,693	8,414	23,848	78,955	–	78,955

Notes to the Financial Statements continued

Adjustments comprise:	Net interest income £m	Non interest income £m	Administration expenses £m	Depreciation and amortisation £m	Impairment losses on loans and advances £m	Provisions for other liabilities and charges £m	Adjustments before tax £m
Reorganisation and other items	(3)	65	-	-	-	-	62
Depreciation on operating lease assets	-	74	-	(74)	-	-	-
Hedging and certain other mark-to-market variances	-	(42)	-	-	-	-	(42)
Treasury losses and impairment	-	-	-	-	(153)	-	(153)
	(3)	97	-	(74)	(153)	-	(133)

No geographical analysis is presented because substantially all of the Group's activities are in the UK.

2. Net interest income

	Group	
	2008 £m	2007 £m
Interest and similar income:		
Loans and advances to banks	**242**	212
Loans and advances to customers	**2,987**	3,029
Other interest earning financial assets	**803**	926
Total interest and similar income	**4,032**	4,167
Interest expense and similar charges:		
Deposits by banks	**1,017**	511
Deposits by customers	**1,262**	1,269
Debt securities in issue	**1,219**	1,372
Other interest bearing financial liabilities	**150**	214
Total interest expense and similar charges	**3,648**	3,366
Net interest income	**384**	801

The mortgage effective interest rate assumptions were adjusted, reflecting the change in approach to the management of the mortgage portfolio going forward, resulting in a £187m reduction in net interest income.

3. Net fee and commission income

	Group	
	2008 £m	2007 £m
Fee and commission income:		
Insurance products	**53**	103
Retail products	**418**	414
Total fee and commission income	**471**	517
Fee and commission expense:		
Other fees paid	**79**	33
Total fee and commission expense	**79**	33
Net fee and commission income	**392**	484

4. Net trading and other income

	Group	
	2008 £m	2007 £m
Net trading and funding of other items by the trading book	**(7)**	(19)
Income from operating lease assets	**88**	94
Excess on sale of credit cards to MBNA	**16**	20
Expense on assets held at fair value through profit or loss	**(11)**	(8)
Expense on liabilities held at fair value through profit or loss	**(1)**	-
Losses on derivatives managed with assets and liabilities held at fair value through profit or loss	**-**	(1)
Mark-to-market losses on credit default swaps	**(115)**	(2)
Hedge ineffectiveness and other	**78**	57
	48	141

5. Administration expenses

	Group 2008 £m	2007 £m
Staff costs:		
Wages and salaries	**221**	220
Social security costs	**20**	22
Pensions costs: – defined contribution plans	**10**	9
– defined benefit plans	**15**	17
Other personnel costs	**74**	7
	340	275
Property, plant and equipment expenses	**39**	41
Information technology expenses	**42**	39
Intangible and tangible assets write offs	**163**	–
Other administrative expenses	**343**	288
	927	643

Other personnel costs include restructuring costs.

6. Depreciation and amortisation

	Group 2008 £m	2007 £m
Depreciation of property, plant and equipment excluding operating lease assets	**32**	46
Depreciation of operating lease assets	**66**	74
Amortisation of intangible assets	**16**	11
	114	131

Depreciation of property, plant and equipment, excluding operating lease assets, includes an asset write down of £9m in 2007 incurred by the Group in connection with the redevelopment of the Bootle administration site.

7. Audit and other services

The fees for audit and other services payable to the Company's auditors, Deloitte LLP, are analysed as follows:

	Group 2008 £m	2007 £m
Audit fees:		
Fees payable to the Company's auditors for the audit of the Group's annual accounts	**0.8**	0.4
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**0.6**	0.4
Total audit fees	**1.4**	0.8
Non-audit fees:		
– Tax services	**1.0**	0.1
– Corporate finance services	**0.2**	-
– Other services	**0.4**	0.7
Total non-audit fees	**1.6**	0.8

Tax services relate to advisory and compliance services on the Group's tax affairs.

No information technology, internal audit, valuation and actuarial, litigation, recruitment and remuneration were provided by the external auditors during 2008.

Corporate finance service costs related to work carried out to support the acquisition by Banco Santander, S.A.

Other services include accounting advice and assurance work on bond issues.

A framework for ensuring auditors' independence has been adopted which defines unacceptable non-audit assignments, pre-approval of acceptable non-audit assignments and procedures for approval of other non-audit assignments by the Audit and Risk Committee. All services provided by the Group's external auditors are either pre-approved or approved by the Committee.

Notes to the Financial Statements continued

8. Impairment losses

	Group	
	2008 £m	2007 £m
Impairment losses on loans and advances to customers	**619**	117
Recoveries of loans and advances to customers	**(12)**	(17)
Total impairment losses on loans and advances to customers	**607**	100
Impairment losses on treasury investment securities and loans to banks	**426**	153

Detail of Treasury impairment losses can be found in the Risk Management Report on page 27. Treasury investment securities include financial assets designated at fair value, available-for-sale securities and loan and receivable securities. Impairment losses on loans and advances to customers increased in 2008 to £607m. Such increase in impairment losses is the result of refinements to accounting estimates reflecting the state of the UK economy.

9. Taxation expense

	Group	
	2008 £m	2007 £m
Current tax:		
UK corporation tax on profit of the year	**–**	104
Adjustments and reclassifications in respect of prior periods	**(45)**	11
Overseas taxation	**1**	1
Total current tax (credit)/charge	**(44)**	116
Deferred tax (credit)/charge:		
Current year	**(340)**	(2)
Adjustments and reclassifications in respect of prior periods	**14**	(11)
Total deferred tax	**(326)**	(13)
Tax (credit)/charge for the year	**(370)**	103

UK corporation tax is calculated at 28.5% (2007: 30%) of the estimated assessable profits for the year. The standard rate of UK corporation tax was reduced from 30% to 28% with effect from 1 April 2008. Taxation for other jurisdictions is calculated at the rates prevailing in the relevant jurisdictions.

The tax on the Group's (loss)/profit before tax differs from the theoretical amount that would arise using the basic tax rate of the Company as follows:

	Group	
	2008 £m	2007 £m
(Loss)/profit before tax	**(1,288)**	399
Tax calculated at a tax rate of 28.5% (2007: 30%)	**(367)**	120
Effect of non-allowable provisions and other non-equalised items	**24**	(10)
Tax relief in respect of Innovative tier 1	**(5)**	(5)
Impact of loss of capital allowances	**4**	–
Effect of non-UK profits and losses	**(2)**	(3)
Effect of change in tax rate on deferred tax provision	**7**	1
Adjustment to prior year provisions	**(31)**	–
Income tax (credit)/charge	**(370)**	103

10. (Loss)/profit on ordinary activities after tax

The loss after tax of the Company attributable to the shareholders is £311m (2007: profit £135m). As permitted by Section 230 of the UK Companies Act 1985, the Company's income statement has not been presented in these Consolidated Financial Statements.

11. Cash and balances at central banks

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Cash in hand	**457**	480	**457**	480
Balances with central banks	**1,096**	2,991	**1,096**	2,991
	1,553	3,471	**1,553**	3,471

Included within balances with central banks are £48m (2007: £68m) of mandatory reserve deposits with the Bank of England that are not available for use by the Group.

12. Trading assets

	Group & Company	
	2008 £m	2007 £m
Debt securities	–	1,439

The Group applied the amendment to IAS 39 regarding the reclassification of financial assets. Details can be found in Note 18.

Debt securities can be analysed by type of issuer as follows:

	Group & Company	
	2008 £m	2007 £m
Issued by public bodies:		
– Government securities	–	26
Other debt securities	–	1,413
	–	1,439

Debt securities can be analysed by listing status as follows:

	Group & Company	
	2008 £m	2007 £m
Debt securities:		
– Listed in the UK	–	868
– Listed elsewhere	–	538
– Unlisted	–	33
	–	1,439

13. Derivative financial instruments

All derivatives are required to be classified as held for trading (except where in a hedge relationship) and held at fair value through profit or loss. Derivatives are held for trading or for risk management purposes. The Group chooses to designate certain derivatives as in a hedging relationship if they meet specific criteria.

Derivatives held for trading purposes

Treasury is the only area of the Group actively trading derivative products and is additionally responsible for implementing Group derivative hedging with the external market. For trading activities, its objectives are to gain value by:

- Marketing derivatives to end users and hedging the resulting exposures efficiently; and
- The management of trading exposure reflected on the Group's balance sheet.

Trading derivatives include interest rate, cross currency, equity, property and other index related swaps, forwards, caps, floors, swaptions, as well as credit default and total return swaps, equity index contracts and exchange traded interest rate futures and equity index options.

Derivatives held for risk management purposes

The main derivatives are interest rate and cross-currency swaps, which are used to hedge the Group's exposure to interest rates and exchange rates. These risks are inherent in non-trading assets, liabilities and positions, including fixed-rate lending and structured savings products within the relevant operations throughout the Group, including medium-term note issues, capital issues and fixed-rate asset purchases.

The table in the Risk Management Report on page 32 summarises activities undertaken by the Group, the related risks associated with such activities and the types of derivative used in managing such risks. Such risks may also be managed using natural offsets within other on-balance sheet instruments as part of an integrated approach to risk management.

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. The fair values of derivative instruments held both for trading and hedging purposes are set out in the following tables. The tables below show the contract or underlying principal amounts, positive and negative fair values of derivatives analysed by contract. Contract or notional amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts of risk. The fair values represent the amount at which a contract could be exchanged in an arm's length transaction, calculated at market rates at the balance sheet date.

Notes to the Financial Statements continued

Derivatives classified as held for trading or held for risk management purposes that have not been designated as in a hedging relationship are classified as derivatives fair valued through profit and loss in the table below. Derivatives that have been designated as in a hedging relationship are classified as derivatives held for hedging below:

2008 Derivatives fair valued through P&L	Contract/notional amount £m	Fair value assets £m	Group Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	6,044	1,729	(14)
– Foreign exchange swaps and forwards	2,461	-	(337)
	8,505	1,729	(351)
Interest rate contracts:			
– Interest rate swaps	20,629	240	(223)
– Caps, floors and swaptions	496	6	(1)
– Credit default swaps	25	–	(12)
	21,150	246	(236)
Total derivative assets and liabilities	29,655	1,975	(587)

2008 Derivatives held for hedging	Contract/notional amount £m	Fair value assets £m	Group Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	170	73	–
Interest rate contracts:			
– Interest rate swaps	39,291	484	(828)
Total derivative assets and liabilities held for hedging	39,461	557	(828)
Accrued interest	–	344	(118)
Total recognised derivative assets and liabilities	69,116	2,876	(1,533)

2008 Derivatives fair valued through P&L	Contract/notional amount £m	Fair value assets £m	Company Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	2,790	714	(83)
– Foreign exchange swaps and forwards	2,486	-	(334)
	5,276	714	(417)
Interest rate contracts:			
– Interest rate swaps	32,953	562	(431)
– Caps, floors and swaptions	496	6	(1)
– Credit default swaps	185	(11)	(66)
	33,634	557	(498)
Total derivative assets and liabilities	38,910	1,271	(915)

2008 Derivatives held for hedging	Contract/notional amount £m	Fair value assets £m	Company Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	170	73	-
Interest rate contracts:			
– Interest rate swaps	37,581	498	(627)
Total derivative assets and liabilities held for hedging	37,751	571	(627)
Accrued interest	–	348	(129)
Total recognised derivative assets and liabilities	76,661	2,190	(1,671)

2007 Derivatives fair valued through P&L	Contract/notional amount £m	Fair value assets £m	Group Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	8,519	260	(265)
– Foreign exchange swaps and forwards	2,407	–	(34)
	10,926	260	(299)
Interest rate contracts:			
– Interest rate swaps	43,287	187	(92)
– Caps, floors and swaptions	390	2	(1)
– Futures (exchange traded)	275	–	–
– Credit default swaps	217	–	(2)
– Forward rate agreements	1,446	–	–
	45,615	189	(95)
Total derivative assets and liabilities	56,541	449	(394)

2007 Derivatives held for hedging	Contract/notional amount £m	Fair value assets £m	Group Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	206	7	–
Interest rate contracts:			
– Interest rate swaps	32,960	128	(191)
Total derivative assets and liabilities held for hedging	33,166	135	(191)
Accrued interest	–	386	(206)
Total recognised derivative assets and liabilities	89,707	970	(791)

2007 Derivatives fair valued through P&L	Contract/notional amount £m	Fair value assets £m	Company Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	5,123	260	(265)
– Foreign exchange swaps and forwards	2,407	–	(34)
	7,530	260	(299)
Interest rate contracts:			
– Interest rate swaps	49,984	102	(139)
– Caps, floors and swaptions	390	2	(1)
– Futures (exchange traded)	275	–	–
– Credit default swaps	217	–	(2)
– Forward rate agreements	1,446	–	–
	52,312	104	(142)
Total derivative assets and liabilities	59,842	364	(441)

2007 Derivatives held for hedging	Contract/notional amount £m	Fair value assets £m	Company Fair value liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	206	7	–
Interest rate contracts:			
– Interest rate swaps	32,960	128	(191)
Total derivative assets and liabilities held for hedging	33,166	135	(191)
Accrued interest	–	405	(236)
Total recognised derivative assets and liabilities	93,008	904	(868)

Gains/losses arising from fair value hedges and transfers from cash flow reserve included in Net trading and other income

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Net gains/(losses):				
On hedging instruments	**(521)**	(224)	**(297)**	(188)
On the hedged items attributable to hedged risk	**509**	220	**343**	185
Transferred from the cash flow reserve	**11**	7	**24**	11
Other	**21**	(12)	**156**	18
Hedge ineffectiveness	**20**	(9)	**226**	26

The Group hedges its exposures to various risks, including interest rate risk and foreign currency risk, in connection with certain mortgage assets and subordinated and senior debt securities in issue. The gains/(losses) arising on these assets and liabilities are included in the table above on a combined basis.

14. Financial assets designated at fair value

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Debt securities	**63**	891	**63**	36

Financial assets are designated at fair value through profit or loss where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring the assets or liabilities or recognising gains or losses on them on a different basis.

Debt securities represent holdings of asset-backed securities. They are managed, and their performance is evaluated, on a fair value basis in accordance with a documented investment strategy and information about them is provided internally on that basis to the Group's key management personnel.

The maximum exposure to credit risk on the financial assets held at fair value through profit or loss at the balance sheet date was £97m (2007: £855m).

Debt securities can be analysed by listing status as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Listed outside UK	**38**	861	**38**	6
Unlisted	**25**	30	**25**	30
	63	891	**63**	36

15. Loans and advances to banks

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Placements with other banks	**1,239**	2,885	**1,236**	2,864
Amounts due from parent	**–**	–	**–**	–
Amounts due from subsidiaries	**–**	–	**–**	–
	1,239	2,885	**1,236**	2,864

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Repayable:				
On demand	**816**	385	**814**	364
In not more than 3 months	**77**	2,319	**77**	2,318
In more than 3 months but not more than 1 year	**346**	2	**345**	3
In more than 1 year but not more than 5 years	**–**	179	**–**	179
	1,239	2,885	**1,236**	2,864

16. Loans and advances to customers

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Advances secured on residential properties	**37,665**	42,788	**37,665**	42,788
Corporate loans	**9,058**	6,474	**5,419**	3,719
Finance leases	**1,791**	1,916	**–**	–
Other secured advances	**57**	75	**10**	12
Other unsecured advances	**3,477**	3,966	**188**	166
Amounts due from subsidiaries	**–**	–	**9,661**	8,984
Loans and advances to customers	**52,048**	55,219	**52,943**	55,669
Less: loan loss allowances	**(646)**	(163)	**(339)**	(44)
Loans and advances to customers, net of loan loss allowances	**51,402**	55,056	**52,604**	55,625

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Repayable:				
On demand	**108**	456	**3,374**	4,244
In no more than 3 months	**831**	1,021	**5,211**	4,016
In more than 3 months but not more than 1 year	**3,262**	2,341	**2,721**	1,889
In more than 1 year but not more than 5 years	**10,282**	5,568	**7,118**	2,063
In more than 5 years	**36,919**	45,670	**34,180**	43,413
Loans and advances to customers	**51,402**	55,056	**52,604**	55,625

Notes to the Financial Statements continued

The Group's leasing subsidiary, Alliance & Leicester Commercial Finance plc and its subsidiaries, enters into finance lease and hire purchase arrangements with customers.

Gross investment in finance leases and hire purchase contracts receivable	2008 £m	2007 £m
Within 1 year	333	344
Between 1-5 years	699	740
In more than 5 years	1,556	1,684
	2,588	2,768
Unearned future finance income on finance leases and hire purchase contracts	(797)	(852)
Net investment in finance leases and hire purchase contracts	1,791	1,916

The net investment in finance leases and hire purchase contracts is analysed as follows:	2008 £m	2007 £m
Within 1 year	230	283
Between 1-5 years	484	583
In more than 5 years	1,077	1,050
Net investment in finance leases and hire purchase contracts	1,791	1,916

Included in the carrying value of Net investment in finance leases and hire purchase contracts is £48m (2007: £60m) residual value at the end of the current lease terms, which will be recovered through re-letting or sale.

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

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Fixed rate	24,788	31,320	19,765	25,705
Variable rate	27,260	23,899	33,178	29,964
Less: loan loss allowances	(646)	(163)	(339)	(44)
	51,402	55,056	52,604	55,625

Movement in loan loss allowances:

Group

	Loans secured on residential property £m	Finance leases £m	Other secured advances £m	Other unsecured advances £m	Total £m
As at 1 January 2008	12	7	19	125	163
Charge to the income statement:					
– Individually assessed	15	(3)	77	147	236
– Collectively assessed	41	(3)	114	219	371
	56	(6)	191	366	607
Write-offs	(9)	–	(4)	(111)	(124)
At 31 December 2008	59	1	206	380	646
As at 1 January 2007	12	5	13	138	168
Charge to the income statement:					
– Individually assessed	–	3	9	3	15
– Collectively assessed	1	–	–	84	85
	1	3	9	87	100
Write-offs	(1)	(1)	(3)	(100)	(105)
At 31 December 2007	12	7	19	125	163

Company

	Loans secured on residential property £m	Amounts due from subsidiaries £m	Finance leases £m	Other secured advances £m	Other unsecured advances £m	Total £m
As at 1 January 2008	12	–	–	14	18	44
Charge to the income statement	56	20	–	88	173	337
Write-offs	(9)	(6)	–	(5)	(22)	(42)
At 31 December 2008	59	14	–	97	169	339
As at 1 January 2007	12	–	–	13	12	37
Charge to the income statement	1	20	–	6	19	46
Write-offs	(1)	(20)	–	(5)	(13)	(39)
At 31 December 2007	12	–	–	14	18	44

Notes to the Financial Statements continued

17. Securitisation of assets

Loans and advances to customers include portfolios of residential mortgage loans, which are subject to non-recourse finance arrangements. These loans have been purchased by, or assigned to, special purpose securitisation companies ('Securitisation Companies'), and have been funded primarily through the issue of mortgage-backed securities ('Securities'). No gain or loss has been recognised as a result of these sales. These Securitisation Companies are consolidated and included in the Group financial statements as subsidiaries.

The Company receives payments from the Securitisation Companies in respect of fees for administering the loans, and payment of deferred consideration for the sale of the loans. While any notes remain outstanding from a Securitised Company, the Company has no right or obligation to repurchase the benefit of any securitised loan from that Securitised Company, except if certain representations and warranties given by the Company at the time of transfer are breached.

Master Trust Structures

The Company makes use of a type of securitisation known as a master trust structure. In this structure, a pool of assets is assigned to a trust company by the asset originator, initially funded by the originator. A funding entity acquires beneficial interests in a share of the portfolios of assets with funds borrowed from qualifying special purpose entities, which at the same time issue asset-backed securities to third-party investors or the Company. The purpose of the special purpose entities is to obtain funding through the issue of asset-backed securities, or to use the asset-backed securities as collateral for raising funds. The share of the pool of assets not purchased from the trust company by the funding entity is known as the beneficial interest of the originator.

The Company established the Fosse Master Trust securitisation structure in 2006. Notes were issued by Fosse Master Issuer plc to third party investors and the proceeds loaned to Fosse Funding (No. 1) Limited, which in turn used the funds to purchase beneficial interests in mortgages held by Fosse Trustee Limited. The Company raised £2,505m in 2006, £2,502m in 2007 and £396m in 2008 from securitisations involving the Fosse Master Trust.

The Company established the Langton Master Trust securitisation structure on 25 January 2008. Notes are issued by Langton Securities (2008-1) plc, Langton Securities (2008-2) plc and Langton Securities (2008-3) plc to the Company, either for the purpose of creating collateral to be used for funding or for subsequent transfer of Notes to investors outside the Group. Each entity loaned the proceeds of the Notes issued to Langton Funding (No.1) Limited, which in turn used the funds to purchase a beneficial interest in the mortgages held by Langton Mortgages Trustee Limited.

The Company and its subsidiaries are under no obligation to support any losses that may be incurred by the Fosse and Langton Companies or holders of the Securities and do not intend to provide such required support. Holders of the Securities are only entitled to obtain payment of principal and interest to the extent that the resources of the Companies are sufficient to support such payments, and the holders of the Securities have agreed in writing not to seek recourse in any other form.

Bracken Securities plc

In October 2007 the Company securitised £10,367m of residential mortgage assets to Bracken Securities plc. Notes of £10,367m were issued by Bracken Securities plc to the Company, either for the purpose of creating collateral to be used for funding or for subsequent transfer of Notes to investors outside the Group.

Outstanding balances of assets securitised and non-recourse finance at 31 December 2008 were as follows:

Securitisation company	Closing date of securitisation	Gross assets securitised £m	Non-recourse finance £m	Issued to A&L as collateral £m
Fosse Master Issuer plc	28 Nov 2006	1,833	1,909	–
Fosse Master Issuer plc	1 Aug 2007	1,935	2,035	–
Fosse Master Issuer plc	21 Aug 2008	360	387	–
Bracken Securities plc	11 Oct 2007	7,841	–	8,168
Langton Securities (2008-1) plc	25 Jan 2008	1,812	–	1,844
Langton Securities (2008-2) plc	5 Mar 2008	1,979	–	2,013
Langton Securities (2008-3) plc	17 Jun 2008	3,549	–	3,611
Beneficial interest in Fosse Master Trust		2,472	–	–
Beneficial interest in Langton Master Trust		773	–	–

The securitisation vehicles have cash deposits totalling £655m, which have been accumulated to finance the redemption of a number of Securities issued by the Securitisation Companies. The Securitisation Companies' contractual interest in advances secured on residential property is therefore reduced by this amount. The Company does not own directly, or indirectly, any of the share capital of any of the above Securitisation Companies or their parents.

A summarised aggregated income statement for the years ended 31 December 2008 and 2007 and a summarised aggregated balance sheet at 31 December 2008 and 2007 for the above companies are set out below:

Income statement for the year ended 31 December

	Securitisation companies	
	2008 £m	2007 £m
Net interest income	**(8)**	15
Other operating expenses	**-**	(1)
Fair value movements on derivatives	**(50)**	(18)
Administrative expenses	**(12)**	(2)
Impairment losses on loans and advances	**(2)**	-
Taxation (credit)/charge	**(1)**	2
Loss for the year	**(73)**	(4)

Balance sheet as at 31 December

	Securitisation companies	
	2008 £m	2007 £m
Derivative financial instruments	**1,083**	166
Loans and advances to banks	**1,059**	1,154
Loans and advances to customers	**4,099**	4,468
Total assets	**6,241**	5,788
Deposits by banks	**411**	381
Debt securities in issue	**5,470**	4,855
Other liabilities	**436**	555
Total liabilities	**6,317**	5,791
Retained earnings	**(76)**	(3)
Total liabilities and equity	**6,241**	5,788

Included within loans and advances to customers are £3,222m (2007: nil) of mortgage advances assigned to a bankruptcy remote special purpose entity, Alliance & Leicester Covered Bonds LLP. These loans provide security to issues of covered bonds made by the Company. On 15 April 2008, the Company issued £500m of covered bonds, under its covered bond programme, which were held by the Company at 31 December 2008. A further £2,000m of covered bonds were issued on 9 October 2008 and were held by the Company at 31 December 2008. These are not included in the table above.

18. Available-for-sale securities and loan and receivable securities

Available-for-sale securities:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Debt securities	**1,648**	12,770	**1,644**	12,758
Equity securities	**10**	3	**10**	3
	1,658	12,773	**1,654**	12,761

Maturities of debt securities:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Due in less than 3 months	**1,644**	739	**1,644**	739
Due in more than 3 months but less than 1 year	**-**	825	**-**	825
Due in more than 1 year but not more than 5 years	**4**	7,521	**-**	7,517
Due in more than 5 years	**-**	3,685	**-**	3,677
	1,648	12,770	**1,644**	12,758

Debt securities include £1,644m of Treasury Bills for both Group and Company. Equity securities do not bear interest and are all unlisted.

The movement in available-for-sale securities can be summarised as follows:

	Group £m	Company £m
At 1 January 2008	**12,773**	**12,761**
Additions	**2,078**	**2,078**
Disposals (sale and redemption)	**(2,385)**	**(2,385)**
Transfers	**(13,436)**	**(13,428)**
Movement in fair value	**(251)**	**(251)**
Other movements	**2,879**	**2,879**
At 31 December 2008	**1,658**	**1,654**

	Group £m	Company £m
At 1 January 2007	10,483	10,471
Additions	3,954	3,954
Disposals (sale and redemption)	(1,991)	(1,991)
Movement in fair value	(199)	(199)
Other movements	526	526
At 31 December 2007	12,773	12,761

Loan & receivable securities

Loan and receivable securities were £14,250m at the end of 2008 (2007: £210m) for Group and £14,321m for 2008 (2007: £13m) for Company.

The Group applied the amendment to IAS 39 regarding the reclassification of financial assets out of 'fair value through profit & loss' and 'available-for-sale' categories into 'loans & receivables'. On 1 July 2008, the amount reclassified out of 'available-for-sale' and into 'loans & receivables' was £13,436m. If these assets had remained as 'available-for-sale', the pre-tax impact on the 'available-for-sale' reserve would have been a charge of £1,018m based on exit prices for these debt securities rather than their recoverable values. The pre-tax charge to the 'available-for-sale' reserve on these assets in 2008 prior to the reclassification was £264m (2007: £210m). The amount reclassified out of 'held-for-trading' and into 'loans & receivables' was £732m. If these assets had remained as 'held-for-trading' a £54m fair value loss would have been recognised in the income statement. The loss recognised in income in 2008 on these assets prior to the reclassification was £6m (2007: £20m). There has been no change in the way net interest income is recognised in the income statement on these assets reclassified. The reclassifications were made as there was no active trading market in the assets. The reduction in the carrying value of the reclassified assets prior to their reclassification is expected to be recovered over the period to maturity of the assets. This is being recognised on a straight-line basis over the period to maturity, which is considered to be immaterially different to using an Effective Interest Rate basis.

The assets were reclassified as the Group identified that a rare circumstance of extreme market illiquidity had arisen. At the date of reclassification, management had the intention to hold the assets for the foreseeable future or until maturity, and the assets would have met the 'loans and receivables' classification had they not originally been required to be classified as held-for-trading or designated as available-for-sale.

19. Investment in subsidiary undertakings

Investments in subsidiaries are held at cost subject to impairment. The movement in investments in Group undertakings was as follows:

			Company
	Cost £m	Impairment £m	Net book value £m
At 1 January 2008	**1,091**	**–**	**1,091**
Additions	**6**	**–**	**6**
Impairments	**–**	**(6)**	**(6)**
At 31 December 2008	**1,097**	**(6)**	**1,091**

	Cost £m	Impairment £m	Net book value £m
At 1 January 2007	1,091	–	1,091
At 31 December 2007	1,091	–	1,091

Notes to the Financial Statements continued

The principal subsidiaries of Alliance & Leicester plc at 31 December 2008 are shown below. The Directors consider that to give full particulars of all subsidiary undertakings would lead to a statement of excessive length. In accordance with Section 231(5) of the Companies Act 1985, the following information relates to those subsidiary undertakings whose results or financial position, in the opinion of the Directors, principally affect the results of the Group. Full particulars of all subsidiary undertakings will be annexed to the Company's next annual return in accordance with Section 231(6)(b) of the Companies Act1985.

Principal subsidiary	Nature of business	% Interest held	Country of incorporation or registration
Alliance & Leicester Personal Finance Limited	Unsecured lending	100%	England & Wales
Alliance & Leicester International Limited*	Offshore deposit taking	100%	Isle of Man
Alliance & Leicester Commercial Finance plc*	Asset Finance	100%	England & Wales

* Held indirectly through subsidiary companies.

All the above companies are included in the Consolidated Financial Statements. 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. The ability of Alliance & Leicester International Limited to pay dividends to the Company is restricted by regulatory capital requirements.

20. Investment in joint ventures

The Group has the following interests in joint ventures none of which is significant to the Company:

Name and nature of business	Country of incorporation	% interest held
Charta Leasing No.1 Limited – Asset leasing	England & Wales	50
Charta Leasing No.2 Limited – Asset leasing	England & Wales	50

21. Intangible assets

a) Goodwill

	Group 2008 £m	Group 2007 £m
Cost		
At 1 January	11	5
Acquisitions	11	6
At 31 December	22	11
Accumulated impairment		
At 1 January	2	2
Impairment losses	20	–
At 31 December	22	2
Net book value	–	9

Impairment of goodwill

A review of the economic value of goodwill was carried out at the balance sheet date. The goodwill of the Group's balance sheet is now considered fully impaired.

Notes to the Financial Statements continued

b) Other intangibles

Group

	Software development cost £m	Intangible assets under development £m	Total £m
Cost			
At 1 January 2008	54	71	125
Additions	14	52	66
Disposals	(22)	(123)	(145)
At 31 December 2008	46	–	46
Accumulated amortisation/impairment			
At 1 January 2008	18	–	18
Charge for the year	16	–	16
Disposals	(5)	–	(5)
At 31 December 2008	29	–	29
Net book value	17	–	17

Group

	Software development cost £m	Intangible assets under development £m	Total £m
Cost			
At 1 January 2007	38	20	58
Additions	16	51	67
Disposals	–	–	–
At 31 December 2007	54	71	125
Accumulated amortisation/impairment			
At 1 January 2007	7	–	7
Charge for the year	11	–	11
Disposals	–	–	–
At 31 December 2007	18	–	18
Net book value	36	71	107

Company

	Software development cost £m	Intangible assets under development £m	Total £m
Cost			
At 1 January 2008	54	71	125
Additions	10	52	62
Disposals	(20)	(123)	(143)
At 31 December 2008	44	–	44
Accumulated amortisation/impairment			
At 1 January 2008	18	–	18
Charge for the year	14	–	14
Disposals	(4)	–	(4)
At 31 December 2008	28	–	28
Net book value	16	–	16

Company

	Software development cost £m	Intangible assets under development £m	Total £m
Cost			
At 1 January 2007	38	20	58
Additions	16	51	67
Disposals	–	–	–
At 31 December 2007	54	71	125
Accumulated amortisation/impairment			
At 1 January 2007	7	–	7
Charge for the year	11	–	11
Disposals	–	–	–
At 31 December 2007	18	–	18
Net book value	36	71	107

Disposals include the costs capitalised in relation to the development of a new banking engine which have been written off following the acquisition of the Company by Banco Santander, S.A. as it intends to implement its global banking system, Partenon.

22. Property, plant and equipment (excluding operating lease assets)

Group

	Owner-occupied properties £m	Office fixtures and equipment £m	Total £m
Cost:			
At 1 January 2008	360	440	800
Additions	4	9	13
Disposals	(1)	(207)	(208)
At 31 December 2008	363	242	605
Accumulated depreciation:			
At 1 January 2008	184	364	548
Depreciation charge for the year	7	25	32
Disposals	(1)	(206)	(207)
Impairment	–	9	9
At 31 December 2008	190	192	382
Net book value	173	50	223

Group

	Owner-occupied properties £m	Office fixtures and equipment £m	Total £m
Cost:			
At 1 January 2007	354	426	780
Additions	12	32	44
Disposals	(6)	(18)	(24)
At 31 December 2007	360	440	800
Accumulated depreciation:			
At 1 January 2007	170	355	525
Depreciation charge for the year	10	26	36
Disposals	(4)	(18)	(22)
Impairment	8	1	9
At 31 December 2007	184	364	548
Net book value	176	76	252

Company

	Owner-occupied properties £m	Office fixtures and equipment £m	Total £m
Cost:			
At 1 January 2008	252	425	677
Additions	5	8	13
Disposals	(1)	(207)	(208)
At 31 December 2008	256	226	482
Accumulated depreciation:			
At 1 January 2008	152	351	503
Depreciation charge	6	24	30
Disposals	(1)	(206)	(207)
Impairment	–	8	8
At 31 December 2008	157	177	334
Net book value	99	49	148

Company

	Owner-occupied properties £m	Office fixtures and equipment £m	Total £m
Cost:			
At 1 January 2007	244	412	656
Additions	11	31	42
Disposals	(3)	(18)	(21)
At 31 December 2007	252	425	677
Accumulated depreciation:			
At 1 January 2007	137	342	479
Depreciation charge	9	26	35
Disposals	(2)	(18)	(20)
Impairment	8	1	9
At 31 December 2007	152	351	503
Net book value	100	74	174

Notes to the Financial Statements continued

At 31 December 2008 capital expenditure contracted, but not provided for was £nil (2007: £2m) in respect of property, plant and equipment. Of the carrying value as at 31 December 2008, £nil (2007: £6m) related to assets under construction.

The cost of office fixtures and equipment held under finance leases was £26m (2007: £26m).

At the balance sheet date, the Group and Company had contracted with lessees for the following future minimum lease payments in leases relating to freehold properties:

	Group		Company	
Leases which expire	**2008 £m**	2007 £m	**2008 £m**	2007 £m
Within 1 year	**–**	–	**–**	–
Between 1-5 years	**3**	4	**2**	3
In more than 5 years	**5**	5	**5**	4
Total	**8**	9	**7**	7

23. Operating lease assets

	Group	
	2008 £m	2007 £m
Cost		
At 1 January	**355**	492
Additions	**152**	84
Disposals	**(32)**	(221)
At 31 December	**475**	355
Depreciation and impairment		
At 1 January	**71**	192
Charge for the year	**66**	74
Disposals	**(10)**	(195)
At 31 December	**127**	71
Net book value	**348**	284

At the balance sheet date, the Group had contracted with lessees for the following minimum lease payments:

	Group	
	2008 £m	2007 £m
Within 1 year	**81**	61
Between 1-5 years	**133**	110
In more than 5 years	**17**	21
Total	**231**	192

The Company has no operating lease assets.

24. Deferred tax

Deferred taxes are calculated on temporary differences under the liability method using the tax rates expected to apply when the liability is settled or the asset is realised.

The movement on the deferred tax account is as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
At 1 January	**(5)**	142	**8**	(11)
Income statement credit – continuing operations	**(326)**	(13)	**(279)**	(1)
(Charged)/credited to equity	**(3)**	22	**(14)**	20
Deferred tax on acquisitions and disposals	**(14)**	(156)	**–**	–
At 31 December	**(348)**	(5)	**(285)**	8

Deferred tax assets and liabilities are attributable to the following items:

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Deferred tax liabilities				
Provision for loan impairment and other provisions	**–**	–	**(1)**	(1)
Accelerated tax depreciation	**(193)**	(210)	**(2)**	(2)
Cash flow hedging	**(64)**	6	**(47)**	12
Other temporary differences	**(21)**	–	**(23)**	(20)
	(278)	(204)	**(73)**	(11)

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Deferred tax assets				
Pensions and other post-retirement benefits	**20**	3	**20**	3
Accelerated book depreciation	**202**	190	**–**	–
Provision for loan impairment and other provisions	**22**	14	**–**	–
Other temporary differences	**14**	2	**–**	–
Tax losses carried forward	**368**	–	**338**	–
	626	209	**358**	3

In 2007, the deferred tax asset of £209m was netted against the deferred tax liability of £204m to show a net asset of £5m for Group and the deferred tax asset of £3m was netted against the deferred tax liability of £11m to show a net liability of £8m for Company.

The deferred tax assets scheduled above have been recognised in both the Company and the Group on the basis that sufficient future taxable profits are forecast within the foreseeable future, in excess of the profits arising from the reversal of existing taxable temporary differences, to allow for the utilisation of the assets as they reverse. Under current UK tax legislation, the tax losses in respect of which deferred tax assets have been recognised do not expire. The benefit of the tax losses carried forward in the Company may only be realised by utilisation against the future taxable profits of the Company. In 2008, deferred tax assets and liabilities are not offset as it is uncertain whether there will be an intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

The deferred tax charge in the income statement comprises the following temporary differences:

	Group 2008 £m	Group 2007 £m
Accelerated tax depreciation	**(16)**	–
Pensions and other post-retirement benefits	**–**	11
Provision for loan impairment and other provisions	**(8)**	5
Tax losses carried forward	**(309)**	–
Other temporary differences	**7**	(29)
	(326)	(13)

At the balance sheet date the aggregate amount of the temporary differences associated with undistributed earnings of subsidiaries for which deferred tax liabilities have not been recognised is £149m (2007: £141m). No liability has been recognised in respect of these differences because the Group is in a position to control the timing of the reversal of the temporary differences and it is probable that such differences will not reverse in the foreseeable future.

25. Other assets

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Trade and other receivables	**171**	215	**1,337**	293
Prepayments	**74**	66	**82**	62
Accrued income	**14**	18	**12**	13
	259	299	**1,431**	368

The increase in Trade and other receivables for Company was due to transactions with securitisation vehicles (see Note 17). These are eliminated on consolidation.

Notes to the Financial Statements continued

26. Deposits by banks

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Items in the course of transmission	**178**	259	**160**	237
Sale and repurchase agreements	**8,816**	13,029	**8,816**	13,029
Amounts due to subsidiaries	**–**	–	**2,090**	2,588
Other deposits	**2,522**	5,224	**2,519**	5,219
	11,516	18,512	**13,585**	21,073

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Repayable:				
On demand	**1,279**	639	**1,907**	1,013
In not more than 3 months	**6,897**	7,521	**8,333**	9,705
In more than 3 months but not more than 1 year	**517**	4,196	**521**	4,196
In more than 1 year but not more than 5 years	**2,823**	6,063	**2,824**	6,063
In more than 5 years	**–**	93	**-**	96
	11,516	18,512	**13,585**	21,073

27. Deposits by customers

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Retail deposits	**24,978**	23,312	**23,050**	20,868
Amounts due to subsidiaries	**–**	–	**3,385**	1,597
Amounts due to fellow subsidiary	**8,741**	–	**8,741**	–
Wholesale deposits by customers	**6,046**	6,664	**6,046**	6,686
	39,765	29,976	**41,222**	29,151
Repayable:				
On demand	**28,435**	24,600	**30,556**	24,890
In no more than 3 months	**8,025**	3,513	**7,592**	2,912
In more than 3 months but no more than 1 year	**3,119**	1,465	**2,902**	967
In more than 1 year but not more than 5 years	**95**	248	**81**	232
In more than 5 years	**91**	150	**91**	150
	39,765	29,976	**41,222**	29,151

28. Financial liabilities designated at fair value

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Due to other banks	**153**	876	**153**	876
Due to customers	**252**	782	**252**	782
Debt securities in issue	**323**	2,369	**323**	2,369
	728	4,027	**728**	4,027

Financial liabilities are designated at fair value through profit or loss where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring assets and liabilities or recognising the gains or losses on them on a different basis. The 'fair value option' has been used where debt securities in issue would otherwise be measured at amortised cost, and the associated derivatives used to economically hedge the risk are held at fair value. No material amount of the movements in the fair value of the above debt securities in issue reflects any element of the Group's own credit risk. The amount that would be required to be contractually paid at maturity of the debt securities in issue above is £14m (2007: £4m) higher than the carrying value.

29. Debt securities in issue

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Bonds and medium-term notes	**16,814**	17,887	**11,421**	13,025
Other debt securities in issue	**663**	3,992	**663**	3,584
	17,477	21,879	**12,084**	16,609

A breakdown, by issue currency, of the above is as follows:

	Interest Rate	Maturity	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Euro	0.00% – 1.99%	Up to 2010	260	474	260	474
	2.00% – 3.99%	Up to 2010	1,637	10	1,637	10
		2011 – 2019	1,939	365	1,939	365
	4.00% – 4.99%	Up to 2010	443	1,899	443	1,899
		2011 – 2019	193	992	193	992
		2030 – 2039	–	382	–	–
		2040 – 2049	–	–	–	–
		2050 – 2059	–	1,299	–	–
	5.00% – 7.99%	Up to 2010	406	663	406	663
		2011 – 2029	148	367	148	367
		2030 – 2039	139	–	–	–
		2040 – 2059	2,105	48	–	–
US Dollar	0.00% – 1.99%	Up to 2010	–	618	–	618
		2011 – 2039	95	–	–	–
	2.00% – 3.99%	Up to 2010	753	–	753	–
	4.00% – 6.87%	Up to 2010	390	2,861	390	2,861
		2011 – 2019	743	542	743	542
		2030 – 2040	–	454	–	–
		2041 – 2059	1,650	1,241	–	–
Pounds Sterling	0.00% – 1.99%	Up to 2010	–	142	–	142
	2.00% – 4.99%	Up to 2010	3,048	600	3,047	600
		2011 – 2019	427	205	427	205
	5.00% – 5.99%	Up to 2010	57	178	57	178
		2011 – 2019	18	1	18	1
		2041 – 2059	–	1,431	–	–
	6.00% – 6.87%	Up to 2010	636	4,354	636	3,954
		2011 – 2019	95	316	95	316
		2041 – 2060	1,388	1,194	–	1,194
Other currencies	0.00% – 5.99%	Up to 2010	852	971	852	971
		2011 – 2019	40	32	40	32
	6.87% – 7.99%	Up to 2010	–	225	–	225
	7.00% – 8.99%	2011 – 2040	15	15	–	–
			17,477	21,879	12,084	16,609

30. Subordinated liabilities

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Dated subordinated liabilities:				
9.75% Subordinated notes 2008	–	81	–	81
5.875% Subordinated notes 2031	191	162	191	162
5.25% Subordinated notes 2023	171	154	171	154
Subordinated floating rate EURIBOR notes 2013	–	55	–	55
Subordinated floating rate EURIBOR notes 2017	145	110	145	110
Subordinated floating rate USD LIBOR notes 2015	102	75	102	75
Subordinated floating rate EURIBOR notes 2017	97	74	97	74
9.625% Subordinated notes 2023	399	–	399	–
Total dated subordinated liabilities	1,105	711	1,105	711

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Undated subordinated liabilities:				
Subordinated floating rate USD LIBOR notes (USD 100m)	69	–	69	–
Subordinated floating rate USD LIBOR notes (USD 220m)	151	–	151	–
Subordinated floating rate EURIBOR notes (EUR 115m)	111	–	111	–
Total undated subordinated liabilities	331	–	331	–
Total subordinated liabilities	1,436	711	1,436	711

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

In 2008, the subordinated notes due 2008 and 2013 were redeemed in full.

The undated USD 100m floating rate notes are redeemable at par, at the option of the Company, on 1 November 2013 and each interest payment date thereafter.

The undated USD 220m floating rate notes are redeemable at par, at the option of the Company, on 17 December 2013 and each interest payment date thereafter.

The undated EUR 115m floating rate notes are redeemable at par, at the option of the Company, on 17 December 2013 and each interest payment date thereafter.

The subordinated liabilities are redeemable in whole at the option of the Company, on any interest payment date, in the event of certain tax changes affecting the treatment of payments of interest on the subordinated liabilities in the UK, at their principal amount together with any accrued interest.

Subordinated liabilities in issue are repayable:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
In more than 3 months but no more than 1 year	**–**	81	**–**	81
In more than 5 years	**1,105**	630	**1,105**	630
Undated	**331**	–	**331**	–
	1,436	711	**1,436**	711

31. Other liabilities

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Trade and other payables	**600**	660	**4,545**	4,969
Deferred income	**31**	42	**104**	112
	631	702	**4,649**	5,081

Trade and other payables include £40m of finance lease obligations mainly relating to a lease and leaseback of Group property. The maturity of net obligations under finance leases are as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Within 1 year	**4**	4	**–**	2
Between 1-5 years	**21**	21	**1**	1
In more than 5 years	**15**	19	**–**	–
	40	44	**1**	3

Future minimum lease payments are:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Within 1 year	**6**	5	**–**	2
Between 1-5 years	**27**	19	**1**	1
In more than 5 years	**17**	22	**–**	–
	50	46	**1**	3

At the balance sheet date, the Group and the Company had contracted with lessees for the following future minimum lease payments on sub-leases:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Leases which expire				
Within 1 year	**1**	1	**–**	–
Between 1-5 years	**2**	2	**–**	–
In more than 5 years	**–**	1	**–**	–
	3	4	**–**	–

During the year, £3m (2007: £3m) was incurred as a finance lease interest charge.

32. Provisions

	Group Misselling £m
At 1 January 2008	**–**
Additional provisions	**38**
Provisions utilised	**(4)**
At 31 December 2008	**34**

	Misselling £m
To be settled:	
Within 12 months	**34**

The charge disclosed in the income statement in respect of provisions for other liabilities and charges of £38m (2007: nil), comprises the additional provisions of £38m (2007: £nil). There were no provisions in Company.

The misselling provision comprises various claims with respect to product misselling. In calculating the misselling provision, management's best estimate of the provision was calculated based on conclusions regarding the number of claims that

will be received, of those, the number that will be upheld, and the estimated average settlement per case. Further information on misselling provisions can be found in 'Critical Accounting Policies' within the Accounting Policies on page 63.

The provision in 2007 was nil for Group and Company.

33. Retirement benefit obligations

The amounts recognised in the balance sheet were as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Assets				
Funded defined benefit pension scheme	**4**	53	**4**	53
Liabilities				
Unfunded benefit obligation	**(11)**	(11)	**(11)**	(11)
Post-retirement medical benefits	**(10)**	(17)	**(10)**	(17)
Total liabilities	**(21)**	(28)	**(21)**	(28)

A one percentage point movement in medical cost trends would increase or decrease the post-retirement medical benefit liability by £1m (2007: £1m).

Defined Contribution Pension schemes

An expense of £10m (2007: £9m) was recognised for defined contribution plans in the year, and is included in staff costs classified within administration expenses in the income statement. None of this amount was recognised in respect of key management personnel for the years ended 31 December 2008 and 2007 (see Note 42).

Defined Benefit Pension schemes

The Group operates one defined benefit pension scheme, the Alliance & Leicester Pension Scheme, covering 31% (2007: 33%) of the Group's employees. The defined benefit section of this scheme closed to new entrants on 31 March 1998 and has a defined contribution section for employees who joined the Company after this date. As the defined benefit section of the scheme is closed to new entrants, under the projected unit method, the current service cost when expressed as a percentage of pensionable salaries, will gradually increase over time.

Formal actuarial valuations of the assets and liabilities of the schemes are carried out on a biennial basis by an independent professionally qualified actuary and updated for accounting purposes at each balance sheet date. The latest formal actuarial valuation was made as at 31 March 2008 and updated to 31 December 2008 by a qualified independent actuary.

The total amount charged to the income statement was determined as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Current service cost	**19**	20	**19**	20
Expected return on pension scheme assets	**(84)**	(81)	**(84)**	(81)
Interest cost	**75**	70	**75**	70
	10	9	**10**	9

The net (liability)/asset recognised in the balance sheet was determined as follows:

	Group				
	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Present value of funded defined benefit obligation	**(1,209)**	(1,324)	(1,327)	(1,305)	(1,119)
Fair value of plan assets	**1,213**	1,377	1,311	1,230	1,060
	4	53	(16)	(75)	(59)
Unfunded benefit obligation	**(11)**	(11)	(10)	(9)	(8)
	(7)	42	(26)	(84)	(67)

Notes to the Financial Statements continued

Movements in the defined benefit obligations during the year were as follows:

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Balance at 1 January	**(1,335)**	(1,337)	**(1,335)**	(1,337)
Current service cost	**(19)**	(20)	**(19)**	(20)
Interest cost	**(75)**	(70)	**(75)**	(70)
Employee contributions	**(2)**	(2)	**(2)**	(2)
Past service cost	**–**	–	**–**	–
Actuarial gain	**170**	57	**170**	57
Actual benefit payments	**41**	37	**41**	37
Balance at 31 December	**(1,220)**	(1,335)	**(1,220)**	(1,335)

Movements in the present value of fair value of scheme assets during the year were as follows:

	Group 2008 £m	Group 2007 £m	Company 2008 £m	Company 2007 £m
Balance at 1 January	**1,377**	1,311	**1,377**	1,311
Expected return on scheme assets	**84**	81	**84**	81
Actuarial (loss) on scheme assets	**(230)**	(3)	**(230)**	(3)
Company contributions paid (regular)	**17**	19	**17**	19
Company contributions paid (special)	**3**	3	**3**	3
Employee contributions	**2**	2	**2**	2
Actual benefit payments	**(40)**	(36)	**(40)**	(36)
Balance at 31 December	**1,213**	1,377	**1,213**	1,377

The rate used to discount the retirement benefit obligation is determined to reflect duration of the liabilities based on the annual yield as at 31 December of the Sterling 15+ year AA Corporate Bond iBoxx Index, representing the market yield of high quality corporate bonds on that date.

The amounts recognised in the statement of recognised income and expense for each of the five years indicated was as follows:

	Group and Company 2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Actuarial (gain)/loss on scheme liabilities	**(170)**	(57)	(34)	130	36
Actuarial loss/(gain) on scheme assets	**230**	3	(13)	(108)	(30)
	60	(54)	(47)	22	6

There was an actuarial gain during the year of £nil (2007: £2m) on the Group's post-retirement medical benefits liability.

The actual return on scheme assets was a loss of £146m (2007: £78m gain). Cumulative net actuarial gains of £13m (2007: £73m) have been recognised in the Consolidated Statement of Recognised Income and Expenses.

The Group's pension schemes did not directly hold any equity securities of the Company or any of its related parties at 31 December 2008. In addition, the Group does not hold insurance policies over the schemes, and has not entered into any significant transactions with the schemes.

The principal actuarial assumptions used for the Group and the Company were as follows:

	2008 Nominal per annum %	2007 Nominal per annum %
To determine benefit obligations:		
– Discount rate for scheme liabilities (pensioners)	**6.4**	5.9
– Discount rate for scheme liabilities (non-pensioners)	**6.4**	5.6
– General salary increase	**3.5**	3.8
– General price inflation	**3.0**	3.3
– Expected rate of pension increase	**3.0**	3.3
To determine net periodic benefit cost:		
– Discount rate (pensioners)	**5.9**	5.2
– Discount rate (non-pensioners)	**5.6**	5.2
– Expected rate of pension increase	**3.0**	3.3
Expected rate of return on plan assets:		
– Equities	**7.8**	7.8
– Bonds	**5.0**	5.0
– Properties	**6.4**	6.2

The mortality assumption used in preparation of the valuation as at 31 December 2008 was the PA 92 series base tables (as published by the Institute and Faculty of Actuaries) with allowance for future improvements in life expectancy in line with the medium cohort projections, subject to minimum rates of improvement of 1.0% per annum for males and 0.5% per annum for females.

Notes to the Financial Statements continued

The Group determined its expense measurements above based upon long-term assumptions taking into account target asset allocations of assets set at the beginning of the year, offset by actual returns during the year. Year-end obligation measurements are determined by reference to market conditions at the balance sheet date. Assumptions are set in consultation with third party advisors and in-house expertise.

The trustees of the schemes are required under the Pensions Act 2004 to prepare a statement of investment principles. The principal duty of the trustees is to act in the best interests of the members of the schemes and they have developed the following investment objectives for their defined benefit sections:

> To maintain a portfolio of suitable assets of appropriate quality, suitability and liquidity which will generate income and capital growth to meet, together with new contributions from members and the employers, the cost of current and future benefits which the pension fund provides, as set out in the trust deed and rules;

> To limit the risk of the assets failing to meet the liabilities, over the long-term and on a shorter-term basis as required by prevailing legislation;

> To minimise the long term costs of the pension fund by maximising the return on the assets while having regard to the objectives shown above.

The statement of investment principles has set the long-term target allocation of plan assets at 25% Equities, 25% alternative return-seeking assets (including Property), 25% Bonds and 25% Gilts. Approximately 20% of the Scheme's liabilities have been hedged by interest rate swaps and other liability-matching assets.

The expected rates of return by asset class used to calculate the expected return for 2008 are Equities 7.8% (2007: 7.75%), Bonds/Gilts 5.0% (2007: 4.95%) and Property 6.4% (2007: 6.2%). The overall long term rate of return on the assets employed has been determined after considering projected movements in asset indices.

The categories of assets in the scheme as a percentage of total scheme assets for Group and Company are as follows:

	2008 %	2007 %
UK equities	**23**	27
Overseas equities	**18**	20
Corporate bonds	**19**	18
Government Fixed Interest	**21**	19
Government Index Linked	**10**	10
Property	**6**	3
Others	**3**	3
	100	100

The Group currently expects to contribute £17m to its defined benefit pension schemes in 2009. The benefits expected to be paid in each of the next five years, and in the aggregate for the five years thereafter are:

Year ending 31 December:	£m
2009	42
2010	41
2011	46
2012	50
2013	54
Five years ended 2018	333

34. Contingent liabilities and commitments

The estimated maximum exposure in respect of contingent liabilities and commitments granted is:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Guarantees given to subsidiaries	**–**	–	**–**	–
Guarantees given to third parties	**202**	244	**200**	240
Formal standby facilities, credit lines and other commitments with original term to maturity of:				
– 1 year or less	**380**	353	**323**	346
– More than 1 year	**1,595**	1,504	**725**	777
	2,177	2,101	**1,248**	1,363

Notes to the Financial Statements continued

Unauthorised overdraft fees

The Group, in line with other UK banks and building societies, levies charges on current account customers, for example when a customer goes overdrawn (if they did not have an arranged overdraft facility) when a customer exceeds their agreed overdraft limit, or when the bank refuses to pay an item if the customer does not have sufficient funds in their account. UK banks and building societies believe these fees customers pay are fair and clearly set out in account terms and conditions.

In common with other banks in the United Kingdom, Alliance & Leicester plc has received claims and complaints from a large number of customers relating to the legal status and enforceability of current and historic contractual terms in personal current account agreements relating to unarranged overdraft and unpaid item charges ('Relevant Charges') and seeking repayment of Relevant Charges that had been applied to their accounts in the past. The claims and complaints are based primarily on the common law penalty doctrine and the Unfair Terms in Consumer Contract Regulations 1999 (the 'Regulations'). Because of the High Court test case referred to below, most existing and new claims in the County Courts are currently stayed and there is also a UK Financial Services Authority ('FSA') waiver of the complaints handling process and a standstill of Financial Ombudsman Service decisions.

On 27 July 2007, following discussions between the Office of Fair Trading ('OFT'), the Financial Ombudsman Service, the FSA and major UK banks, the OFT issued proceedings in a test case against the banks which was intended to determine certain preliminary issues concerning the legal status and enforceability of contractual terms relating to Relevant Charges.

The preliminary trial concluded on 8 February 2008 and the judgement was handed down on 24 April 2008. The High Court held that the contractual terms relating to unarranged overdraft charges currently used by the Group (i) are not unenforceable as penalties, but (ii) are not exempt from assessment for fairness under the Regulations. At a subsequent court hearing on 22 and 23 May 2008, the judge granted test case banks permission to appeal his decision that unarranged overdraft charges are assessable for fairness under the Regulations. Alliance & Leicester plc is not a test case bank but will abide by the outcome of the appeal. The appeal hearing concluded in November 2008 and on 26 February 2009 the Court of Appeal upheld the judge's decision and rejected the appeal. The test case banks are now likely to take the appeal to the House of Lords. In October 2008 the High Court also delivered its judgement to the effect that terms and conditions previously used by the test case banks are not capable of being penalties but are assessable for fairness under the Regulations. Depending on the outcome of an appeal to the House of Lords, further hearings may be required in order for the Court to determine the fairness of the charges.

The issues relating to the legal status and enforceability of the Relevant Charges are complex. The Company maintains that its Relevant Charges are fair and enforceable and believes that it has a number of substantive and credible defences. The Group cannot, however, at this stage predict with any certainty if, or for how long, the stays, waiver and standstill referred to above will remain in place. Nor can it at this stage predict with any certainty the timing or substance of the final outcome of the customer claims and complaints, any appeals and any further stages of the test case. It is unable reliably to estimate the liability, if any, which may arise as a result of or in connection with these matters or its effect on the Group's consolidated net assets, operating results or cash flows in any particular period.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS), the UK's statutory fund of last resort for customers of authorised financial services firms, pays compensation if a firm is unable to meet its obligations as they fall due. As a result of the failure of a number of deposit-taking institutions during the second half of 2008, the FSCS now stands as a creditor of Bradford & Bingley plc and the administrations of Heritable Bank, Kaupthing Singer & Friedlander and Landsbanki "Icesave". The FSCS has borrowed from HM Treasury to fund the compensation costs associated with those failures. These borrowings are currently on an interest-only basis until September 2011.

The FSCS fulfils its obligations by raising management expenses levies and compensation levies on the industry. In relation to compensation relating to protected deposits, each deposit-taking institution contributes towards these levies in proportion to their share of total protected deposits, subject to a threshold set by the Financial Services Authority establishing the maximum that the FSCS can levy for compensation in any one year. The limit on the FSCS management expenses for the three years from September 2008 in relation to the above-mentioned failures has been capped at £1bn per annum. The FSCS has the power to raise levies on firms who have ceased to participate in the scheme and are in the process of ceasing to be authorised (so called 'exit levies') for the amount that the firm would otherwise have been asked to pay during the relevant levy year. The Group has accrued for its share of management expenses levies for the 2008/9 and 2009/10 levy years in the amount of £21m.

The FSCS will receive funds from asset sales, surplus cash flow, or other recoveries from each of the above-named banks. These recoveries will be used to reduce the principal amount outstanding on the FSCS's borrowings. Only after the interest-only period which is expected to end in September 2011 will a schedule for repayment of any remaining principal outstanding (after recoveries) on the borrowings be agreed between the FSCS and HM Treasury. It is expected that, from that point, the FSCS will begin to raise compensation levies (principal repayments) relating to the above-named banks. As a consequence, the amount of the principal which the FSCS will levy to deposit-taking institutions is not yet known and is unlikely to be determined until 2011. No provision for compensation levies, which could be significant, has been made in these Consolidated Financial Statements.

Notes to the Financial Statements continued

Regulatory

The Group engages in discussion, and fully co-operates with the UK Financial Services Authority in their enquiries, including those exercised under statutory powers, regarding its interaction with past and present customers and policyholders both as part of the UK Financial Services Authority's general thematic work and in relation to specific products and services.

Obligations under stock borrowing and lending agreements

Obligations under stock borrowing and lending agreements represent contractual commitments to return stock borrowed. These obligations totalling £2,795m at 31 December 2008 (2007: £2,049m) are offset by a contractual right to receive stock under other contractual agreements.

Other off-balance sheet commitments

The Group has commitments to lend at fixed interest rates which expose it to interest rate risk.

Operating lease commitments

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Rental commitments under operating leases expiring:				
– No later than 1 year	1	1	1	7
– Later than 1 year but no later than 5 years	7	10	7	37
– Later than 5 years	64	69	124	102
	72	80	132	146

At 31 December 2008, the Group held various leases on land and buildings, many for extended periods, and other leases for equipment, which require the following aggregate minimum lease payments:

Leases expiring year ended 31 December:	Group £m	Company £m
2009	1	1
2010	1	1
2011	1	1
2012	3	3
2013	2	2
Total thereafter	64	124

Group rental expense comprises:

	Group 2008 £m	Group 2007 £m
In respect of minimum rentals	12	12
Less: sub–lease rentals	(1)	(1)
	11	11

35. Innovative tier 1

On 22 March 2004, the Company issued £300m of innovative tier 1 capital securities. At the end of 2008, the balance sheet value of £311m included the accrued coupon. The tier 1 securities are perpetual securities and pay a coupon on 22 March each year, with the first coupon paid on 22 March 2005. At each payment date, the Company can decide whether to declare or defer the coupon indefinitely. If a coupon is deferred then the Company may not pay a dividend on any share until it next makes a coupon payment. The Company can be obliged to make payment in the event of winding up.

The coupon is 5.827% per annum until 22 March 2016. Thereafter the coupon steps up to a rate, reset every five years, of 2.13% per annum above the gross redemption yield on a UK Government Treasury Security. The tier 1 securities are redeemable at the option of the Company on 22 March 2016 or on each payment date thereafter. No such redemption may be made without the consent of the Financial Services Authority. In both 2008 and 2007 the coupon of £17.5m was paid.

Notes to the Financial Statements continued

36. Share capital and preference shares

	Ordinary shares of 50 pence each £m
Share capital	
Authorised share capital	
At 1 January 2008	**388**
Increase	**–**
At 31 December 2008	**388**
At 1 January and 31 December 2007	388
Issued and fully paid share capital	
At 1 January 2008	**210**
Shares issued	**118**
At 31 December 2008	**328**
At 1 January 2007	219
At 31 December 2007	210

The Company has one class of ordinary shares which carry no right to fixed income. The ordinary shares in issue at 31 December 2008 reflect the investment made by Abbey National plc on 17 December 2008 and subscription for 234,113,712 shares.

	Ordinary shares of 50 pence each £m
Share premium account	
At 1 January 2008	**125**
Shares issued	**599**
At 31 December 2008	**724**
At 1 January 2007	106
At 31 December 2007	125

Preference shares

On 24 May 2006, the Company issued £300m fixed/floating rate non-cumulative callable preference shares, resulting in net proceeds of £294m. The preference shares entitle the holders to a fixed non-cumulative dividend, at the discretion of the Board, of 6.22% per annum payable annually from 24 May 2007 until 24 May 2019 and quarterly thereafter at a rate of 1.13% per annum above three month sterling LIBOR. The preference shares are redeemable only at the option of the Company on 24 May 2019 or on each quarterly dividend payment date thereafter. No such redemption may be made without the consent of the Financial Services Authority.

37. Retained earnings and other reserves

Movements in retained earnings were as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
At 1 January	**1,421**	1,558	**788**	1,046
(Loss)/profit for the year	**(954)**	256	**(311)**	135
Post-tax actuarial movement on retirement benefit obligations	**(45)**	42	**(45)**	42
Transfer from share based payment reserve	**17**	–	**17**	–
Repurchase of share capital	**–**	(194)	**–**	(194)
Equity dividends paid	**(229)**	(241)	**(229)**	(241)
At 31 December	**210**	1,421	**220**	788

Movements in minority interest were as follows:

	Group	
	2008 £m	2007 £m
At 1 January	**4**	–
Share of profit	**–**	4
Disposal	**(4)**	–
At 31 December	**–**	4

Notes to the Financial Statements continued

Analysis of dividends paid is as follows:

	Group & Company
	Pence per Share
Ordinary shares (equity):	
2007 interim	18.8
2007 final	36.5
2008 interim	18.0

Movements in capital redemption reserve were as follows:

	Group & Company	
	2008 £m	2007 £m
At 1 January	**90**	80
Repurchase of share capital	**–**	10
At 31 December	**90**	90

Movements in share based payment reserve were as follows:

	Group & Company	
	2008 £m	2007 £m
At 1 January	**26**	21
Share option costs charged to profit	**8**	8
Equity and reserves transfer	**(32)**	(3)
Deferred tax	**(2)**	(5)
Current tax	**–**	5
At 31 December	**–**	26

Movements in available-for-sale reserve were as follows:

	Group & Company	
	2008 £m	2007 £m
At 1 January	**(143)**	4
Net losses from changes in fair value	**(241)**	(220)
Net losses/(gains) transferred to profit on disposal	**14**	(1)
Impairment loss transferred to Income Statement	**18**	11
Deferred tax	**59**	63
At 31 December	**(293)**	(143)

The available-for-sale reserve is being amortised on a straight-line basis over the period to maturity, which is considered to be immaterially different to using an Effective Interest Rate basis. The estimated cash flows on the assets are the carrying value plus the available-for-sale reserve. These assets are not impaired as at 31 December 2008.

Movements in cash flow hedging reserve were as follows:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
At 1 January	**(14)**	(20)	**(11)**	(11)
Gains from changes in fair value	**259**	15	**235**	11
Transferred to net profit – hedge ineffectiveness	**(11)**	(7)	**(24)**	(11)
Deferred tax	**(70)**	(2)	**(59)**	–
At 31 December	**164**	(14)	**141**	(11)

The cash flow hedging reserve arises on cash flow hedges of interest rate risk on a portfolio of variable rate assets. The hedged interest rate cash flows on the underlying portfolio are expected to occur on a reducing basis over a period of approximately five years from the balance sheet date.

Notes to the Financial Statements continued

38. Cash flow statement

a) Reconciliation of (loss)/profit after tax to net cash inflow from operating activities:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
(Loss)/profit for the year	**(918)**	296	**(275)**	171
Non-cash items included in net profit				
Increase in prepayments and accrued income	**(4)**	(27)	**(7)**	(30)
Decrease in accruals and deferred income	**(36)**	(1)	**(29)**	(7)
Depreciation and amortisation	**114**	118	**44**	44
Provisions for liabilities and charges	**15**	(16)	**(19)**	(16)
Provision for impairment	**1,033**	253	**783**	199
Other non-cash items	**(221)**	103	**(153)**	84
	(17)	726	**344**	445
Changes in operating assets and liabilities				
Net decrease/(increase) in trading assets	**1,439**	(286)	**1,439**	(286)
Net increase in derivative assets	**(1,905)**	(279)	**(1,286)**	(187)
Net decrease/(increase) in financial assets designated at fair value	**828**	482	**(27)**	483
Net decrease/(increase) in loans and advances to banks and customers	**5,114**	(6,845)	**4,750**	(7,322)
Net increase in other assets	**(5,887)**	(568)	**(6,813)**	(600)
Net increase in deposits by banks and deposits by customers	**2,794**	13,468	**4,583**	14,214
Net increase in derivative liabilities	**990**	123	**1,013**	145
Net decrease in financial liabilities designated at fair value	**(3,299)**	(4,873)	**(3,299)**	(4,873)
Net increase in debt issued	**3,603**	580	**2,582**	465
Net (decrease)/increase in other liabilities	**(29)**	(179)	**(391)**	1,896
Net cash flow from operating activities before tax	**3,631**	2,349	**2,895**	4,380
Income tax received/(paid)	**21**	(54)	**32**	(64)
Net cash flow from operating activities	**3,652**	2,295	**2,927**	4,316

b) Analysis of the balances of cash and cash equivalents in the balance sheet:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Cash and balances with central banks	**1,553**	3,471	**1,553**	3,471
Loans and advances to banks	**816**	385	**814**	364
Cash and cash equivalents	**2,369**	3,856	**2,367**	3,835

39. Collateral pledged and received

The Company pledges assets as collateral in the following areas of the business.

The Company enters into securitisation transactions whereby portfolios of residential mortgage loans are purchased by or assigned to special purpose securitisation companies, and have been funded through the issue of mortgage-backed securities. Holders of the securities are only entitled to obtain payments of principal and interest to the extent that the resources of the securitisation companies are sufficient to support such payments and the holders of the securities have agreed in writing not to seek recourse in any other form. At 31 December 2008, £22,582m (2007: £18,464m) of residential mortgage loans were so assigned.

In 2008, the Company also established a covered bond programme, whereby securities are secured by a pool of ring-fenced residential mortgages. At 31 December 2008, £3,222m of residential mortgage loans had been so secured.

Collateral is also provided in the normal course of derivative business to counterparties. As at 31 December 2008 £196m (2007: £164m) of such collateral in the form of cash had been pledged.

The Company enters into sale and repurchase agreements and similar transactions, which are accounted for as secured borrowings. Upon entering into such transactions, the subsidiaries pledge collateral equal to 100%-131% of the borrowed amount. The fair value of assets that were so pledged at 31 December 2008 was £21,133m (2007: £17,683m).

The Company also enters into purchase and resale agreements and similar transactions whereby the Company receives collateral. The Company is permitted to sell or re-pledge the collateral held. At 31 December 2008, the fair value of such collateral was £2,795m (2007: £2,049m) of which £2,763m (2007: £1,936m) was sold or re-pledged.

40. Share-based compensation

During the year ended 31 December 2008, the Group had seven share-based payment arrangements, including Share Incentive Plan (SIP) partnership shares. Following acquisition by Banco Santander, S.A., the Executive Directors of the Company participate in schemes as disclosed in the Annual Report & Accounts of Abbey National plc.

Options held under the ShareSave plan, share option plan and senior manager deferred bonus scheme became exercisable on 7 October 2008 and will lapse, if unexercised, on 7 April 2009. Shares acquired upon exercise of the option in that period will automatically be exchanged for Banco Santander shares in the same three for one ratio as was applicable to all shareholders upon acquisition by Banco Santander S.A. Outstanding executive deferred bonus scheme options were all exercised on 7 October 2008 and Long-Term Incentive Plan (LTIP) shares all lapsed on 7 October 2008. Restricted share plan shares vested and were converted to Banco Santander, S.A. shares on acquisition in the same three for one ratio, in accordance with the scheme rules.

The following table summarises the movement in the number of options over Alliance & Leicester shares between those outstanding at the beginning and end of the year, together with the changes in weighted average exercise price over the same period:

	ShareSave No. of shares	Share option plan No. of shares	Executive deferred bonus No. of shares	Restricted share plan No. of shares	Long term incentive plan (LTIP) No. of shares	Senior manager deferred bonus[1] No. of shares
2008						
Outstanding at 1 January	**3,388,840**	**3,830,524**	**58,721**	**306,932**	**1,083,669**	**243,597**
Granted[4]	**–**	**376,255**	**–**	**627,598**	**676,876**	**291,901**
Lapsed	**(2,768,842)**	**(1,974,353)**	**(32,514)**	**(627,361)**	**(1,736,241)**	**(137,725)**
Exercised	**(55,323)**	**–**	**(26,207)**	**(307,169)**	**(24,304)**	**(333,047)**
Outstanding at 31 December 2008	**564,675**	**2,232,426**	**–**	**–**	**–**	**64,726**
Exercisable at 31 December 2008[3]	**564,675**	**2,232,426**	**–**	**–**	**–**	**64,726**
Weighted average exercise price in 2008	**630.2p**	**n/a**	**525.5p**	**274.2p**	**525.5p**	**285.5p**
Range of exercise prices for options	**632p – 815p**	**544p – 1,093p**	**n/a**	**n/a**	**n/a**	**n/a**
Weighted average remaining contractual	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Weighted average fair value options	**n/a**	**84p**	**n/a**	**390p**	**428p**	**1,553p[2]**

	ShareSave No. of shares	Share option plan No. of shares	Executive deferred bonus No. of shares	Restricted share plan No. of shares	Long term incentive plan (LTIP) No. of shares	Senior manager deferred bonus No. of shares
2007						
Outstanding at 1 January	3,513,908	5,172,169	93,372	126,942	649,945	233,181
Granted	1,080,293	484,051	–	206,481	477,000	96,516
Lapsed	(469,530)	(326,697)	–	(25,542)	(39,175)	(28,862)
Exercised	(735,831)	(1,498,999)	(34,651)	(949)	(4,101)	(57,238)
Outstanding at 31 December 2007	3,388,840	3,830,524	58,721	306,932	1,083,669	243,597
Exercisable at 31 December 2007	407,188	1,113,918	16,423	–	–	10,017
Weighted average exercise price in 2007	805.9p	1,118.8p	1,093.0p	1,100.0p	1,137.0p	1,128.9p
Range of exercise prices for options	364p – 815p	510p – 1,093p	n/a	n/a	n/a	n/a
Weighted average remaining contractual	2.2 years	0.7 years	0.2 years	2.0 years	1.4 years	1.4 years
Weighted average fair value options	195p	181p	n/a	917p	879p	2,593p[2]

1. The figures in the table relate to the level of bonus deferred, i.e. excluding the matching element.
2. The option value includes the deferred share and the fair value of the matched element less the cash bonus foregone.
3. Upon exercise, Alliance & Leicester shares would automatically be converted to Banco Santander S. A. shares in the ratio three to one.
4. No shares have been granted under any of the schemes since acquisition by Santander on 7 October 2008.

The Share Incentive Plan ("SIP") is available to all employees. Prior to the Company's acquisition by Banco Santander, S.A., participants could elect to invest up to £125 per month from pre-tax salary to purchase shares at the prevailing market price. Shares can be released from Trust after five years free of income tax and national insurance contributions.

On the acquisition of the Company by Banco Santander, S.A., Alliance & Leicester shares held in the SIP were converted to Banco Santander shares on the same three for one basis as was applicable to all other shareholders upon acquisition by Banco Santander S.A. These will remain in the SIP Trust under the terms of the SIP rules. 195,454 SIP partnership shares (2007: 126,924) were issued during the year prior to acquisition, at the prevailing market rate of Alliance & Leicester shares, at a weighted average price of 428p (2007: 977p) per share. No Banco Santander SIP shares have been issued since acquisition.

For these schemes, the estimated fair value is calculated as the value of the share price option plus the present value of any deferred dividends. The assumptions used in the model are as follows:

Input	Assumption
Share price	Price at date of grant
Exercise price	Per scheme rules
Expected volatility	Estimated by calculating the annualised, exponential weighted monthly volatility of Alliance & Leicester share price over preceding two years
Option life	Per scheme rules
Risk free rate	Generated from LIBOR swap curve

41. Directors' emoluments and interests

There were no loans, quasi loans and credit transactions entered into or agreed by the Company or its subsidiaries with persons who are or were Directors, Other Key Management Personnel and each of their connected persons during the year except as described below:

Other Key Management Personnel Loans*	Number of persons	Aggregate amount outstanding £000
2008	2	217
2007	2	207

* Other Key Management Personnel are defined as the Executive Committee of Alliance & Leicester and the Board and Executive Committee of Alliance & Leicester's parent company, Abbey National plc. who served during the year.

Secured and unsecured loans are made to Directors, Other Key Management Personnel and their connected persons, in the ordinary course of business, with terms prevailing for comparable transactions and on the same terms and conditions as applicable to other employees or customers within the Group. Such loans do not involve more than the normal risk of collectability or present any unfavourable features.

42. Related party disclosures

Transactions with Directors, Other Key Management Personnel and each of their connected persons

Directors, Other Key Management Personnel and their connected persons have undertaken the following transactions with the Group in the course of normal banking.

2008	Number of Directors and Other Key Management Personnel[1]	Amounts in respect of Directors, Other Key Management Personnel[1] and their connected persons £000
Secured loans, unsecured loans and overdrafts		
Loans outstanding at 1 January	4	541
Net movements in the year	2	(324)
Loans outstanding at 31 December	2	217
Deposit, bank and instant access accounts and investments		
Deposits, bank instant access accounts and investments at 1 January[2]	10	850
Net movements in the year	(6)	(580)
Deposit, bank and instant access accounts and investments at 31 December	4	270
Life assurance policies		
Life assurance policies at 1 January and 31 December	-	-

2007	Number of Directors and Other Key Management Personnel[2]	Amounts in respect of Directors, Other Key Management Personnel[1] and their connected persons £000
Secured loans, unsecured loans and overdrafts		
Loans outstanding at 1 January	2	754
Net movements in the year	-	(420)
Loans outstanding at 31 December	2	334
Deposit, bank and instant access accounts and investments		
Deposits, bank instant access accounts and investments at 1 January	11	2,206
Net movements in the year	(1)	(1,356)
Deposit, bank and instant access accounts and investments at 31 December	10	850
Life assurance policies		
Life assurance policies at 1 January and 31 December	-	-

(1) In 2008, other Key Management Personnel are defined as the Executive Committee of the Company and the Board and Executive Committee of Alliance & Leicester's parent company, Abbey National plc who served during the year.
(2) In 2007, only the Board of Directors of the Company were Key Management Personnel.

Secured and unsecured loans are made to Directors, Other Key Management Personnel and their connected persons, in the ordinary course of business, with terms prevailing for comparable transactions and on the same terms and conditions as applicable to other employees and customers within the Group. Such loans do not involve more than the normal risk of collectability or present any unfavourable features. Amounts deposited by Directors, Other Key Management Personnel and their connected persons 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.

No life assurance policies and investments were entered into by Directors, Other Key Management Personnel and their connected persons with the Company or its subsidiaries during the year.

Remuneration of Key Management Personnel

The remuneration of the Directors, and Other Key Management Personnel of Alliance & Leicester plc, is set out in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. Further information about the aggregate remuneration of the Directors is provided in the 'Directors' Remuneration' table in the Directors' Report on page 38.

Key management compensation	2008 £m	2007 £m
Short-term employee benefits	3.7	3.6
Post-employment benefits	0.4	0.9
Other long-term benefits	-	-
Termination benefits	2.2	-
Share-based payments	2.3	1.1
	8.6	5.6

Company Share Option Plan

In 2008, Executive Directors and Other Key Management Personnel were granted options over shares in the Company under the Alliance & Leicester Company Share Option Plan. These options will lapse on 7 April 2009.

In 2005, three Executive Directors and five Other Key Management Personnel were granted options over shares in the Company. The amount of shares participants would receive at the end of the three-year period depended on the Earnings per Share performance of the Company in this period. The performance condition was not met and the options lapsed on 7 April 2008.

Deferred Bonus Scheme

In 2005 and 2004, three Executive Directors and five Other Key Management Personnel were granted deferred and matching options over shares in the Company under the Alliance & Leicester Deferred Bonus Scheme. The amount of matching shares Executive Directors would receive at the end of the three-year period depended on the Company's Total Shareholder Return against a competitor benchmark group. The conditions attached to the matching shares were not met at the end of the three-year period and the matching options awarded to Executive Directors lapsed. During 2008, three Executive Directors exercised deferred options and four Key Management Personnel exercised deferred and matching options on 7 October 2008.

Long Term Incentive Plan

In 2008, three Executive Directors and six Other Key Management Personnel were granted conditional awards of shares in the Company under the Alliance & Leicester plc Long Term Incentive Plan for a total fair value of £518,893, (based on the fair value of £4.28 per share). The value attributable to the current year of these conditional awards is included in share-based payments in Note 40. Under the Alliance & Leicester Long Term Incentive Plan granted on 27 March 2008, certain Executive Directors, Other Key Management Personnel (as defined above) and other nominated individuals were granted a conditional award of shares in the Company. The amount of shares participants would receive throughout a three-year period depended on the performance of the Company during this period. All awards under the Alliance & Leicester Long Term Incentive Plan depended on the Company's Total Shareholder Return against a competitor benchmark group, Return on Equity and Earnings per Share performance. These conditions were not met at 9 October 2008, when the Scheme of Arrangement for the acquisition of the Company by Banco Santander, S.A. was completed, and the awards lapsed.

Parent undertaking and controlling party

At 31 December 2008, the Company's ultimate parent undertaking and controlling party was Banco Santander, S.A., a company incorporated in Spain. Banco Santander, S.A. is the parent undertaking of the largest Group of undertakings for which Group accounts are drawn up and of which the Company is a member. See Note 43 below for changes in Company ownership since 31 December 2008.

Copies of all sets of Group accounts, which include the results of the Company, are available from Abbey Secretariat, Abbey National House, 2 Triton Square, Regent's Place, London NW1 3AN.

Transactions with related parties

During the year, the Group entered into the following transactions with related parties:

	Interest, fees and other income received		Interest, fees and other expenses paid		Amounts owed by related parties		Amounts owed to related parties	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Parent company	-	-	-	-	-	-	-	-
Fellow subsidiaries	3	-	38	-	149	-	9,465	-
	3	-	38	-	149	-	9,465	-

During the year, the Company entered into the following transactions with related parties:

	Interest, fees and other income received		Interest, fees and other expenses paid		Amounts owed by related parties		Amounts owed to related parties	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Parent company	–	–	–	–	–	–	–	–
Subsidiaries	1,376	652	636	503	11,272	9,121	9,717	8,842
Fellow subsidiaries	3	–	38	–	149	–	9,465	–
	1,379	652	674	503	11,421	9,121	19,182	8,842

In addition, transactions with pension schemes operated by the Group are described in Note 33. Transactions with fellow subsidiaries mainly relates to funding received from Abbey National plc.

43. Events after the reporting date

On 9 January 2009, in order to optimise the capital, liquidity funding and overall financial efficiency of the enlarged group, Banco Santander, S.A. transferred all of its Alliance & Leicester plc shares to Abbey National plc in exchange for Abbey National plc ordinary shares. The result of this was to increase Abbey National plc's holding of 35.6% of the Company's equity voting interests to 100%. Accordingly, Abbey National plc is now the immediate parent company of Alliance & Leicester plc.

The Company has given a full and unconditional guarantee in respect of the unsubordinated liabilities of Abbey National plc incurred prior to 31 July 2012 under a deed poll guarantee entered into by the Company on 19 March 2009. Abbey National plc has given a reciprocal guarantee in respect of the unsubordinated liabilities of the Company incurred prior to 31 July 2012 on the same day. It has not yet been practicable to estimate the financial effect of the deed poll guarantee given by the Group due to its recent completion.

44. Financial instruments

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The Accounting Policies Note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. Each class of financial asset and liability on the balance sheet has a single measurement basis, which is described in the Accounting Policies Note.

The following tables analyse the fair value of financial instruments not measured at fair value in the balance sheet:

			Group
2008	Carrying value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	1,553	1,553	–
Loans and advances to banks	1,239	1,240	1
Loans and advances to customers	51,402	52,377	975
Held to maturity	–	–	–
Loans & receivables	14,250	13,153	(1,097)
Liabilities			
Deposits by banks	11,516	11,501	15
Deposits by customers	39,765	39,826	(61)
Debt securities in issue	17,477	16,605	872
Subordinated liabilities	1,436	1,411	25

			Company
2008	Carrying value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	1,553	1,553	–
Loans and advances to banks	1,236	1,237	1
Loans and advances to customers	52,604	53,275	671
Loans & receivables	14,321	13,224	(1,097)
Liabilities			
Deposits by banks	13,585	13,570	15
Deposits by customers	41,222	41,283	(61)
Debt securities in issue	12,084	11,790	294
Subordinated liabilities	1,436	1,411	25

Notes to the Financial Statements continued

2007	Carrying value £m	Fair value £m	Group Surplus/(deficit) £m
Assets			
Cash and balances at central banks	3,471	3,471	–
Loans and advances to banks	2,885	2,882	(3)
Loans and advances to customers	55,056	55,121	65
Held to maturity	213	181	(32)
Loans & receivables	210	210	–
Liabilities			
Deposits by banks	18,512	18,426	86
Deposits by customers	29,976	29,979	(3)
Debt securities in issue	21,879	21,507	372
Subordinated liabilities	711	680	31

2007	Carrying value £m	Fair value £m	Company Surplus/(deficit) £m
Assets			
Cash and balances at central banks	3,471	3,471	–
Loans and advances to banks	2,864	2,860	(4)
Loans and advances to customers	55,625	55,669	44
Held to maturity	213	181	(32)
Loans & receivables	13	13	–
Liabilities			
Deposits by banks	21,073	20,987	86
Deposits by customers	29,151	29,153	(2)
Debt securities in issue	16,609	16,377	232
Subordinated liabilities	711	680	31

The surplus/(deficit) in the table above represents the surplus/(deficit) of fair value compared to the carrying amount of those financial instruments for which fair values have been estimated.

Fair value measurement
The fair value of financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. Where quoted market prices are not available, fair value is determined using pricing models which use a mathematical methodology based on accepted financial theories, depending on the product type and its components. Pricing models take into account the contract terms of the securities as well as market-based valuation parameters, such as interest rates, volatility, exchange rates and the credit rating of the counterparty. Valuation adjustments are an integral component of the fair value estimation process and are taken on individual positions where either the absolute size of the trade or other specific features of the trade or the particular market (such as counterparty credit risk, concentration or market liquidity) require more than the simple application of pricing models. Further information on fair value measurement can be found in 'Critical Accounting Policies' within the Accounting Policies on pages 59 to 63.

Fair value management
The fair value exposures, as tabled above, are managed by using a combination of hedging derivatives and offsetting on balance sheet positions. The approach to specific categories of financial instruments is described below.

Assets:
Cash and balances at central banks/Loans and advances to banks
The carrying amount is deemed a reasonable approximation of the fair value, because they are short term in nature.

Loans and advances to customers
Loans and advances to personal customers are made both at variable and at fixed rates. As there is no active secondary market in the UK for such loans and advances, there is no reliable market value available for such a significant portfolio.

a) Variable rate
The Directors believe that the carrying value of the variable rate loans may be assumed to be their fair value.

Notes to the Financial Statements continued

b) Fixed rate

Certain of the loans secured on residential properties are at a fixed rate for a limited period, typically two to five years from their commencement. At the end of this period these loans revert to the relevant variable rate. The excess of fair value over carrying value of each of these loans has been estimated by reference to the market rates available at the balance sheet date for similar loans of maturity equal to the remaining fixed period.

Loan and receivable securities

Where reliable prices are available, the fair value of investment securities has been calculated using indicative market prices. Other market values have been determined using in-house pricing models.

Liabilities:

Deposits by banks

The carrying amount is deemed a reasonable approximation of the fair value, because it is short-term in nature.

Deposits by customers

The majority of deposit liabilities are payable on demand and therefore can be deemed short-term in nature with the fair value equal to the carrying value. However, given the long-term and continuing nature of the relationships with the Group's customers, the Directors believe there is significant value to the Group in this source of funds. Certain of the deposit liabilities are at a fixed rate until maturity. The deficit of fair value over carrying value of these liabilities has been estimated by reference to the market rates available at the balance sheet date for similar deposit liabilities of similar maturities.

Debt securities in issue and subordinated liabilities

Where reliable prices are available, the fair value of debt securities in issue and subordinated liabilities has been calculated using quoted market prices. Other market values have been determined using in-house pricing models.

Net gains and losses on financial instruments

	Group	
	2008 £m	2007 £m
	-	-
Financial assets and liabilities at fair value through profit or loss on initial recognition	**(7)**	(19)
Financial assets and liabilities held for trading	**3,274**	3,262
Loans and receivables	**(14)**	1
Available-for-sale	**(3,532)**	(3,190)
Financial liabilities held at amortised cost	**(279)**	54

45. Capital Management and Resources

Capital management and capital allocation

The Board is responsible for capital management strategy and policy and ensuring that capital resources are appropriately monitored and controlled within regulatory and internal limits. Authority for capital management flows to the Chief Executive and from him to specific individuals who are members of the Group's Asset and Liability Management Committee ('ALCO').

ALCO adopts a centralised capital management approach that is driven by the Group's corporate purpose and strategy. This approach takes into account the regulatory and commercial environment in which the Group operates, the Group's risk appetite, the management strategy for each of the Group's material risks (including whether or not capital provides an appropriate risk mitigant) and the impact of appropriate adverse scenarios and stresses on the Group's capital requirements. This approach is reviewed annually as part of the Group's Internal Capital Adequacy Assessment Process ('ICAAP').

The Group manages its capital requirements, debt funding and liquidity on the basis of policies and plans reviewed regularly at ALCO and as part of the ICAAP process.

On an ongoing basis, and in accordance with the latest ICAAP review, the Group forecasts its regulatory and internal capital requirements based on the approved capital volumes allocated to business units as part of the corporate planning process and the need to have access to a capital buffer. Capital allocation decisions are made as part of planning based on the relative returns on capital using both economic and regulatory capital measures. Capital allocations are reviewed in response to changes in risk appetite and risk management strategy, changes to the commercial environment, changes in key economic indicators or when additional capital requests are received.

This combination of regulatory and economic capital ratios and limits, internal buffers and restrictions, together with the relevant costs of differing capital instruments and a consideration of the various other capital management techniques are used to shape the most cost-effective structure to fulfil the Group's capital needs.

Capital adequacy

From 1 January 2007, the Group has managed its capital on a Basel II basis. Throughout 2008, the Group held capital over and above its regulatory requirements, and managed internal capital allocations and targets in accordance with its capital and risk management policies.

Notes to the Financial Statements continued

Group Capital

	31 December 2008 £m	31 December 2007 £m
Core tier 1 capital	1,352	1,846
Deductions from Core Tier 1 capital	(78)	(180)
Total Core Tier 1 capital after deductions	1,274	1,666
Other Tier 1 capital	605	605
Total Tier 1 capital after deductions	1,879	2,271
Tier 2 capital	1,306	655
Deductions from Tier 2 capital	(61)	(64)
Total Tier 2 capital after deductions	1,245	591
Deductions from total tier 1 and tier 2 capital	–	(5)
Tier 3 capital	147	–
Total capital resources	3,271	2,857

Core Tier 1 capital includes £700m from ordinary shares issued to Abbey National plc in December 2008.