Abbey National PLC 2294747

Our corporate objectives

- To strengthen Abbey National's market position in UK personal financial services.
- To win and hold competitive advantage through superior customer service.
- To continue to diversify profit streams away from our traditional mortgage and savings activities.
- To remain a low cost operator.
- To maintain strong management of risks.
- To promote brand strength.
- To develop synergies between our mutually supporting businesses.

Our corporate purpose

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

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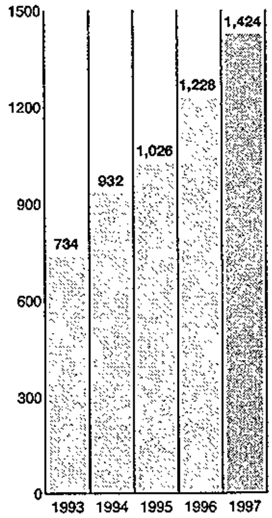
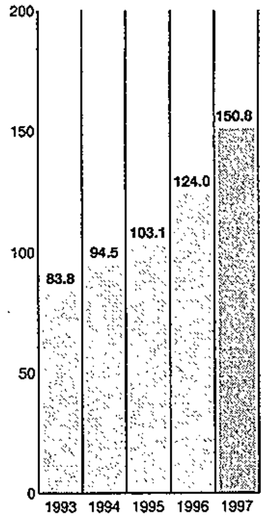
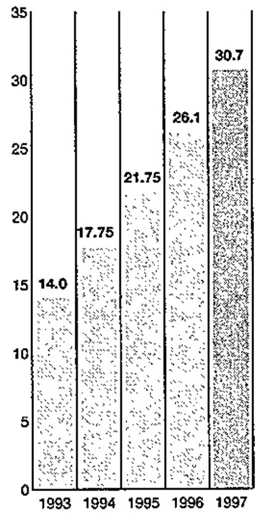
Group Highlights 1997



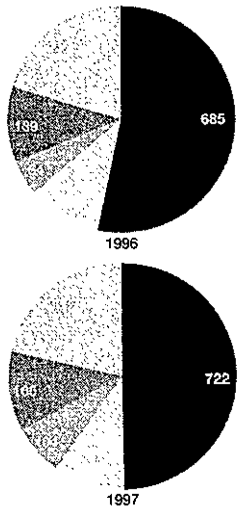
Profit before tax and exceptional items (£m)



Total assets (£bn)



Net dividends (pence per ordinary share)



Profit before tax and exceptional items by business sector (£m)

excluding Continental Europe and Group Central Holdings

Dividend policy

- The directors will pursue a progressive dividend policy.
- The effect of continuing to pursue a progressive policy is expected to result in full year dividends paid being covered by earnings by around 2 times during the current planning cycle.
- During the current planning cycle, the directors expect to retain sufficient capital such that the equity content of the tier 1 capital ratio remains in excess of 7.25% at the end of the period.
- The interim dividend will normally represent one-third of the total dividend which will be paid for a full year.

Chairman's Statement

The proposed final net dividend of 20.5 pence per ordinary share increases total dividends per ordinary share for the year from 26.1 pence in 1996 to 30.7 pence, a growth of 18%.

Lord Tugendhat, Chairman.

During 1997, Abbey National's profit before tax and exceptional items rose by 16% to £1,424 million while total assets rose by 22% to £150.8 billion. The Board is proposing a final net dividend of 20.5 pence per ordinary share. The proposed dividend increases total dividends per ordinary share for the year from 26.1 pence in 1996 to 30.7 pence, a growth of 18%. At the half year, Abbey National announced a new dividend policy, with a reduced dividend cover target which will result in earnings covering dividends by around two times. We expect to retain sufficient capital in order that the equity tier 1 capital ratio stands at 7.25% at the end of the current planning period. This emphasises Abbey National's continued commitment to delivering value to shareholders.

Highlights of 1997

Unusual conditions prevailed in the financial services market during much of 1997 due to the impact of people awaiting windfall payments from demutualisations. This made them unable to move their savings and mortgages without jeopardising their entitlement. However, by the final quarter this effect had largely disappeared and the market had begun to return to normal. Against this background, Abbey National continued to pursue its twin goals of maintaining growth in traditional businesses whilst diversifying into new markets. Almost fifty percent of Group profits now come from areas outside the Company's traditional businesses.

UK Retail Banking

Nonetheless, 1997 was a successful year for our traditional businesses. In particular our savings business benefited from the successful launch of our highly competitive Bonus Postal Account in March, and from the launch of our new investment account range in May.

Our performance in the mortgage market began to recover during the second half of the year, with a £0.7 billion increase in net mortgage lending. This resulted in an estimated 3.5% share of growth in total UK mortgages outstanding over the full year.

Abbey National's personal banking business continues to perform well, and over the year the total number of bank accounts increased to nearly 1.7 million. We plan to continue growing our share of this market. We also have over 1.76 million debit cards and over 456,000 credit cards in operation.

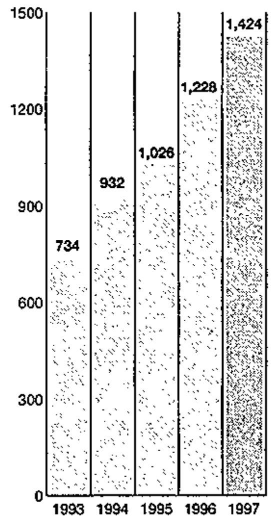
In 1997, the Company took steps to ensure that customers are using the most appropriate products for their needs. In particular, we contacted Instant Saver customers who are using a savings account as a bank account, and invited them to transfer to an account that would better suit their needs. This initiative has the added advantage of ensuring that we are taking the most cost effective approach to meeting customer requirements.

Our aim is to be straightforward and to tailor services as closely as possible to the needs of the individual - whilst also making sure that each product we offer is profitable on its own terms.

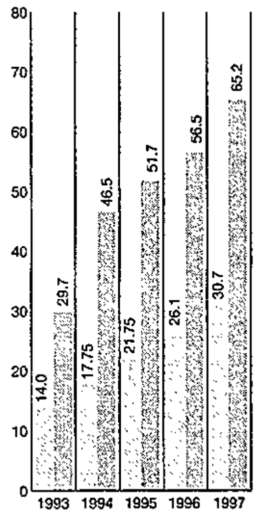
1997 saw further development of Abbey National's retail branch network with the relocation of a significant number of smaller branches into larger premises better suited to the nature of today's business. Since conversion to plc in 1989, the square footage of retail space available to customers has increased significantly.

Our branches will continue to have a major role in distribution, complemented by an increasing range of telephone distribution services. Our newest branch - in Cross Street, Manchester - is the first of a new generation of superstore branches offering the fullest range of facilities and services as well as extended opening hours. Through these sites, we will develop new branch technology for the future. Abbey National has also opened branches in Safeway stores in Leicester, Darlington and Lincoln as part of the Company's strategic partnership with Safeway.

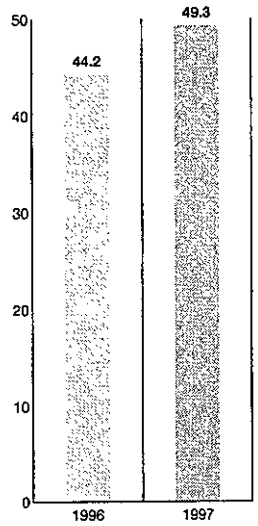
Abbey National has continued to place a firm emphasis on service. The introduction of a new centralised call centre in Bradford, soon to be followed by a second centre in Belfast, will improve handling of customer telephone enquiries and will enable staff in Abbey National's branch network to spend more time providing face to face customer service. Within our mortgage and



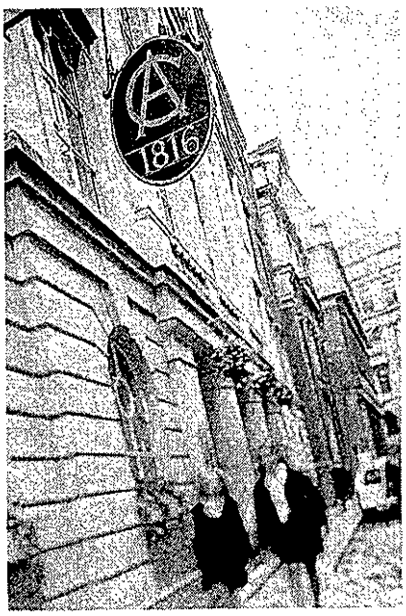
Profit before tax and exceptional items (£m)



Net dividends and earnings per ordinary share (pence)



Profit from non-traditional activities (%)



Cater Allen, acquired in summer 1997, will strengthen Abbey National's Treasury operation.

banking operations we are centralising our processing into a reduced number of large sites which will use the latest document imaging and process management technology to increase efficiency and provide improved customer service.

In November, we launched an initiative to strengthen the positioning of the Abbey National Retail brand in the market place. The new advertising slogan - 'Abbey National - Because Life's Complicated Enough...' is a reinforcement of our core values within the retail business which aim to ensure the customer's needs always come first. Customer focused initiatives include extended branch opening hours and the introduction of more straightforward, flexible products. Queues in branches are being tackled with the introduction of express tills and increased self-service facilities to take simple transactions away from branch counters.

Finance House

1997 was also a successful year for Abbey National's Finance House, with growth in net loan assets of 5% to £4.6 billion. During the year, gross lending by First National Bank (FNB) rose to a record £1 billion. This achievement reflects growth of market share in personal loans, vehicle finance and business finance. In addition, gross lending of Abbey National-branded unsecured personal loans grew to £872 million, also a result of strengthening market share in that sector.

During the year, FNB acquired County Factors Ltd, a factoring business, and in January 1998 acquired Whitechapel Corporate Services Ltd, an advisory business for vehicle contract hire. Both of these acquisitions have strengthened the business finance activities of our Finance House Division.

General Insurance

In November 1997, Abbey National's General Insurance business - which includes household, travel and payment protection insurance - was strengthened by the launch of a new telephone general insurance operation based at Brunswick Dock in Liverpool. As well as broadening distribution channels for the general insurance business, the Liverpool operation provides access to a new group of customers, and will speed growth of our non mortgage-related general insurance business. During the year, Abbey National's general insurance business saw profits grow by 63% to £104 million.

Joint ventures

Our general insurance joint venture with Commercial Union is the largest of the series of successful joint ventures Abbey National has created in recent years. Joint ventures allow each party to gain from the knowledge and expertise of the other, whilst growing their respective businesses and expanding channels of distribution. Our latest joint venture with Norwich Union to provide private medical insurance was launched in November, providing an important addition to the range of personal financial services offered by Abbey National.

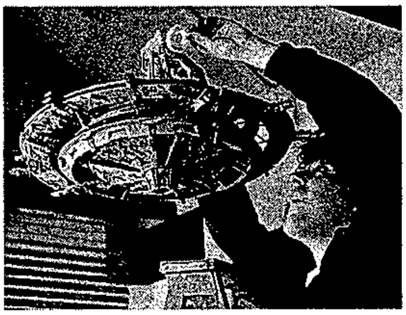
In August 1997, we announced another joint venture with the merger of Willis Corroon Financial Planning Ltd and Abbey National Independent Financial Advisers Ltd. The new company, Willis National, will create one of the strongest groups in the independent financial adviser sector - the combined knowledge and experience of the two companies allowing Willis National to provide a broader range of services to clients.

Life Assurance

Abbey National's life and pensions business continues to grow - in particular, funds under management within Abbey National's life assurance businesses in Glasgow exceeded £10 billion for the first time during 1997, underscoring our ability to meet our growth ambitions by organic means. Both Scottish Mutual and Abbey National Life showed strong growth in new business with total new business premium income up by 20% to £1,939 million (1996: £1,620 million) and profits before tax for the Life Division as a whole growing by 19% to £165 million during the year.

Treasury & Offshore

In 1997, Treasury & Offshore increased pre-tax profit by 19% to £308 million with asset growth of 10% to £52.4 billion. In addition, the acquisition of Cater Allen added £18.1 billion to total assets at the year end.



Abbey National's 'Because Life's Complicated Enough...' advertising campaign, featuring comedian Alan Davies, reinforces the Company's customer-focused approach.

Through its Treasury business, Abbey National is a market leader in the international debt securities markets. Treasury invests in a range of high quality, low risk assets, over 70% of which are rated AA or better by the world's major credit rating agencies.

In 1997, we continued to meet the demands of our large and diverse base of institutional investors. We also addressed the increasing demand for high quality securities from retail investors, particularly in Switzerland and Italy. We responded to the Japanese Government's deregulation of financial markets with the launch in November of a bond targeted at Japanese retail investors, making Abbey National the first UK banking group to develop such a product.

In July, Abbey National acquired Cater Allen. This acquisition will strengthen Abbey National's Treasury operation by enabling us to build up our wholesale banking activities in specialised areas such as the gilt repo market. The acquisition also brings in excess of £1 billion of offshore retail deposits to the Group.

The Group's exposure to troubled Asian economies totalled just over £500 million (0.3% of total Group assets), which consists of bonds issued by banks guaranteed or supported by their national governments. These assets continue to perform fully, and no provisions are considered necessary.

Wealth Management

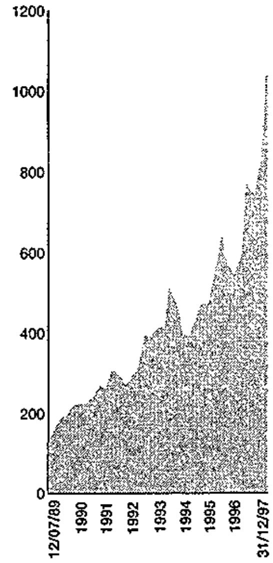
In December, Abbey National announced the creation of a new Wealth Management Division. This will include the Scottish Mutual businesses in Glasgow and Dublin which sell through intermediaries; the independent benefit consulting group; the offshore retail operations in Jersey, Isle of Man and Gibraltar; and the representative office in Hong Kong. The acquisition of Cater Allen will further strengthen the range of offshore and private banking services which the Wealth Management Division can offer to high net worth individuals.

Future prospects

Abbey National has long recognised that inadequate pensions provision for a large sector of the population is likely to become an issue of pressing importance over the years ahead.

The government's proposals for stakeholder pensions have put the spotlight on costs, and the success of this concept will depend very much upon the ability to provide low cost products. Through our life assurance and long term savings businesses we have demonstrated our ability to lead the field in terms of cost control.

Abbey National will continue to take a keen interest in the progress of this initiative and is well placed to play a leading role in the development of stakeholder pensions. We are equally concerned to help in the shaping of the proposed new Individual Savings Account, to ensure that it provides a simple and transparent concept, with sufficient scope to appeal to savers from all sectors of the population.



Share price performance (pence)

Change at the top

On 28 February, we say farewell to Peter Birch and welcome Ian Harley as Abbey National's new Chief Executive. Peter joined Abbey National as Chief Executive in 1984, and during his fourteen years with Abbey National he has transformed the organisation - in so doing he also led the way for many of the far-reaching changes that have subsequently affected the entire financial services industry. Peter led the first building society demutualisation in 1989 - an initiative which it took other organisations seven years to follow. On conversion to plc, Abbey National's assets were around £34 billion. At the end of 1997 our total assets were £151 billion and we were the 16th largest quoted company in the UK (based on market capitalisation). Since conversion, and up to 31 December 1997, Abbey National shareholders received a total return of 1157% - the best performance of any share that was in the FTSE 100 both at the time of our conversion and at the end of 1997.

My colleagues and I are united in thanking Peter for all he has done for Abbey National and in paying tribute to the scale of his achievements.

New Chief Executive

Not least of Peter Birch's achievements has been his ability continually to bring forward younger executives and to create a dynamic, forward-looking executive team. I am delighted to welcome Ian Harley as our new Chief Executive, and I am confident that Ian will ensure the continuing strength of the management team.

Mark Pain and Ian Treacy were appointed to the Board of Abbey National plc on 1 January 1998. Mark Pain assumes the role of Finance Director. Mark joined Abbey National in 1989 and most recently held the post of Group Financial Controller. Ian Treacy continues in his role as Company Secretary, whilst taking on responsibility for Group-wide risk management.

The appointment of a new Chief Executive is a significant moment for Abbey National - it is not a time for a change in direction, but a time for a change in emphasis. Ian Harley will ensure that Abbey National's business focus remains predominantly in the UK while responding to the challenge of Economic and Monetary Union and seizing opportunities elsewhere as they arise. Ian will ensure Abbey National retains a clear focus on business priorities at all times. His aim will be to maximise the synergy between Abbey National's different business areas by building good communications, and fostering strong partnerships within the business as well as with customers, shareholders and the communities in which we live and work.

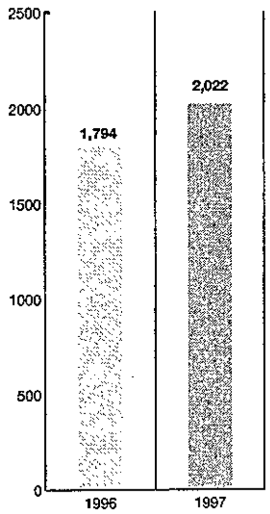
Our people

Finally, I would like to extend my thanks to all of our staff for the way they have risen to the challenges of the past year. The enthusiasm and commitment of our people cannot be underestimated - particularly as the need to differentiate and diversify becomes ever stronger. We value the adaptability and willingness to embrace change that Abbey National staff have demonstrated throughout the year, and we have recognised their contribution in profit share payments which averaged 8% of salary.

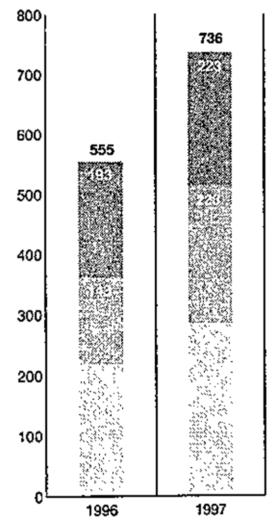
Christopher Tugendhat

Lord Tugendhat
Chairman

Foreground: Briege Bradley, PFA, Belfast.
Background: new automated branch within Safeway supermarket, Darlington.



Net interest income (£m)



Commissions, fees and other income (£m)

Insurance income receivable

Other net fees and commissions receivable

Income from long term assurance business

Other operating income

Overview of results

Abbey National's profit before tax increased by 16% from £1,228 million to £1,424 million. This excludes the exceptional charges against income from leasing and life assurance of £133 million and £12 million respectively, arising from the significant changes to the UK corporation tax regime announced by the Government in 1997. The leasing charge is compensated in full by a reduction in the tax charge. Operating income grew 17% to £2,758 million whilst costs grew 22% to £1,194 million, reflecting the ongoing development of the business. This results in a cost:income ratio of 42.4%, excluding exceptional charges of £145 million and Year 2000 and Economic and Monetary Union (EMU) expenditure of £25 million, (1996: 41.6%). Provisions for bad and doubtful debts fell by 5% to £121 million.

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

Net interest income*

	1997	*1996*
Net interest income (£m)	**2,022**	1,794
Group net interest margin (%)	**1.68**	1.76
Average interest earning assets (£bn)	**121.4**	103.1
UK Retail Banking net interest spread (%)**	**1.99**	2.12

*excludes exceptional items.

**re-based following changes to segmental reporting.

Net interest income increased by 13% to £2,022 million, primarily resulting from an 18% growth in average interest earning assets. This growth reflects the expansion of mortgage assets in UK Retail Banking during the second half of 1997, and growth in Finance House and Treasury & Offshore assets during the year. The Group net interest margin declined by only 8 basis points because of the increasing amount of high margin assets taken on over the period, particularly in the unsecured lending activities of the Group. This was achieved despite a 13 basis point decline in the UK Retail Banking net interest spread due to continuing competitive pressures in the residential mortgage and liquid saving markets.

Commissions, fees and other income*

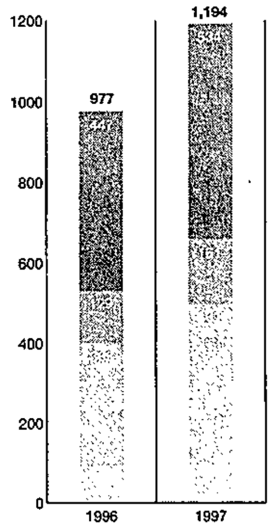
	1997	*1996*
	£m	***£m***
Insurance income receivable	**223**	193
Other net fees and commissions receivable	**228**	143
Income from long term assurance business	**147**	133
Other operating income	**138**	86
Total	**736**	555

*excludes exceptional items.

In total, commissions, fees and other income increased by 33% to £736 million. Insurance income increased by 16%, reflecting the continuing benefits of the Group's operation as a joint venture general insurer, the integrated N&P portfolio and increased sales to non-mortgage customers. Other net fees and commissions grew by 59% to £228 million, mainly as a result of increased banking income derived from the Abbey National Bank Account and Abbey National Credit Card, and increased mortgage-related fee income (including survey and administration fees). Income from long term assurance business increased by 11%, with growth in new business premiums from both Scottish Mutual Assurance and Abbey National Life. Other operating income rose 60%, including the impact of income growth within Treasury & Offshore, largely related to profits from the trading portfolios, deal related fees and increased income from Abbey National Financial Products (ANFP). Other operating income is net of a charge of £14 million relating to compensation for pensions mis-selling (1996: £6 million). The total of such provisions amounted to £22 million at 31 December 1997 (1996: £26 million).

Operating expenses

	1997 £m	1996 £m
Salaries	**455**	374
Other staff costs	**79**	73
Property and equipment expenses	**161**	129
Other administrative expenses	**401**	308
Depreciation	**98**	93
Total	**1,194**	977



Operating expenses (£m)

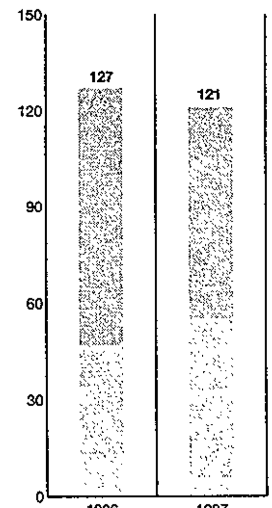
Total operating expenses increased by 22% to £1,194 million. Salaries and other staff costs increased by 19% to £534 million in 1997. This reflects the increase in the average full time equivalent headcount during 1997 which rose 16% from 20,267 to 23,498. The growth in headcount (3,231) reflects the full year effect of the additional staff of N&P and growth within other diversified businesses. This includes employees of Cater Allen Holdings PLC (Cater Allen), acquired in late July (part of Treasury & Offshore), and increases in Finance House, Life Assurance and the recently launched general insurance direct sales operation.

Property and equipment expenses increased by 25% to £161 million, primarily as a consequence of increased rent, rates and maintenance costs relating to the expanded branch network following the transfer of the business of N&P and the cost of re-configuring mortgage service centres. Other administrative expenses rose 30% to £401 million. This reflects the full year impact of N&P as well as expenditure of £25 million required to upgrade software and computer systems because of Year 2000 and EMU. In addition, £13 million of capital expenditure was incurred for Year 2000 and EMU. The total expected incremental cost for Year 2000 and EMU is £120 million in the years 1997-2000 inclusive, £20 million of which is expected to be capital expenditure, with £91 million provisionally allocated to Year 2000 and £29 million to EMU.

The Group cost:income ratio rose slightly to 42.4% (excluding the impact of exceptionals and Year 2000 and EMU expenditure) from 41.6% in 1996.

Provisions

	1997 £m	1996 £m
Bad and doubtful debts		
UK Retail Banking	**66**	80
Finance House	**49**	34
Continental Europe	**7**	10
Group Central Holdings	**(1)**	3
Total	**121**	127
Contingent liabilities and commitments	**16**	4
Amounts written off fixed asset investments	**3**	13



Provisions (£m)

Provisions for bad and doubtful debts fell by 5% from £127 million to £121 million in 1997. In UK Retail Banking, the provision charge for UK residential mortgages fell by £35 million, reflecting the benefits of favourable economic conditions, reduced levels of arrears and lower average losses per repossession case. This fall was partly offset by a £20 million increase in provisions against personal banking products. This was a result of a 71% growth in average assets following increased sales of the Abbey National Bank Account and the Abbey National

Top: new mortgage centre, Sheffield.
Bottom: Lorraine Cowden, Team Manager, Abbey National Direct, Belfast.

Credit Card. The provision charge for Finance House increased by £15 million to £49 million with the unsecured loan asset increasing by 19%. The charge includes £29 million of provisions for Abbey National-branded unsecured loans (1996: £13 million), reflecting asset growth of 106% over the last 2 years.

Exceptional items

	1997 £m	1996 £m
Adjustment to net investment in finance leases	**133**	–
Adjustment to income from long term assurance business	**12**	–
Integration costs incurred in respect of the purchase of the business of N&P	**–**	61

In 1997, the UK Government announced a number of measures which represent a significant change to the UK corporation tax regime. In particular, in the Finance (No. 2) Act 1997, the Government reduced the main rate of corporation tax from 33% to 31%, and abolished the reclaim of tax credits on dividends from UK equity investments by pension funds. In November 1997, the Government announced a further reduction in the main rate of corporation tax to 30% from April 1999, and announced proposals to change from annual to quarterly tax payment dates. Best estimates of the likely effects of all of these changes on the accounts are shown as exceptional items.

In common with the industry as a whole, the changes in corporation tax result in a reduction in value of the Group's net investment in finance leases. The effect for the Group is an estimated reduction in interest receivable on finance leases of £133 million. Tax variation clauses in the leases, which preserve the lessors' post tax rate of return over the life of the leases, result in lower gross rental income when tax rates are reduced. A compensating reduction in the deferred tax liability has been recognised and shown as a reduction in the tax charge. Group profit after tax and earnings per ordinary share are unaffected.

As a result of the abolition of the reclaim of tax credits on dividends from UK equity investments by pension funds, a provision of £12 million before tax (£8 million after tax) has been made against the embedded value profits for the Life Assurance business in 1997.

Taxation

	1997	1996
Tax on profit on ordinary activities before the impact of exceptional items (£m)	**463**	403
Effective tax rate (%) before the impact of exceptional items	**32.5**	34.5

After the impact of exceptional items the tax charge for 1997 was £326 million and was 25.5% of profit before tax.

Results of operations of the Group by business segment

UK Retail Banking

	1997 £m	1996 £m
Net interest income	**1,335**	1,189
Commissions, fees and other income	**259**	247
Operating expenses	**(794)**	(667)
Provisions for bad and doubtful debts	**(66)**	(80)
Provisions for contingent liabilities and commitments	**(12)**	(4)
Profit before tax	**722**	685
Integration costs	**–**	(60)
Market share of increase in UK liquid savings (%)	**4.1**	n/a
Market share of UK liquid savings stock (%)	**9.2**	9.3
Market share of increase in UK mortgages outstanding (%)	**3.5**	2.4
Market share of UK mortgage stock (%)	**14.1**	14.6

UK Retail Banking increased its profit before tax by 5% to £722 million.

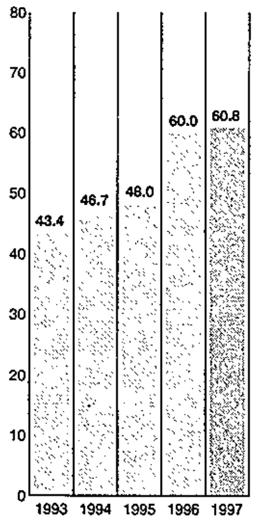
Net interest income increased by 12%, supported by the 1.3% growth in mortgage assets since 31 December 1996 and a full year's contribution from the N&P portfolio. As a consequence of the competitive nature of both the savings and the mortgage markets, the spread between UK Retail Banking's average lending rates and average funding rates narrowed from 2.12% at 31 December 1996 to 1.99% at 31 December 1997. This has resulted in a reduction in the UK Retail Banking net interest margin to 2.28% (1996: 2.35%).

Commissions, fees and other income increased by 5% to £259 million. This was partly due to higher levels of administration and survey fees reflecting an increased amount of fixed rate lending. In addition, there was growth in income from personal banking activity, driven by an expanded bank account and credit card base, and an enlarged ATM network (now over 2,000). Since 1 January 1997, over 127,000 new bank accounts and 148,000 Instant Plus accounts (a card-based instant access account) have been opened. Abbey National now has 1.68 million bank accounts, of which over 52% are primary accounts, 556,000 Instant Plus accounts, as well as over 1.76 million debit cards (1996: 1.34 million), and over 456,000 credit cards in operation (1996: 444,000).

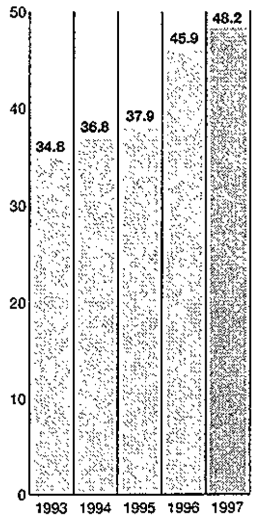
The 19% (£127 million) growth in operating expenses arose mainly as a consequence of a full year's impact of the additional staff employed and property expenses following the transfer of the business of N&P in August 1996, and also increased IT expenditure on the costs associated with Year 2000.

The provisions charge was £66 million, with £12 million (1996: £47 million) relating to residential mortgages. Residential mortgage provisions fell by £35 million, reflecting reduced levels of arrears, and lower average losses per repossession case.

Since the end of 1996, the number of mortgages six months or more in arrears has decreased from 19,155 to 14,692. The average provision for capital losses and interest arrears for a repossessed property under offer has fallen from £10,440 as at 31 December 1996, to £5,650 as at 31 December 1997. The stock of repossessed properties fell by 5% from 2,017 at 31 December 1996 to 1,908 as at 31 December 1997. Repossessions during the year increased by 4% to 5,272 cases (31 December 1996: 5,092 cases), reflecting the integration of the N&P mortgage portfolio.



Abbey National UK residential mortgage asset (£bn)

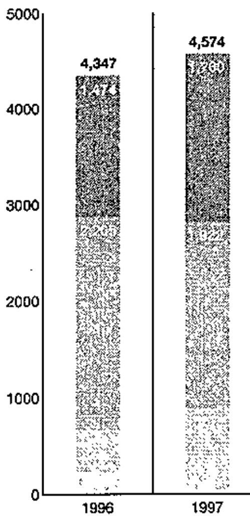


Abbey National UK retail savings liability (£bn)

Provisions charges against overdrafts and credit cards increased to £54 million (1996: £34 million). This reflects the 71% growth in average personal banking unsecured lending assets (including credit card and overdraft balances) over the years 1996 and 1997. At the year end, Abbey National's credit card asset was £234 million (1996: £205 million) reflecting growth in the credit card base, while the overdraft asset has grown from £165 million to £197 million in 1997.

As at 31 December 1997, Abbey National had UK mortgage assets of £60.8 billion (31 December 1996: £60.0 billion), representing an estimated 14.1% market share. The second half of the year saw a £0.7 billion increase in net mortgage lending (estimated 6.4% market share). The £0.8 billion increase in the year represents an estimated 3.5% (1996: 2.4%) market share of the increase in UK mortgages outstanding. This reflects an estimated 11.7% (1996:11.3%) share of gross mortgage lending (£9.0 billion), and an estimated 15.1% (1996: 14.5%) market share of mortgage capital repayments (customers repaying or redeeming their mortgages) equating to £8.2 billion.

As at 31 December 1997, Abbey National had retail liabilities of £48.2 billion (1996: £45.9 billion), representing an estimated 9.2% share of the total UK liquid savings stock. Abbey National experienced a £1.3 billion increase on the year (1996: £1.5 billion net outflow) representing an estimated 4.1% (1996: n/a) market share of the increase in UK liquid savings. This excludes the transfer of £1.0 billion of savings liabilities from Cater Allen. The retail savings performance in the first part of the year was adversely affected by the amount of money which had been tied up in building societies prior to their conversion to plc status, with customers topping up accounts ahead of flotation and large speculative money flows going into other building societies. Abbey National experienced a significant turnaround in the flow of liquid savings during 1997, with a net inflow of £1.6 billion during the second half of the year (estimated 24.0% market share) as the market returned to more normal conditions. In addition, Abbey National PEPs, unit trusts and investment bonds have attracted £487 million of new business premiums, much of which came from Abbey National savings accounts, reflecting changing customer preferences towards longer term savings products. Continued success in cross-selling these products has been a key driver behind the growth in Abbey National Life.



Finance House Net loan assets (£m)

Secured personal loans

Unsecured personal loans

Motor finance

Business finance

Finance House

	1997 £m	1996 £m
Net interest income	305	246
Commissions, fees and other income	4	8
Operating expenses	(108)	(87)
Provisions	(49)	(34)
Profit before tax	152	133
Net loan assets:		
Unsecured	1,760	1,474
Secured	1,922	2,205
Motor finance	557	432
Business finance	335	236
Total	4,574	4,347

Finance House increased its profit before tax by 14% to £152 million, with net loan assets growing 5% to £4.6 billion.

Net interest income increased by 24%, supported by 22% growth in net unsecured lending and motor finance assets since 31 December 1996.

Unsecured lending includes both Abbey National and FNB-branded unsecured personal loan assets. Abbey National-branded unsecured personal loan assets increased 25% to £1,138 million (1996: £914 million). Gross lending during the year rose 17% to £872 million. This was as a result of greater cross-selling to the customer base. FNB's unsecured personal loan assets increased 11% to £622 million (1996: £560 million). Within FNB, gross lending rose by 62% to over £1 billion.

Secured lending activity includes second mortgage loans by FNB, the centralised mortgage portfolios of Abbey National Mortgage Finance and HMC.

Motor Finance consists of the business of Wagon Finance (net loan assets up 29% to £557 million).

Business Finance includes commercial mortgages, leasing, vehicle contracting and factoring. Assets increased by 42% to £335 million, helped by strong growth in the leasing, vehicle contract hire businesses and by the acquisition of County Factors in February 1997.

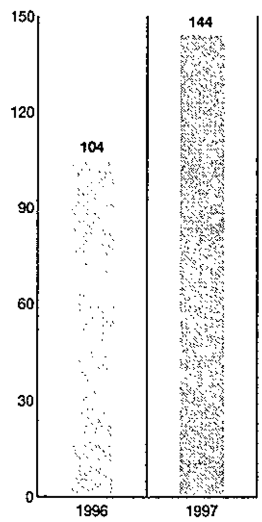
The 24% increase in operating expenses was mainly due to the 419 additional average headcount arising mainly from the impact of the businesses acquired over the last 18 months and systems replacement costs.

Provision charges have increased by £15 million to £49 million. This increase reflects growth in new business volumes in Abbey National-branded assets and the emergence of arrears against which these provisions are made, which tend to lag behind lending by an average of 12 to 18 months. Provision balances as a proportion of loan assets have reduced during the year, from 2.41% at 31 December 1996 to 2.15% at 31 December 1997.

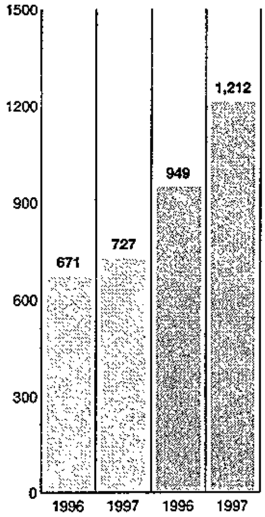
General Insurance

	1997	*1996*
	£m	*£m*
Net interest income	(3)	(3)
Commissions, fees and other income	**144**	104
Operating expenses	(37)	(37)
Profit before tax	**104**	64

Profit before tax rose 63% to £104 million, reflecting insurance income growth of 38% to £144 million as at 31 December 1997. The growth reflects the annualised benefit from the integrated N&P portfolio and organic growth. The latter was mostly due to increased non-mortgage related sales, together with benefits arising from the joint venture arrangements on the household and creditor portfolios. Operating expenses remained broadly flat, as the project costs incurred in 1996 and early 1997 in setting up a new direct operation were offset by one-off contributions to those costs received from a related party in the year.



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



Total new business premiums (£m)

Abbey National Life

Scottish Mutual

Life Assurance

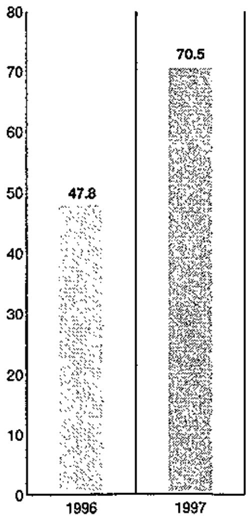
	1997	*1996*
	£m	*£m*
Profit before tax and exceptional items		
Abbey National Life*	**101**	80
Scottish Mutual **	**64**	59
Total	**165**	139
Annualised premium income		
Abbey National Life*	**129**	121
Scottish Mutual **	**172**	135
Total	**301**	256
New business premiums		
Abbey National Life *	**727**	671
Scottish Mutual **	**1,212**	949
Total	**1,939**	1,620

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

Life Assurance increased profit before tax by 19% to £165 million excluding exceptional items, as a result of growth in business volumes. Funds under management increased by 33% from £7.9 billion at 31 December 1996 to £10.5 billion at 31 December 1997.

Abbey National Life made a pre-tax profit of £101 million (1996: £80 million). Annualised premium income increased by 7% to £129 million and total new business premium income increased by 8%. Sales of PEPs were strong in 1997, generating £469 million of premium income. This represents a 6.6% market share of net new business sales. The sale of non mortgage-related investment, pensions and protection products to UK Retail Banking customers accounted for 48% of policies sold. These policies represent a major component of the Abbey National Life product offering.

Scottish Mutual contributed pre-tax profit of £64 million (1996: £59 million). Annualised premium income increased by 27% and total new business premium income increased by 28%. The rate of net earnings growth reflected margin pressure within the industry as a whole. However, with its low cost, shared platform and access to capital, Scottish Mutual is highly efficient and is better placed than most to cope with margin pressures and grow earnings. Included in the new business figures was Pegasus, Scottish Mutual's healthcare division, which contributed new annual premium business of £8.5 million (1996: £3.9 million). In its first full year, Scottish Mutual International, a sister company based in Dublin, contributed new business premium income of £221 million (1996: £46 million).



Treasury & Offshore total assets (£bn)

Treasury & Offshore

	1997	*1996*
	£m	*£m*
Net interest income	**305**	291
Commissions, fees and other income	**88**	36
Operating expenses	**(82)**	(55)
Amounts written off fixed asset investments	**(3)**	(13)
Profit before tax and exceptional items	**308**	259
Integration costs	**–**	(1)
Adjustment to net investment in finance leases	**(133)**	–
Total assets (£bn)	**70.5**	47.8

Treasury & Offshore's profit before tax was 19% higher than in 1996 at £308 million, excluding the reduction in the value of the net investment in finance leases arising from the change in the corporation tax regime announced by the Government in 1997 - which affects the leasing industry as a whole. This adjustment has no effect on Group profit after tax. The increase in profit arose from non interest income and growth in assets.

Treasury & Offshore's total operating income rose 20% to £393 million in 1997. Net interest income increased by £14 million, as a result of the growth in assets and the contribution from Cater Allen.

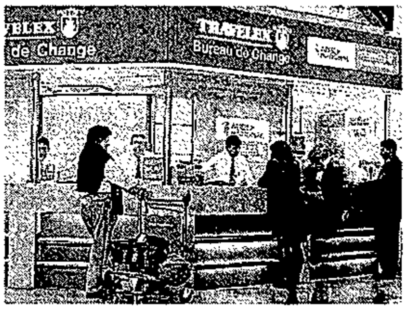
Commissions, fees and other income within Treasury & Offshore grew by £52 million to £88 million in 1997. This principally reflected earnings from the higher average level of assets in the trading portfolios, increased deal related fees and growth in contribution from Abbey National Financial Products (ANFP).

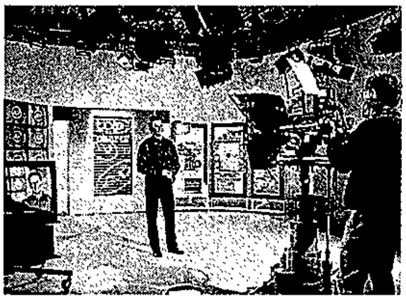
Treasury & Offshore's operating expenses increased by 49% to £82 million, largely as a result of the inclusion of Cater Allen and investment in the IT infrastructure of the existing business.

Treasury & Offshore has continued to be a major issuer of debt securities in the international capital markets, raising nearly US$17 billion over the year in a range of currencies, maturities and geographical areas. Including Cater Allen, offshore retail liabilities increased 78% to £2.6 billion during the year to 31 December 1997.

Over the year, total assets grew by 10% to £52.4 billion, including asset-backed and other highly rated investment securities. In addition, Cater Allen added £18.1 billion to total assets at the year end.

The financial crisis in Indonesia, South Korea, Thailand, the Philippines and Malaysia impacted on markets world-wide. However, Treasury sustained its profit growth through careful management of risks throughout the year. At the end of 1997, the Group's exposure to these troubled Asian economies totalled just over £500 million (0.3% of total Group assets) and consisted of bonds issued by banks guaranteed or supported by their national governments. These assets continue to perform fully and accordingly no provisions are considered necessary.





Top: Travelex, Heathrow Terminal 2.
Bottom: filming Abbey Vision - part of a major new communication initiative aimed at retail branch staff.

Continental Europe

	1997 £m	1996 £m
Underlying business:		
Spain	(10)	(17)
France	(8)	(12)
Italy	(2)	1
	(20)	(28)
Year 2000/EMU costs	(4)	–
Costs associated with anticipated sale of loan portfolio	(6)	–
Loss before tax	(30)	(28)

Continental Europe's underlying pre-tax loss of £20 million was 29% lower than in 1996. In Spain, underlying pre-tax losses fell to £10 million (1996 loss: £17 million). The underlying pre-tax loss in France fell to £8 million (1996 loss: £12 million), excluding £6 million costs incurred against the anticipated disposal of the commercial loan portfolio and £2 million of Year 2000 and EMU costs. The Italian operation made a loss of £2 million (1996 profit: £1 million) reflecting in part the cost of expanding the product ranges offered. Italy also incurred £2 million of EMU and Year 2000 expenditure.

Group Central Holdings

	1997	*1996*
	£m	*£m*
Profit/(Loss) before tax	3	(24)

Group Central Holdings comprises central costs, earnings on the difference between the Group's statutory capital and the target regulatory capital allocated to segments, and the results of certain small non-core businesses.

Development of the business

Strategy for the business

Abbey National's vision is to be the outstanding financial services company in the UK. Abbey National's purpose is to continue to achieve above average growth in value for shareholders. To support this, the Group's strategy is to continue to focus on its principal interdependent businesses - UK Retail Banking, Finance House, General Insurance, Life Assurance, Treasury & Wholesale Banking and Wealth Management.

The Group intends to continue to broaden its earnings base to reduce dependence on traditional mortgage and savings activities. By the end of 1997, 49.3% of Abbey National's pre-tax profit, excluding exceptional items, was derived from non-traditional areas - including Finance House, General Insurance, Life Assurance and Treasury & Offshore.

Complementing the strategic goals outlined above are the Group's objectives to maintain strong management of, and control over, risks; to secure and maintain competitive advantage through superior customer service; to improve efficiency further, and thus maintain a low cost:income ratio; to maintain a prudent capital base; and to preserve and further enhance the Group's strong brand name in the markets in which it operates.

Given the assumption that lower inflation and interest rates will lead to further modest growth in residential loan assets in the UK, a progressive dividend policy will be maintained. During the current 3 year planning cycle it is expected that the full year dividends to be paid will be covered by earnings by around two times, and that sufficient capital will be retained in order that the equity content of the tier 1 capital ratio remains in excess of 7.25% at the end of the period. The policy that the interim dividend will normally represent one-third of the total dividend which will be paid for a full year, will continue.

Investment for the future

During 1997, Abbey National continued to widen the range of services it provides to customers in all major business areas. Abbey National has increased its customer base to 15.3 million (1996: 14.4 million), whilst significantly increasing its cross-selling abilities (the average number of account holdings per customer at 31 December 1997 was 1.66 compared to 1.55 at 31 December 1996).

In December, Abbey National announced the creation of a new Wealth Management Division. This new division includes the Scottish Mutual businesses in Glasgow and Dublin which sell through intermediaries, the independent benefits consulting group and the offshore retail operations in Jersey, Isle of Man and Gibraltar and the representative office in Hong Kong. These offshore businesses were previously within Treasury & Offshore and include Cater Allen's offshore business which added over £1 billion of retail deposits to the Group. Over time, Abbey National will grow its business with higher net worth individuals, particularly onshore customers, and by attracting new customers.

UK Retail Banking

UK Retail Banking manages the design, pricing, sales, marketing and distribution of the Group's Abbey National-branded retail products and is a major UK provider of mortgages and savings deposit products, current account banking, short term and long term protection insurance and investment offerings. It intends to broaden the services offered to customers, thereby continuing to diversify its earnings stream away from traditional mortgage and savings business.

During 1997, UK Retail Banking pursued a three-fold strategy of strengthening the brand, raising customer profitability and widening the range of distribution channels available.

1. **Strengthening the brand**

   A new customer proposition "Abbey National - Because Life's Complicated Enough" was developed in the autumn, to underpin the brand. Three core values were identified to support this proposition across all Abbey National-branded businesses: straightforwardness, flexibility and customer partnerships. Since the autumn, these values have been reflected in initiatives to provide more flexible opening hours, to reduce queues at lunch times, and to simplify form design and layout. Further initiatives to remove complexity are planned for 1998.

2. **Customer profitability**

   The business is concentrating on increasing the commitment of valuable customers and improving the profitability of those who are not currently profitable. Abbey National is now able to rank its customers by profitability and is providing a service to them accordingly, with a strong emphasis on retention of profitable customers and on building the relationships they have with the Company. During the year, cross-selling to secure more profitable customers has been highly successful, with the number of customers holding 3 or more accounts rising by 31% to over 2.6 million from 2.0 million as at 31 December 1997.

3. **Channel management**

   UK Retail Banking is pursuing a strategy aimed at widening the range of channels available to meet the needs of customers while ensuring that distribution remains cost effective.

   The strategy is supported by moving more customers towards greater use of self service facilities for simple transactions, thus leaving staff free to provide added value service face-to-face. The promotion of electronic banking and ATMs, coupled with the introduction of measures such as charges for counter transactions on the Instant Plus Account and the increase in opening balance levels, have led to customers changing their behaviour and using less expensive transaction channels. These initiatives have also been well received by customers. For example, 127,000 more bank accounts have been opened, the number of Instant Plus Accounts has increased by 148,000 and 420,000 debit cards were issued during the year. In 1997, the number of ATMs increased by 26% to 2,074, with the number of remote machines increasing by 36% to 768. Abbey National now has the second largest remote ATM network in the UK. At the same time, during 1997, counter transactions fell from around 29% of total transactions at the start of the year to 23% by 31 December 1997 and in 1998, this proportion is expected to reduce to 20%. There has been a corresponding increase in ATM usage, where unit costs are substantially lower.

The Retail Banking network is also being reconfigured, with the focus being placed on larger units in city centres and shopping malls where footfall is greater. To this effect, 58 smaller, less productive branches were closed during the year. However, Abbey National remains committed to providing a high quality face-to-face service for customers and plans to enhance the network. This will be through the development of "superstores" - the new flagship branch which is typically a large branch in a prime location offering the fullest range of products, facilities and merchandising and selective extended opening hours. The first superstore, located in Manchester, is already running, with 5 more planned. Coupled with this has been the development of in-store banks in Safeway stores, with 3 opening during the year in Leicester, Darlington and Lincoln and more planned for 1998.

UK Retail Banking has centralised mortgage processing into a reduced number of larger sites where the latest document imaging and process management technology can be harnessed to provide improved customer service and greater efficiency. When this process is complete in 1998, it is expected that unit processing costs per mortgage account (excluding front-office) will have fallen by 24% since 1995.

Market developments

During 1997, Abbey National strengthened its traditional mortgage and savings businesses and extended its personal banking services. In 1997, there were innovative developments in both savings and mortgage products.These included further launches of stock market and bond-related savings accounts, a new range of notice accounts and the development of competitive fixed and capped rate mortgage products, including a highly flexible range of mortgage choices for the broker market. The Bonus Postal Account was launched in March and has taken over £4.0 billion of funds. In mid January 1998, Abbey National announced the launch of a new direct savings account with Safeway, adding to the range of personal banking services offered. This account has proved popular with Safeway customers and the general public, with over £100 million taken in deposits to the end of February 1998. In November, a pilot scheme commenced, offering banking and savings products to professionals and small businesses, managed centrally by telephone, which will continue in 1998.

In November, a range of private healthcare products was launched through the joint venture with Norwich Union, with the aim of making private healthcare more accessible and straightforward, and this will be rolled out nationally in 1998.

Finance House

Finance House provides unsecured personal loans under the Abbey National and First National brands. It also provides secured loans under the HMC and First National brands, motor finance through Wagon Finance, and business finance through vehicle contract hire, leasing, factoring and commercial mortgages.

In 1997, FNB's gross lending increased by 62% to nearly £1.1 billion, contributing to an increased market share within its main business activities of home improvement loans and car finance. In addition, gross lending of Abbey National-branded unsecured personal loans increased by 17% to £0.9 billion in 1997.

Abbey National's Finance House activities have continued to expand. During the year, FNB acquired County Factors Ltd, a small factoring company, thereby broadening the business finance activities of Finance House. In January 1998, FNB acquired the business of Whitechapel Corporate Services Ltd, which provides a consultancy service to large employers offering company car schemes.

General Insurance

Abbey National and Commercial Union Assurance Company plc have successfully continued the joint venture established in 1995. As part of the joint venture, the underwriting risk from the buildings, contents and payment protection portfolio is borne by Commercial Union Underwriting Ltd, in which Abbey National holds 15% of the voting share capital. The joint venture's operations business unit, owned 100% by Abbey National, is responsible for product design and pricing, policy administration and claims handling on behalf of Commercial Union Underwriting Ltd.

The range of general insurance products includes property, buildings and contents, payment protection and travel insurance. In 1997, the General Insurance Division concentrated on growing the non mortgage-related portfolio, successfully directing marketing activity towards Abbey National savings customers and other non-borrowers. In October, Abbey National General Insurance launched a new direct telephone operation based in Liverpool, aimed at attracting new customers by direct mail and retaining existing ones. This will provide significant opportunity for future growth of the insurance business in 1998 and beyond, with the planned launch of motor insurance by mid-1998.

Life Assurance

This division primarily consists of Scottish Mutual which distributes life assurance, pensions and long term savings products through independent financial advisers, and Abbey National Life which sells through the retail distribution network.

Life Assurance continues to provide new and innovative products to the market, and funds under management in Glasgow now exceed £10 billion. During 1997, Abbey National Life launched an Abbey National Safety Plus PEP and Scottish Mutual launched various products, including a Rising Income Bond and Triple Bonus Bond. Abbey National is now the sixth largest unit trust provider by PEP fund value.

Treasury & Offshore

Abbey National Treasury Services plc (ANTS) manages the liquidity needs of the Group, provides wholesale funding to the Group through its activities in the international capital markets, provides risk management services and makes a significant contribution to the Group's profit, predominantly through investing in high quality assets.

The offshore operation provides savings and mortgage products through offices in Jersey, the Isle of Man and Gibraltar. This operation will transfer into the new Wealth Management Division in 1998.

ANTS is responsive to opportunities in the range of markets in which it participates and its reputation for being innovative and professional continues to develop internationally. In addition, ANTS will continue to increase the diversity of its activities in these markets in 1998.

In July, Abbey National acquired Cater Allen. The acquisition of Cater Allen will strengthen ANTS by complementing its existing wholesale banking activities, particularly in areas such as the gilt repo market and international stock lending. The acquisition of Cater Allen will also enable Abbey National to develop further the range of wealth management services it can offer to high net worth individuals by strengthening the Group's position in the offshore and onshore private banking markets.

Wealth Management

The high net worth personal sector is expanding. This new division will enable Abbey National to increase earnings by expanding its presence and capability in this market while attracting new business and retaining existing high value customers.

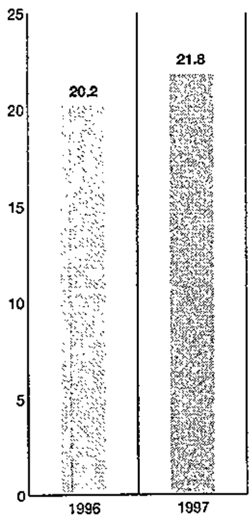
Continental Europe

This consists of operations in France, Spain and Italy. Their principal activity is to provide mortgage finance, as well as providing unsecured personal loans, deposits and long term savings products. This enables Abbey National both to strengthen its presence in Continental Europe and to continue to develop its understanding of business in other regions of the European Community. This strategy will enhance Abbey National's ability to take advantage of the opportunities that will arise from a unified single market in Europe. Measures to restore the operations' profitability are continuing.

Capital expenditure

Capital expenditure during the year amounted to £187 million (1996: £147 million). This included £31 million of expenditure relating to the replacement of furniture, fittings and equipment in branches and head offices, £66 million relating to computer and ATM investment, £28 million relating to other property expenditure and £57 million relating to cars for the motor finance businesses.

Capital expenditure in recent years has, to a large extent, been incurred for the purpose of extending, modernising and re-siting UK Retail Banking branches. It has also been incurred in order to improve processing efficiency in service centres. With the modernisation of UK Retail Banking's branches now almost complete, the focus has switched towards implementing technology that will provide for greater self-service by customers. This includes further development of Abbey National's network of internal and remote automated teller machines, thereby establishing Abbeylink as one of the largest networks in the UK.



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

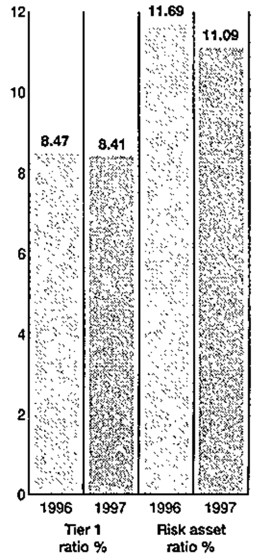
Return to shareholders

Abbey National's corporate purpose is to continue to achieve above average growth in value for shareholders.

Earnings per ordinary share rose 15% to 65.2p per share, and the post tax return on average ordinary shareholders' funds increased to 21.8% (1996: 20.2%). Ordinary dividends of (30.7p per share) are payable to shareholders and were covered 2.1 times by earnings.

Abbey National believes that the best overall measure of Group performance is total return to shareholders (TSR), which equates to gross dividends paid plus the movement in the share price over time. Share price for any given year is defined as the average of daily share prices. In 1997, TSR achieved was 51%, ranking

Abbey National 7th in the FTSE 100. Over the last three years, Abbey National achieved 32% per annum TSR, ranking it 10th in the FTSE 100. At the end of 1997, the Company had a market capitalisation of £15.4 billion and ranked as the sixteenth largest UK quoted company on this measure. Executive remuneration via the long term incentive plan is also based on TSR performance of the Company relative both to specified financial institutions and the constituents of the FTSE 100 Share Index.



Capital adequacy

Capital resources

Abbey National's capital resources (shareholders' funds including subordinated liabilities and preference shares) increased by £574 million to £7,341 million (31 December 1996: £6,767 million). This reflected an increase in shareholders' funds of £485 million, and a net increase in subordinated liabilities of £89 million. Shareholders' funds increased mainly as a result of £485 million of profits retained plus transfers to reserves, £125 million of new preference share capital and £15 million of new ordinary share capital, largely offset by £139 million of goodwill taken to reserves mainly in respect of the acquisition of Cater Allen.

The basic instruments of capital monitoring are the risk asset ratio and the tier 1 capital ratio. As at 31 December 1997, the Group's risk asset ratio was 11.09% (31 December 1996: 11.69%), the tier 1 ratio was 8.41% (31 December 1996: 8.47%) and the equity tier 1 ratio was 7.64% (31 December 1996: 7.85%). The tier 1 ratio was maintained at a similar level to 31 December 1996, principally due to the increase in retained earnings and the issue of preference share capital, offset by growth in risk weighted assets and goodwill taken to reserves.

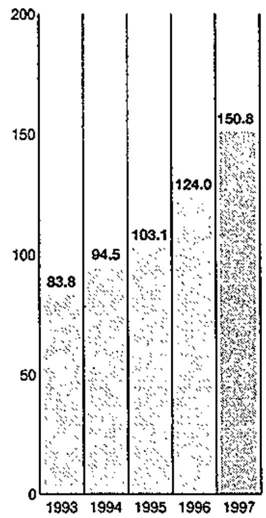
Abbey National's risk asset ratio and tier 1 ratio remain comfortably above the minimum standards for the Group set by the Bank of England. Abbey National believes that the Group could operate with a lower level of equity tier 1, with equity tier 1 over 7.25% at the end of the Group's current planning cycle. Going forward, Abbey National intends to continue to balance the interests of shareholders and debt holders in determining the capital resources required for the business.

Capital adequacy data

	1997	*1996*
	£m	*£m*
Tier 1	**4,878**	4,393
Tier 2 and Tier 3	**2,500**	2,475
less supervisory deductions	**(947)**	(806)
Total regulatory capital	**6,431**	6,062
Total risk weighted assets:		
Banking book	**54,680**	49,084
Trading book	**3,297**	2,787
	57,977	51,871
Capital ratios:		
Risk asset ratio	**11.09%**	11.69%
Tier 1 ratio	**8.41%**	8.47%
Equity Tier 1 ratio	**7.64%**	7.85%

Balance sheet

Total assets increased by 22% to £150.8 billion in 1997, principally reflecting the assets acquired with the purchase of Cater Allen. Of this growth, £21.4 billion was funded through the wholesale debt markets and £2.7 billion from retail sources, whilst a further £2.2 billion related to growth in long term assurance funds. As at 31



Total assets (£bn)

December 1997, wholesale liabilities represented 55% of total liabilities. During 1997, UK mortgage assets grew by £0.8 billion. The percentage of UK mortgage assets funded from retail savings has increased from 76% in 1996 to 80% in 1997.

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

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

Credit risk
Credit risk is the risk that counterparties will not meet their financial obligations, which may result in Abbey National losing the principal amount lent, the interest accrued, and any unrealised gains (less any security held). Credit risk occurs mainly in UK Retail Banking's residential mortgage portfolio and unsecured lending, in Finance House's unsecured lending, and in wholesale lending and derivatives activity by Treasury & Offshore.

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

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

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

Market risk
Market risk in UK Retail Banking arises primarily from fixed rate mortgage and savings products, and in ANTS as a result of investment, trading and funding activities. For a description of the sources of risk, see page 84. The principal aim of the Group's market risk exposure management is to limit the adverse impact of

interest and other rate movements on profitability. Abbey National's aim is to ensure that business areas have sufficient expertise to manage the risks associated with their operations, and to devolve the responsibility for risk management. Within this framework, policies, limits and mandates are established and monitored by ALCO each month.

In measuring exposure to market risk, all segments use a sensitivity analysis approach. This measures the potential change in fair value of assets and liabilities (including derivatives) resulting from the statistically determined potential adverse movement in interest rates and foreign exchange rates that is expected over a selected period of time and within a defined level of confidence.

a) For Treasury & Offshore, the sensitivity measure used to monitor both the trading and non-trading operations is calculated by applying the statistically determined potential adverse movements in market rates that can be expected within a 95% level of confidence as a result of overnight market movements.

b) For other segments, including UK Retail Banking, the sensitivity measure is calculated by applying the statistically determined potential adverse movements in market rates that can be expected within a 99% level of confidence as a result of market movements over a one month time horizon.

It should be noted that due to the range of possible modelling techniques and assumptions and their statistical nature, these measures are not precise indicators of expected future losses but are estimates of the maximum foreseeable change in the fair value of the portfolio over a specified time horizon and within a given confidence level. Actual results could differ materially from those estimated below. For more complex interest rate products entered into by Treasury & Offshore, risk exposures are calculated using several alternative models. Where exposures thus calculated differ significantly from approved models, a provision is made for the greater of these exposures for monitoring and reporting purposes.

Within the Life Division, market risk arises on the returns from the long term assurance funds. This risk is managed within a framework of mandates delegated to the life assurance subsidiaries' boards.

The following table sets forth the sensitivity-based exposures for the major risk classes run by the Group as a whole as at 31 December 1997, together with the highest, lowest and average exposures for the year. These figures are based upon market movements over a one month time horizon and within a 99% level of confidence. All averages are calculated using monthly exposure measures.

	For the year ended 31 December 1997			
	Exposure as at December 1997	*Average exposure*	*Highest exposure*	*Lowest exposure*
	£m	*£m*	*£m*	*£m*
Trading instruments				
Interest rate risk	16.93	7.72	16.93	–
Non-trading instruments				
Interest rate risk	48.39	62.83	91.63	46.94
Foreign exchange risk	1.60	2.16	3.80	1.60
Basis risk	3.22	3.94	4.25	3.22

Trading instruments are held only in Treasury & Offshore.

The above sensitivity exposures should not be aggregated, as no account has been taken of the correlation between risk classes and between the trading and non-trading instruments.

Liquidity risk

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

Derivatives

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

For a further description of the Group's use of derivatives and the associated accounting policy see pages 55 and 83.

Foreground: Ian Kelly, Sales Team Leader, Liverpool.
Background: Mortgage Centre, Sheffield.

The Board


The Lord Tugendhat


Peter Birch


Ian Harley


Mair Barnes


Sir Terry Heiser


Tim Ingram


Gareth Jones


Martin Llowarch


Peter Ogden

The Lord Tugendhat
Chairman
Appointed to the Board as joint Deputy Chairman on 1 June 1991 and as Chairman on 1 July of that year. He is also non-executive Chairman of Blue Circle Industries PLC, a non-executive director of Eurotunnel plc and of Rio Tinto PLC.

Formerly a Member of Parliament, he was successively a Member (1977-1981) and a Vice President (1981-1985) of the Commission of the European Communities. He was previously Chairman of the Civil Aviation Authority, a Deputy Chairman of National Westminster Bank plc and Chairman of the Royal Institute of International Affairs (Chatham House). Aged 61.

Peter Birch CBE FCIB *
Chief Executive (retires 28 February 1998)
Joined Abbey National as Chief Executive in 1984. He is also Chairman of Abbey National Treasury Services plc, a non-executive director of Scottish Mutual Assurance plc and Dah Sing Financial Holdings Limited and a director of the Corporate Trustee for the four Abbey National pension schemes. He is a non-executive director of Argos plc, Dalgety PLC and Land Securities PLC. In addition, he is the Deputy President of the British Bankers' Association, a past member of the Bank of England Deposit Protection Board, a pension trustee for Cap Gemini and President of Middlesex Young Peoples' Club. Aged 60.

Ian Harley FCA *
Finance Director
Ian Harley will succeed Peter Birch as Chief Executive on 1 March 1998.

After joining Abbey National in 1977 as a Financial Analyst, he progressed through two management appointments in the Finance Division before being appointed Regional Manager responsible for the Retail Division's network in the South East of England in 1984.

He then became Commercial Manager in the Business Development Division in 1986, where he was involved in various acquisitions before being appointed Assistant General Manager, Finance in 1988 and Finance Director, Retail Operations in 1991. In 1992 he became Retail Division's Operations Director, controlling all of Abbey National's UK branches, mortgage and cheque centres.

He was appointed Group Treasurer and Chief Executive of Abbey National Treasury Services plc in October 1992 and joined the Board of Abbey National plc in 1993 as Finance Director. Aged 47.

Mair Barnes #
Appointed to the Board in 1992. She is Executive Chairman of Vantios Plc, the parent company of Dollond & Aitchison, and a non-executive director of George Wimpey PLC. From 1987 until February 1994 she was Managing Director of Woolworths plc. Aged 53.

Sir Terry Heiser GCB +
Appointed to the Board in 1992. Currently a non-executive director of J Sainsbury plc and Wessex Water plc. He is also a director of the Personal Investment Authority. He was formerly with the Civil Service, holding various senior positions, including Permanent Secretary to the Department of the Environment from 1985 to June 1992. Aged 65.

Tim Ingram FCIB *
Managing Director, Europe and First National Finance Corporation
Appointed to the Board in August 1996. Chief Executive of First National Finance Corporation plc (FNFC) since its acquisition by Abbey National in 1995, he is also responsible for Household Mortgage Corporation and Abbey National's French, Italian and Spanish operations. He previously worked for 22 years for ANZ Grindlays Bank where he held a number of senior international banking positions. Aged 50.

Gareth Jones FCA FCT *
Managing Director, Treasury and Wholesale Banking
Appointed to the Board in 1993. He joined Abbey National in 1989 as Assistant General Manager and Group Treasurer and in July 1989 was appointed Chief Executive, Abbey National Treasury Services plc. After serving as Director, Retail Operations he was reappointed Group Treasurer and Chief Executive, Abbey National Treasury Services plc in September 1993. He is also a non-executive director of Marley plc. Aged 49.

Martin Llowarch FCA +#
Deputy Chairman
A Board member since 1989, he became a non-executive Deputy Chairman in 1994. He is Chairman of Transport Development Group plc and Firth Rixson plc and a non-executive director of Hickson International plc. His past appointments include director and Chief Executive of British Steel plc. Aged 62.

Peter Ogden
Appointed to the Board in September 1994. He is Chairman of Computacenter Limited, a director of Omnia Limited, which is an investment management company, and a non-executive director of Anglo & Overseas Trust PLC. He was previously a Managing Director of Morgan Stanley & Co. Aged 50.

Mark Pain FCA *
Finance Director designate
Mark Pain will succeed Ian Harley as Finance Director on 1 March 1998.

Appointed to the Board in January 1998. After joining Abbey National in 1989, he has held a number of senior management positions in the Company including Group Financial Controller, Regional Director responsible for the Retail Division's network in the North East and West of England and Manager, European Operations. Aged 36.

Andrew Pople *
Managing Director, Retail Division
Appointed to the Board in August 1996. Since joining Abbey National in 1988, he has held a number of senior positions including Chief Executive, Scottish Mutual, Head of the Life Division and Regional Director responsible for


Mark Pain


Andrew Pople


The Lord Rockley


The Lord Shuttleworth


Charles Toner


Ian Treacy


James Tuckey


Charles Villiers


Keith Woodley

the branch network in Central Region. Current responsibilities include the development of all Abbey National-branded retail businesses in the UK, including savings, lending, banking and life, general and healthcare insurance. Aged 40.

The Lord Rockley +
Joined the Board in 1990. He is a non-executive director of the Kleinwort Benson Group plc, which incorporates a merchant bank used by Abbey National. He is also a non-executive director of Christie's International plc, The Foreign and Colonial Investment Trust PLC and Cobham plc. Aged 63.

The Lord Shuttleworth JP FRICS #
Deputy Chairman
Appointed to the Board as a Deputy Chairman in August 1996. Previously Chairman of the National and Provincial Building Society. He is also Lord-Lieutenant for the County of Lancashire. Aged 49.

Charles Toner *
Deputy Chief Executive
A Board member since 1992, he was appointed Deputy Chief Executive in August 1996. Since joining Abbey National in 1964, he has held a number of executive positions, including appointments as a General Manager and Managing Director, Retail Division. Current responsibilities include the Life Division and the newly established Wealth Management Division which encompasses the Scottish Mutual businesses in Glasgow and Dublin, benefit consulting and the offshore retail operations. He is also a non-executive director of the National House Building Council and Deputy Chairman of the Council of Mortgage Lenders. Aged 56.

Ian Treacy FCA *
Director and Secretary
Appointed to the Board in January 1998. He joined Abbey National in 1983 as Manager, European Operations and was appointed Deputy Secretary in 1986 and Company Secretary and a member of the Executive Committee in 1991. He is responsible for the Group Risk Division. Aged 53.

James Tuckey FRICS #
Appointed to the Board in 1990. He is currently Chief Executive of MEPC plc. Aged 51.

Charles Villiers FCA *
Managing Director, Corporate Development
A Board Member since 1989. He is also a non-executive director of Debenham, Tewson and Chinnocks Holdings PLC. He was formerly the Chief Executive of NatWest Investment Bank Ltd, an executive director of National Westminster Bank plc and the Chairman of County NatWest Ltd. He is also responsible for information technology. Aged 57.

Keith Woodley FCA +
Appointed to the Board in August 1996. Previously a non-executive director of National and Provincial Building Society from 1991. He is a past President of the Institute of Chartered Accountants in England & Wales and Complaints Commissioner for the London Stock Exchange, the Personal Investment Authority and the Securities and Futures Authority. He is also a Council Member of the National Association of Citizen's Advice Bureaux. Aged 58.

Peter Birch retires from the Board on 28 February 1998, Allan Denholm retired on 24 April 1997 and Alastair Lyons resigned on 4 April 1997.

- * Executive Director
- \+ Audit Committee Member
- \# Personnel and Remuneration Committee Member

If the dates of appointment to the Board are before 12 July 1989, then these dates refer to appointments to the Board of Abbey National Building Society, the predecessor of Abbey National plc. All those directors concerned were appointed to the Board of Abbey National plc on 28 February 1989.

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

Number of meetings attended

Board meetings	
The Lord Tugendhat	12
Peter Birch	12
Ian Harley	12
Mair Barnes	12
Sir Terry Heiser	11
Tim Ingram	12
Gareth Jones	12
Martin Llowarch	12
Peter Ogden	10
Andrew Pople	12
The Lord Rockley	12
The Lord Shuttleworth	11
Charles Toner	11
James Tuckey	11
Charles Villiers	11
Keith Woodley	12
Audit Committee	
Keith Woodley	4
Sir Terry Heiser	5
Martin Llowarch	5
The Lord Rockley	4
Personnel and Remuneration Committee	
Martin Llowarch	5
Mair Barnes	5
The Lord Shuttleworth	5
James Tuckey	4

In 1997, there were 12 full Board meetings, 5 Audit Committee meetings and 5 Personnel and Remuneration Committee meetings.

Directors' Report

The directors have pleasure in presenting their report for Abbey National plc for the year ended 31 December 1997.

Principal activities

The principal activity of Abbey National plc and its subsidiaries continues to be the provision of an extensive range of personal financial services. The Operating and Financial Review for the year, including a review of non-banking activities, is set out on pages 8 to 24 of this document. Note 23 to the accounts on pages 70 and 71 provides a list of the principal subsidiaries and the nature of each company's business as well as details of overseas branches. Details of important events which have occurred since the end of the financial year and prospects for 1998 are included in the Chairman's Statement, and in the Operating and Financial Review under Development of the business.

Results and dividends

The profit on ordinary activities before tax for the year ended 31 December 1997 was £1,279 million (1996: £1,167 million).

An interim net dividend of 10.20 pence per ordinary share was paid on 6 October 1997 (1996: 8.70 pence per ordinary share).

The directors propose a final net dividend for the year of 20.50 pence per ordinary share (1996: 17.40 pence per ordinary share) to be paid on 5 May 1998.

Corporate Governance

A report on corporate governance is set out on pages 42 to 46.

Payment policy and practice

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

The Company's practice on payment of creditors has been quantified under the terms of the Companies Act 1985 (Directors' Report) (Statement of Payment Practice) Regulations 1997. The number of days' supplier invoices which are included in trade creditors at 31 December 1997 is 30. The equivalent period calculated for the UK Group is 29 days.

Environmental policy

The Company considers environmental issues, wherever practicable, in all business areas - in investment and lending decisions, in the design and management of its buildings, in choosing suppliers and in the way resources are used. The Company has initiated a recycling campaign to increase its recycling of waste and packaging and an Environmental Working Group is in place that co-ordinates environmental initiatives with reports to the Board. An updated environmental policy was approved at the October Board meeting.

Employees

Abbey National's commitment to involve employees as financial stakeholders in the business continued this year with a further invitation to eligible employees to participate in the Company's Sharesave scheme. During 1997, two issues under the Sharesave scheme matured at a time when the share price had grown to around £8.50 per share. Employees were able to purchase shares at £1.49 and £2.39, being the prices set at the outset of the respective issues. Through the various schemes that have been introduced over the years virtually all employees have a shareholding interest in the Company.

Employee communications are vital to the success of Abbey National and the Company adopts a comprehensive approach using a variety of media. Through the regular use of electronic mailing, videos and newsletters the Company aims to ensure that employees are fully informed of news and developments including information on Company performance. Abbey National also runs schemes to encourage and reward employees for their ideas and suggestions to improve the business. Employee consultation through the Abbey National Staff Association takes place at both national and local level.

Abbey National's commitment to equality of opportunity and support of national campaigns such as Opportunity 2000 and Race for Opportunity continued throughout the year.

Individual members of staff have continued to take part in mentoring programmes, such as the National Mentoring Consortium, which offers support and guidance to ethnic minority undergraduates. In Milton Keynes, projects like the Equal Choices Schools Initiative, which aims to broaden the career aspirations of ethnic minority students, demonstrate the Company's practical commitment to reflecting the diversity of the communities we serve. This innovative initiative, which operates in partnership with three other Milton Keynes-based employers, won a silver award in this year's prestigious British Diversity Awards.

As a user of the Department of Employment Service "Positive about Disabled People" symbol, we continue to encourage applications from people with disabilities and take all practical measures to assist in the recruitment, retention and career development of disabled people.

Share capital

The authorised and issued share capital of the Company are detailed in note 39 to the accounts on pages 79 and 80.

During the year, 4,681,433 ordinary shares were issued on the exercise of options under the Sharesave scheme, 18,750 ordinary shares were issued on the exercise of options under the terms of the Employee Share Option scheme and 779,495 ordinary shares were issued under the terms of the Executive Share Option scheme. No shares were issued under the terms of the Share Participation scheme. It is intended that shares to meet future grants under the Executive Share Option scheme will be purchased in the market by an Employee Trust.

On 9 June 1997, the Company issued 125,000,000 8.625% non-cumulative sterling preference shares of £1 each.

At the Annual General Meeting on 24 April 1997 shareholders authorised the Company to make market purchases of its own shares, to a maximum of 140,723,085 ordinary shares of 10 pence each. No purchases have been made during the year under this authority. This authority remains valid until the forthcoming Annual General Meeting, when it is intended that a resolution will be put to shareholders to renew it.

Market value of land and buildings

On the basis of a regular valuation review process, the estimated market value of the Group's land and buildings was below the fixed asset net book value of £383m, as disclosed in note 25 to the accounts, by approximately £51m as at 31 December 1997. It is considered that, except where specific provisions have been made, the land and buildings have a value in use to the Group which exceeds the estimated market value, and that the net book value is not permanently diminished. Provisions of £7m have been made for the cost of empty premises.

Charitable donations

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

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

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

The Trust has continued to give priority to charities working to improve equality of opportunity for people with disabilities. It has also given major support to charities helping homeless people and families in crisis. The Trust supports the charity fund raising efforts of Abbey National staff, which included the raising of over £100,000 for Children in Need. The Company also sponsors the RADAR People of the Year Awards.

Political contributions

No contributions were made for political purposes.

Directors and directors' interests

Details of all the current directors are included on pages 26 and 27.

Peter Birch retires from the Board on 28 February 1998, Allan Denholm retired on 24 April 1997 and Alastair Lyons resigned on 4 April 1997.

On 1 January 1998, Mark Pain and Ian Treacy were appointed to the Board and, having been appointed since the last Annual General Meeting they will retire and, being eligible, offer themselves for election at the forthcoming Annual General Meeting.

All other directors listed on pages 26 and 27 have served on the Board for the whole of the period 1 January 1997 to 31 December 1997. Ian Harley, Sir Terry Heiser, Martin Llowarch, Peter Ogden and Lord Tugendhat will retire by rotation at the Annual General Meeting and, all being eligible, offer themselves for re-election.

No director had a material interest in any contract of significance, other than a service contract, with the Company or any of its subsidiaries at any time during the year. Disclosures required by Financial Reporting Standard (FRS) 8, 'Related Party Disclosures', are set out in note 51 on pages 90 and 91 of the accounts.

Directors' interests in the shares of the Company, awards under the Long Term Incentive Plan and options to acquire shares are set out in the Report of the

Personnel and Remuneration Committee on pages 32 to 41.

Substantial shareholdings

The Company has received a notification from the Prudential Corporation group of companies that, as at 28 November 1997, they held 44,820,003 ordinary shares of 10 pence each which represented 3.17% of the issued ordinary share capital of the Company. No further disclosable interest in the issued ordinary share capital has been notified to the Company in accordance with Sections 198 to 208 of the Companies Act 1985.

Auditors

A resolution to re-appoint Coopers & Lybrand as auditors will be proposed at the forthcoming Annual General Meeting.

Annual General Meeting

Details of the business of the Annual General Meeting can be found in the accompanying booklet entitled "Notice of Annual General Meeting 1998".

By Order of the Board

Ian K. Treacy

Ian K Treacy
Director and Secretary
25 February 1998

Report of the Personnel and Remuneration Committee

The purpose of this report is to inform shareholders of the Board's policy on directors' remuneration and to provide details of the remuneration arrangements of individual directors.

Remuneration strategy

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

Personnel and Remuneration Committee

Remuneration arrangements are supervised by a Personnel and Remuneration Committee. This Committee exists to provide a mechanism through which the Board can satisfy itself that the Company is adopting human resources policies which are consistent with the Company's business objectives and philosophy. It has written terms of reference which include a remit to determine the Company's policy on executive directors' remuneration and to set the remuneration of each executive director, including pension rights and any compensation payments. The Committee, which is chaired by myself, also comprises Mair Barnes, Lord Shuttleworth and James Tuckey. Its membership is restricted to independent non-executive directors although the Committee consults, as appropriate, with both the Chairman and the Chief Executive. The Committee is assisted in its deliberations by the Human Resources Director and takes advice from time to time from external advisers. The Committee's constitution and operation have complied throughout 1997 with the best practice provisions set out in Section A of the Annex to the London Stock Exchange Listing Rules, and the Committee, in framing the remuneration policy, has given full consideration to Section B of that Annex.

Remuneration policy for executive directors

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

- establishes a remuneration structure which will attract, retain and motivate executive directors of appropriate calibre;
- rewards executive directors based on their performance and as strategic objectives are met;
- establishes an appropriate balance between fixed and variable elements of total remuneration;
- aligns the interests of shareholders and executive directors by encouraging executive directors to build up a shareholding in the Company; and
- ensures that basic salaries are around the median for our comparator group.

The comparator group used when considering remuneration matters comprises retail banks, including those which have recently converted from building society status, insurance companies with which Abbey National competes and other companies in a variety of fields with a market capitalisation broadly similar to

Abbey National's. The Committee obtains advice and information from external experts when making its comparisons.

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

The remuneration package is made up of the following elements:

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

- **Annual performance related bonus**
  The discretionary annual performance related bonus scheme is designed to provide a direct link between each individual's remuneration and the performance of the Company in the short term. It is thus based on both individual and Company performance. It will pay out in March 1998 in relation to performance in 1997. The maximum potential cash payment, to be shared among the executive directors and other members of the top management team, is 30% of that group's basic salary earned during the year.

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

  The Committee pays particular attention to certain quantifiable targets and may then modify that assessment in the light of its view of performance against qualitative objectives, such as customer service, product quality, and the dynamics of the market. The key financial targets for 1997 were: budgeted levels of operating expenses and income; market share targets for key products; and a specified measure of shareholder value (known as the value based management profit after capital charge). In setting the level of bonuses, the Personnel and Remuneration Committee is guided by a formula which envisages an on-target performance equating to half the maximum potential cash payment.

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

- **Long Term Incentive Plan**
  A Long Term Incentive Plan for senior executives was adopted at the 1997 Annual General Meeting. It is designed to enhance the link between the remuneration of executives and the Company's medium and long term performance and incorporates challenging performance targets, measured over a three-year period. The performance targets are based on the share price and dividend performance (total shareholder return) of the Company relative both to specified financial institutions and the constituents of the FTSE 100 Share Index. For the 1997-1999 performance period the specified

financial institutions are: Bank of Scotland, Barclays, Lloyds TSB, National Westminster, Royal Bank of Scotland, Legal & General, Prudential, Commercial Union, General Accident and Royal Sun Alliance. The conversion of a number of building societies to banks during 1997 has given the Committee the opportunity to alter the composition of the group to reflect better the spread of Abbey National's business. For the 1998-2000 performance period the specified financial institutions are: Bank of Scotland, Barclays, Lloyds TSB, National Westminster, Royal Bank of Scotland, Legal & General, Prudential, Alliance & Leicester, Halifax, Northern Rock and Woolwich.

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

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

The Plan is currently open only to the 10 members of the Executive Committee. Details of the grants to directors under this Plan are set out below.

- **Previous long term incentives**
  Prior to the introduction of the Long Term Incentive Plan, the Company's long term incentive arrangements consisted of a three year cash bonus scheme and an Executive Share Option scheme. No new awards have been made under the three year cash bonus scheme since March 1996 and no payments will be made under the scheme after March 1999.

  Payments under the three year bonus scheme will be made in March 1998 for the period 1995 to 1997 and may be made in March 1999 for the period 1996 to 1998. The maximum potential cash payment under the scheme, to be shared among the executive directors and other members of the top management team, is 30% of that group's basic salary.

  In determining whether or not to make a payment under the three year bonus scheme, and if so its size, the Personnel and Remuneration Committee will be guided by a formula which compares, over the relevant three year period, total shareholder return (i) against the FTSE 100 Share Index, and (ii) against specified quoted competitors. Originally it had been the Committee's intention to include a third comparator group consisting of building societies but the various changes in the sector have led the Committee to conclude that this comparison is not practical. The maximum bonus is paid for performance in the top quartile and there is no payment for performance in the bottom quartile with pro rata payments in between.

Each of the executive directors participates in the three year bonus scheme pro rata to his service in that period. In respect of the 1995-1997 scheme, entitlements represented 25% of participants' salaries at 31 December 1997 and are detailed below.

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

Future participation in the Company's Executive Share Option scheme will be primarily confined to less senior executives, comprising a group of approximately 120 managers.

- **Other payments**
  In addition, the Personnel and Remuneration Committee may in certain circumstances make an ex-gratia payment. The circumstances in which such a payment may be paid include an individual executive director rendering a particular and outstanding contribution. Ex-gratia payments may also be made where the employment market for particular directors suggests that median remuneration for specialist jobs is higher than that being paid to the executive directors concerned. A payment for this reason was made to Gareth Jones in respect of 1997 and this is shown under the "Other payments" column on page 37.

  Andrew Pople has received an ex-gratia payment in consideration of the disturbance and attendant expenses including income tax which he incurred in relocating his home and family from Glasgow to London at the Company's request. The Company also reimbursed his direct relocation expenses which totalled £102,184. Those which were reimbursed after he became a director are included in his taxable benefits in 1996 and 1997.

- **Benefits**
  There is an Employee Sharesave scheme, and an Employee Share Option scheme both of which have been approved by shareholders. Membership of all these schemes is available to employees including executive directors, and their interests are set out below.

  Taxable benefits for executive directors include medical expenses, relocation expenses and subsidised mortgage loans.

Service contracts

Executive directors seeking election or re-election at the 1998 Annual General Meeting will each have an unexpired contract term of one year. Non-executive directors do not have service contracts, save for the Chairman whose contract is renewable on an annual basis at the first Board meeting in each year following the Annual General Meeting and provides for payment of fees for a period of twelve months.

All of the executive directors have rolling one year service contracts, but if an executive director is made redundant under employment law, he may claim a total payment (which would include payment in lieu of notice period) of up to a maximum of two years' salary depending on length of service. Fifteen years of continuous service would be required to secure this maximum payment. This provision is in line with Abbey National's well established practices on redundancy which equally apply to the service contracts of the members of the Abbey National executive management group. During the year Alastair Lyons resigned to become Chief Executive of another financial services provider and, in accordance with the terms applicable to former National and Provincial Building Society (N&P) employees, he was entitled to receive 6 weeks salary for each complete year of service since 1 March 1991, 104 weeks pay in lieu of notice and a payment representing compensation for loss of additional pension benefits to which he would have been entitled under the terms of his contract. These arrangements were inherited by Abbey National on the purchase of the business of N&P. Full details of his emoluments are included in the table below.

Non-executive directors

The remuneration arrangements of the Chairman and non-executive directors are as follows:

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

Fees are paid to non-executive directors. The basic fee for non-executive directors during 1997 was £20,000 per annum augmented by £5,000 for service on Board committees.

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

Directors' emoluments

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

	Salary/ Fee £	*Annual performance related bonus* £	*3 year performance related bonus* £	*Other payments* £	*Taxable benefits* £	*1997 Total* £	*1996 Total* £
The Lord Tugendhat (Chairman)	292,800				15,056	307,856	288,128
Executive directors							
P G Birch (Chief Executive)	440,000	105,600	110,000		1,569	657,169	600,903
J M Fry (retired 17 April 1996) (1)							144,928
I Harley	260,000	62,400	65,000		1,670	389,070	345,381
T C W Ingram	190,000	45,600	38,264		416	274,280	131,951
D G Jones	240,000	57,600	60,000	65,000	866	423,466	371,356
R F Knighton (resigned 31 December 1996) (1)							407,911
A D Lyons (resigned 4 April 1997)	69,496	16,679	14,533	1,234,822	1,080	1,336,610	125,253
A H Pople	210,000	50,400	52,500	63,000	36,523	412,423	163,542
C G Toner	240,000	57,600	60,000		2,246	359,846	326,051
C N Villiers	250,000	60,000	62,500		1,100	373,600	322,256
Non-executive directors							
M Barnes	25,000				731	25,731	22,045
J A Denholm (retired 24 April 1997)	2,500					2,500	26,000
Sir Terence Heiser	25,000				320	25,320	21,078
M E Llowarch	42,500				921	43,421	35,277
P J Ogden	20,000					20,000	18,000
The Lord Rockley	25,000					25,000	21,000
The Lord Shuttleworth	40,000				289	40,289	13,278
J L Tuckey	25,000					25,000	21,000
K S Woodley	25,000				1,916	26,916	7,864
Totals	2,422,296	455,879	462,797	1,362,822	64,703	4,768,497	3,413,202

Note:

(1) During the year ended 31 December 1997, payments were made to two former directors under the terms of the three year cash bonus scheme. Payments of £51,667 and £18,667 were made to R F Knighton and J M Fry respectively relating to the period in which they both served as directors.

Directors' pensions

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

The following table shows an analysis of the accrued pension benefits as at 31 December 1997 for executive directors participating in the Company's defined benefits pension schemes. Further information concerning the Company's pension schemes is set out in note 49 to the accounts.

	Contributions from directors during 1997 £	*Increase in accrued pension during 1997* (1) (4) £	*Transfer value of the increase in accrued pension during 1997* (2) £	*Total accrued pension as at 31 December 1997* (3) £	*Total accrued pension as at 31 December 1996* £
Executive directors					
P G Birch (Chief Executive) (5)	4,400	52,475	845,727	293,328	235,899
I Harley	6,656	19,251	232,373	101,692	80,745
D G Jones	66,137	20,119	192,769	54,000	33,184
A D Lyons (resigned 4 April 1997)	3,125	3,192	29,602	40,999	37,807
A H Pople	6,699	14,861	121,888	38,850	23,496
C G Toner	2,400	20,086	315,229	148,927	126,191
C N Villiers	55,034	23,272	323,632	102,498	77,596
Totals	144,451	153,256	2,061,220	780,294	614,918

Notes:

(1) The increase in accrued pension during 1997 represents the increase in the annual pension which each director would be entitled to receive from normal retirement age (less the statutory inflationary increase of 2.1%, where relevant) if he had left service voluntarily at 31 December 1997 or at his actual retirement date if earlier.

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

(3) The accrued pension as at 31 December 1997 represents the annual pension which each director would be entitled to receive from normal retirement age if he had left service voluntarily at 31 December 1997 or at his actual retirement date if earlier.

(4) The figure for the increase in accrued pension during 1997 which appears in the table does not in all cases equal the difference between the total accrued pension as at 31 December 1997, and the total accrued pension as at 31 December 1996. The difference arises where the increase in accrued pension is stated after deducting the statutory inflationary increase which would have been applied to the deferred pension entitlement had the director left at the start of the year. This deduction has been made where directors have been in service for the whole year, and is made in order to present a figure showing that element of the increase which results from an extra full year of service and from changes in remuneration.

(5) P G Birch retires from the Board on 28 February 1998. He will retire from the Company on 30 April 1998.

(6) The pension provision for T C W Ingram has been made on a defined contributions basis during 1997. The cost of this provision, including ancillary benefits, amounted to £22,900 during the year. He made contributions of nil during the year.

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

Gains made on exercise of directors' share options

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

	1997 £	*1996* £
P G Birch	123,376	–
I Harley	9,547	15,878
D G Jones	514,285	8,589
C G Toner	9,547	5,939
The Lord Tugendhat (Sharesave scheme only)	47,737	–
C N Villiers	9,547	6,189
	714,039	36,595

Note:

(1) Details of the options giving rise to these gains are set out on pages 39 to 41. The gains are based on the amount by which the market value of shares on the date of exercise exceeded the option price, irrespective of whether the shares were sold or retained.

Directors' share interests

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

Ordinary shares:

	No. of shares	
	At 1.1.97	*At 31.12.97*
M Barnes	1,000	1,000
P G Birch	313,838	336,708
I Harley	27,643	29,212
Sir Terry Heiser	1,500	1,500
T C W Ingram	18,150	18,900
D G Jones	68,576	66,145
M E Llowarch	1,750	1,750
P J Ogden	4,000	4,000
A H Pople	4,386	3,554
The Lord Rockley	5,000	5,000
The Lord Shuttleworth	816	816
C G Toner	21,898	23,551
J L Tuckey	12,000	12,000
The Lord Tugendhat	10,000	17,845
C N Villiers	26,323	25,492
K S Woodley	660	2,160

In addition, at 31 December 1997, T C W Ingram held £116,529 Abbey National Floating Rate Unsecured Loan Notes 2000 issued on 23 August 1995 in consideration for shares held in FNFC plc (1996: £232,529).

Share options:

		No. of options				*Market price*	*Date from*		
				At	*Exercise*	*at date of*	*which*	*Expiry*	
	At 1.1.97	*Granted*	*Exercised*	*31.12.97*	*price £*	*exercise £*	*exercisable*	*date*	*Notes*
P G Birch	8,456		8,456		1.49	8.450	01/07/97	31/12/97	Sharesave
	1,939			1,939	2.32		01/10/98	31/03/99	Sharesave
	1,882			1,882	2.39		01/06/99	30/11/99	Sharesave
	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
		568		568	6.07		01/04/02	30/09/02	Sharesave
	14,134		14,134		2.99	7.555	05/05/95	05/05/02	Executive
	69,478			69,478	2.99		05/05/95	05/05/02	Executive[1]
	25,215			25,215	3.69		29/03/96	29/03/03	Executive
	8,404			8,404	3.69		29/03/96	29/03/03	Executive[2]
	60,897			60,897	4.68		11/04/97	10/04/04	Executive
	71,500			71,500	4.83		10/04/98	09/04/05	Executive
	97,765			97,765	5.37		29/08/98	28/08/02	Executive*
	150			150	5.91		09/09/99	08/09/06	Employee
	362,238	568	22,590	340,216					
I Harley	1,569		1,569		2.39	8.475	01/06/97	30/11/97	Sharesave
	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
		568		568	6.07		01/04/02	30/09/02	Sharesave
	15,000			15,000	3.69		29/03/96	29/03/03	Executive
	6,825			6,825	3.69		29/03/96	29/03/03	Executive[2]
	23,237			23,237	4.68		11/04/97	10/04/04	Executive
	7,745			7,745	4.68		11/04/97	10/04/04	Executive[2]
	40,500			40,500	4.83		10/04/98	09/04/05	Executive
	38,053			38,053	5.65		25/03/99	24/03/06	Executive
	36,379			36,379	5.91		09/09/99	08/09/06	Executive*
	150			150	5.91		09/09/99	08/09/06	Employee
	171,876	568	1,569	170,875					

Share options (continued):

	At 1.1.97	No. of options Granted	Exercised	At 31.12.97	Exercise price £	Market price at date of exercise £	Date from which exercisable	Expiry date	Notes
T C W Ingram	3,701			3,701	4.66		01/04/01	30/09/01	Sharesave
	4,180			4,180	4.097		31/08/96	30/08/03	Executive#
	25,663			25,663	5.65		25/03/99	24/03/06	Executive
	150			150	5.91		09/09/99	08/09/06	Employee
	33,694			33,694					
D G Jones	1,569		1,569		2.39	8.425	01/06/97	30/11/97	Sharesave
	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
		568		568	6.07		01/04/02	30/09/02	Sharesave
	23,322		23,322		2.54	10.570	05/05/97	05/05/02	Executive
	25,575		25,575		3.69	10.570	29/03/96	29/03/03	Executive
	8,525			8,525	3.69		29/03/96	29/03/03	Executive(2)
	24,038		24,038		4.68	10.570	11/04/97	10/04/04	Executive
	8,012			8,012	4.68		11/04/97	10/04/04	Executive(2)
	39,500			39,500	4.83		10/04/98	09/04/05	Executive
	36,106			36,106	5.65		25/03/99	24/03/06	Executive
	22,829			22,829	5.91		09/09/99	08/09/06	Executive#
	150			150	5.91		09/09/99	08/09/06	Employee
	192,044	568	74,504	118,108					
A H Pople	1,939			1,939	2.32		01/10/98	31/03/99	Sharesave
	1,882			1,882	2.39		01/06/99	30/11/99	Sharesave
	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
		568		568	6.07		01/04/02	30/09/02	Sharesave
	25,000			25,000	4.00		01/09/97	31/08/04	Executive
	30,000			30,000	4.83		10/04/98	09/04/05	Executive
	23,008			23,008	5.65		25/03/99	24/03/06	Executive
	150			150	5.91		09/09/99	08/09/06	Employee
	84,397	568		84,965					
C G Toner	1,569		1,569		2.39	8.475	01/06/97	30/11/97	Sharesave
	2,221			2,221	4.66		01/04/01	30/09/01	Sharesave
	24,449			24,449	3.69		29/03/96	29/03/03	Executive
	8,149			8,149	3.69		29/03/96	29/03/03	Executive(2)
	24,038			24,038	4.68		11/04/97	10/04/04	Executive
	8,012			8,012	4.68		11/04/97	10/04/04	Executive(2)
	39,500			39,500	4.83		10/04/98	09/04/05	Executive
	30,884			30,884	5.65		25/03/99	24/03/06	Executive
	35,364			35,364	5.91		09/09/99	08/09/06	Executive#
	150			150	5.91		09/09/99	08/09/06	Employee
	174,336		1,569	172,767					
The Lord Tugendhat	7,845		7,845		2.39	8.475	01/06/97	30/11/97	Sharesave
	7,845		7,845						
C N Villiers	1,569		1,569		2.39	8.475	01/06/97	30/11/97	Sharesave
	2,418			2,418	4.28		01/10/00	31/03/01	Sharesave
		568		568	6.07		01/04/02	30/09/02	Sharesave
	37,111			37,111	2.99		05/05/95	05/05/02	Executive(1)
	31,145			31,145	3.69		29/03/96	29/03/03	Executive
	10,381			10,381	3.69		29/03/96	29/03/03	Executive(2)
	9,612			9,612	4.68		11/04/97	10/04/04	Executive
	3,204			3,204	4.68		11/04/97	10/04/04	Executive(2)
	32,086			32,086	4.83		10/04/98	09/04/05	Executive
	10,055			10,055	5.65		25/03/99	24/03/06	Executive
	36,988			36,988	5.91		09/09/99	08/09/06	Executive#
	150			150	5.91		09/09/99	08/09/06	Employee
	174,719	568	1,569	173,718					

Replacement options

Notes:
The executive share options detailed above become exercisable if the average growth of earnings per ordinary share exceeds the average increase in the retail prices index in any three years prior to exercise. For those executive options granted in 1997, the average growth of earnings per ordinary share must exceed the average increase in the retail prices index by 2%. Parallel discounted options were granted over the shares noted 1, 2 and 3 and are exercisable as follows:

1. at £2.54 from 5.5.1997 to 5.5.2002. *2.* at £3.14 from 29.3.1998 to 29.3.2003. *3.* at £3.98 from 11.4.1999 to 10.4.2004.

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

The options refer to those granted under the Company's Executive Share Option, Employee Share Option and Sharesave schemes, as set out in note 39 to the accounts.

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

Market price at the date of exercise is the Middle Market Quotation, as derived from the London Stock Exchange Daily Official List. The market price of the shares on 31 December 1997 was 1093p (1996: 765p) and the range during 1997 was 710p to 1200p.

There have been no changes to the beneficial and other interests of the directors in the ordinary shares of the Company as shown above up to 25 January 1998, other than the automatic reinvestment on 2 January 1998 of dividends arising from the Abbey National Personal Equity Plan as follows: P G Birch 63 shares, T C W Ingram 12 shares, A H Pople 4 shares, C G Toner 22 shares and Lord Tugendhat 1 share.

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

	Shares held under Plan at 1.1.97	*Rights granted during year*	*Shares held under Plan at 31.12.97*
I Harley	–	19,527	19,527
T C W Ingram	–	14,270	14,270
D G Jones	–	18,025	18,025
A H Pople	–	15,772	15,772
C G Toner	–	18,025	18,025
C N Villiers	–	18,776	18,776

Notes:
(1) Shares awarded under the Plan during the year were bought in the market and are held by the Abbey National Employee Trust (the 'Trust'), which is administered by an independent professional trustee. The cost of these conditional awards is being charged to the profit and loss account over the three-year performance period to which they relate. In 1997, £278,514 was charged to the profit and loss account. The Plan did not apply in 1996.

(2) Subject to the performance criteria being met, 50% of the above awards are excercisable from 16 May 2000 and the remainder from 16 May 2002. The awards will lapse if not exercised by 16 May 2004. The awards will be included in directors' emoluments in the year of exercise.

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

(4) By virtue of their being potential beneficiaries of the Trust, each executive director is deemed, for the purpose of the Companies Act 1985, to have an interest in the shares held in the Trust. At 31 December 1997, the Trust held 129,780 ordinary shares (31 December 1996 - nil) for the above named directors and other senior executives.

Martin Llowarch
Deputy Chairman and Chairman of the Personnel and Remuneration Committee.
25 February 1998

Corporate Governance

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

In January 1998, the Committee on Corporate Governance (the Hampel Committee) published its final report. The Board supports the broad principles of Corporate Governance advocated by the Committee. How these principles are applied within Abbey National is set out below and in the Report of the Personnel and Remuneration Committee on pages 32 to 41.

Abbey National values its dialogue with both institutional and private investors. Effective two-way communication with fund managers, institutional investors and analysts is promoted and private investors are encouraged to participate in the Annual General Meeting. The Chairman already presents a review of the results and current business activity, and both Keith Woodley, Chairman of the Audit Committee and myself will be available to answer questions, where appropriate, at the AGM. Additionally the Notice of AGM has been produced in plain English and will be sent to shareholders well over 20 working days before the meeting. Shareholders are also given the opportunity of voting separately on each proposal.

The Stock Exchange requires directors to report on compliance with the recommendations set out in the Code of Best Practice published in December 1992 by the Committee on the Financial Aspects of Corporate Governance. The directors have carefully considered these and confirm that Abbey National plc, in the light of the Company's particular circumstances, has met throughout the year and continues to meet these recommendations. Specific statements are provided below on the application of the concept of "going concern" in the accounts, and on internal control.

The Board

Following the retirement of Peter Birch on 28 February 1998, the Board will comprise a part-time Chairman, eight executive directors and eight independent non-executive directors, who bring a wide range of skills and experience to the Board. The full Board met on twelve occasions during 1997, including a separate session specifically devoted to the long term strategic direction of the Group. The Board's focus is on strategy formulation, policy and control and a Framework of High Level Authorities is in place which maps out the structure of delegation below Board level as well as specifying those issues which remain within the Board's preserve. Risk management in banking is critical and the Board has in place policies covering the risks associated with liquidity, foreign exchange, interest rates and credit. During 1997, particular attention was devoted to the development of a comprehensive framework for managing and reporting on operational risks. The roles of Chairman and Chief Executive are separated and clearly defined. The Chairman is primarily responsible for the working of the Board and the Chief Executive for the running of the business and implementation of Board strategy and policy.

A key role is played by the Assets and Liabilities Committee (ALCO), which monitors and controls the level of Group structural balance sheet risk, and by the Group Credit Committee, which reviews and oversees high level credit policies and exposures. ALCO meets monthly, chaired by the Chief Executive, and its membership comprises all the executive directors and some executive managers. Group Credit Committee meets fortnightly and comprises two executive directors plus several members of the executive management group. The Board, at its regular monthly meetings, reviews the minutes of ALCO which incorporate extracts from the minutes of the Group Credit Committee.

The Board has recognised the significant risks faced by all businesses in connection with Year 2000 compliance and has ensured that resources are allocated with the objective of achieving compliance for business critical systems by the end of 1998. It also receives regular reports on progress.

Economic and Monetary Union (EMU) is an initiative without precedent and poses strategic and operational risks to Abbey National, regardless of UK membership. Despite the many uncertainties about the timing and nature of EMU, a programme to monitor developments and assess the impact on Abbey National's customers, markets, products and services has been ongoing since spring 1995. During 1997, EMU plans have been prepared for all businesses around the Group under the management of the EMU Steering Committee, which includes the majority of the executive directors. Abbey National has begun to implement its EMU plans in France, Spain and Italy as all are potential first wave entrants. Treasury & Offshore, and the Investments Division of Scottish Mutual will also be affected because of their involvement in the international wholesale markets. All these areas will therefore aim to be ready to manage the Euro by 1 January 1999.

As Abbey National diversifies, a growing responsibility falls on the boards of directors of its subsidiary companies, particularly those in the life assurance, treasury and consumer credit sectors. Each of these boards (Scottish Mutual Assurance plc, Abbey National Life plc, Abbey National Treasury Services plc, and First National Bank plc) includes at least one independent non-executive director.

All directors have access to the advice and services of the Company Secretary and the Board has established a procedure whereby directors, wishing to do so in the furtherance of their duties, may take independent professional advice at the Company's expense.

Board committees

Two standing board committees are maintained both of which operate within written terms of reference. Their minutes are circulated for review and consideration by the full complement of directors, supplemented by oral reports from the committee chairmen.

The Audit Committee met five times in 1997. Its prime tasks are to review the scope of external and internal audit, to receive regular reports from Coopers & Lybrand and the Chief Internal Auditor, and to review the half yearly and annual accounts before they are presented to the Board, focusing in particular on accounting policies and compliance, and areas of management judgement and estimates. The Committee more generally acts as a forum for discussion of internal control issues. Membership of the Committee is restricted to independent non-executive directors and it is chaired by Keith Woodley, a past President of the Institute of Chartered Accountants in England & Wales.

The Personnel and Remuneration Committee is chaired by myself and met five times in 1997. Its principal function is to monitor the human resource policies of the Group to ensure they are consistent with the Company's business objectives and philosophy. The Committee is also specifically charged with determining the Company's policy on executive director and executive management remuneration. Its report to shareholders on how directors are remunerated, together with details of individual directors' remuneration packages, is to be found on pages 32 to 41.

The Board does not operate a nominations committee and believes that this is appropriate in the light of existing arrangements. Appointments of non-executives are made on a formalised basis with the Chairman agreeing selection criteria with his colleagues. Use is made of independent recruitment consultants. The final decision rests with the full Board, after a period of extensive consultation. Appointments are for an initial term of three years which is extendable upon mutual agreement.

Appointments of executive directors are made on a similar formalised basis and the recent appointment of the new Chief Executive is an example of this process operating in practice.

Peter Birch reached the age of 60, the mandatory retirement age for Abbey National executives, in December 1997. Succession planning had therefore been focused on that date for some years. In 1993 and 1996 a number of younger executives were appointed to the Board both because of the responsibilities that they had been given and with a view to one or more of them emerging as suitable candidates to succeed to the post of Chief Executive on or soon after December 1997.

At a meeting in October 1996, the non-executives concluded that there were four executives with the requisite qualities and it would, therefore, be preferable to make an internal appointment rather than go outside. This view was communicated to the whole Board although going outside in the event of the four proving unsatisfactory remained an option.

In September 1997, a meeting of non-executives accepted a proposal from the Chairman that as the four individuals continued to display the requisite qualities a special Selection Panel of the Board comprising the Chairman plus three other non-executive directors should be constituted. Before the interviews took place the Chairman canvassed the views of the remaining executive directors and reported these to the panel. The panel made a recommendation to a full meeting of the non-executive directors which agreed that Ian Harley should be appointed as Chief Executive. This was endorsed by the whole Board. At each stage there was unanimous agreement.

Pension funds

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

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

Legal advice to the Trustees of the various schemes is provided by external firms of solicitors. The audit of the Abbey National pension schemes is separated from that of Abbey National, being undertaken by Deloitte & Touche, however, Coopers & Lybrand, the Company's auditors, are still retained as auditors to the National and Provincial scheme. The audit of the SMA Staff Pension scheme is undertaken by KPMG Audit Plc.

Going concern

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

Internal control

The Board of Directors has overall responsibility for systems of internal financial control throughout the Abbey National Group, though in the context of the size and complexity of operations it has to be understood that such systems can provide only reasonable and not absolute assurance against material misstatement or loss.

The key elements of internal financial control are set out below, though these should be seen within the wider framework of high level controls described above:

- A planning framework which incorporates a Board approved rolling Three Year Plan, with detailed annual operating objectives and milestones to business unit levels.
- A comprehensive system of financial reporting to the Board, based on an annual budget with monthly reports against actual results, analysis of variances, scrutiny of key performance indicators, plus regular reforecasting.
- Well defined regulations governing appraisal and approval of capital expenditure. These include an annual budget, detailed project approval procedures, incorporating appropriate levels of authority, and a post investment review process.
- A network of financial risk committees, supplemented by Group Risk Department, which operate under the overall framework of a Board endorsed group wide high level "Risk Map".
- The Assets and Liabilities Committee (ALCO) receives regular reports which track the various components of market risk, and also the generation and absorption of capital, and the level, composition and trends in liquidity, including projected demands on liquidity.
- The use of control manuals to document key controls against identified risks, supplemented by procedure manuals at the operating level. Procedures have also been developed whereby management submits Self Certification Statements against material risks. These statements are reviewed by the Audit Committee.

Monitoring of the effectiveness of internal control is undertaken by the Audit Committee, which receives regular reports from Internal Audit, and where relevant from external auditors. The Board also receives regular and exception reports on high level prudential control issues, such as compliance with the Financial Services Act.

The Audit Committee has reviewed the effectiveness of the system of internal financial control which operated during the period covered by this Directors' Report and Accounts.

Martin Llowarch
Deputy Chairman
25 February 1998

Report by the Auditors

To Abbey National plc
on Corporate Governance Matters

In addition to our audit of the accounts, we have reviewed the directors' statements on pages 42 to 46 concerning the Company's compliance with the paragraphs of the Cadbury Code of Best Practice specified for our review by the London Stock Exchange and their adoption of the going concern basis in preparing the accounts. The objective of our review is to draw attention to non-compliance with Listing Rules 12.43(j) and 12.43(v).

Basis of opinion

We carried out our review in accordance with guidance issued by the Auditing Practices Board. That guidance does not require us to perform the additional work necessary to, and we do not, express any opinion on the effectiveness of either the Company's system of internal financial control or its corporate governance procedures, nor on the ability of the Company to continue in operational existence.

Opinion

With respect to the directors' statements on internal financial control and going concern on pages 45 and 46, in our opinion the directors have provided the disclosures required by the Listing Rules referred to above and such statements are not inconsistent with the information of which we are aware from our audit work on the accounts.

Based on enquiry of certain directors and officers of the Company, and examination of relevant documents, in our opinion the directors' statement on page 42 appropriately reflects the Company's compliance with the other aspects of the Code specified for our review by Listing Rule 12.43(j).

Coopers & Lybrand.

Coopers & Lybrand
Chartered Accountants
London
25 February 1998

Directors' Responsibilities for Accounts

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

In respect of the accounts the directors are required to:

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

Auditors' Report

To the Members of Abbey National plc

We have audited the accounts on pages 49 to 91.

Respective responsibilities of directors and auditors

As described above, the Company's directors are responsible for the preparation of the accounts. It is our responsibility to form an independent opinion, based on our audit, on those accounts and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion the accounts give a true and fair view of the state of affairs of the Company and the Group at 31 December 1997 and of the profit, total recognised gains and cash flows of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Coopers + Lybrand.

Coopers & Lybrand
Chartered Accountants and Registered Auditors
London
25 February 1998

Consolidated Profit and Loss Account

For the year ended 31 December 1997

Notes		1997 Before exceptional items £m	1997 Exceptional items £m	1997 Total £m	1996 Total £m
	Interest receivable				
2	Interest receivable and similar income arising from debt securities	2,008		2,008	2,016
3	Other interest receivable and similar income	5,823		5,823	4,544
4	Adjustment to net investment in finance leases	–	(133)	(133)	–
5	Interest payable	(5,809)		(5,809)	(4,766)
	Net interest income	2,022	(133)	1,889	1,794
6	Dividend income	3		3	3
	Fees and commissions receivable	547		547	398
	Fees and commissions payable	(96)		(96)	(62)
	Dealing profits	52		52	29
	Other operating income				
21	Income from long term assurance business	147		147	133
4	Adjustment to income from long term assurance business	–	(12)	(12)	–
7	Other operating income	83		83	54
	Total operating income	2,758	(145)	2,613	2,349
	Administrative expenses				
4	Integration costs in continuing businesses	–		–	(61)
8	Other administrative expenses	(1,096)		(1,096)	(884)
25	Depreciation and amortisation	(98)		(98)	(93)
	Provisions				
10	Provisions for bad and doubtful debts	(121)		(121)	(127)
37	Provisions for contingent liabilities and commitments	(16)		(16)	(4)
19	Amounts written off fixed asset investments	(3)		(3)	(13)
	Profit on ordinary activities before tax	1,424	(145)	1,279	1,167
11	Tax on profit on ordinary activities	(463)	137	(326)	(403)
12	**Profit on ordinary activities after tax**	961	(8)	953	764
	Minority interests - equity	1		1	3
	Profit attributable to the shareholders of Abbey National plc	962	(8)	954	767
40	Transfer to non-distributable reserve	(78)		(78)	(67)
13	Dividends including amounts attributable to non-equity interests	(469)		(469)	(373)
	Profit retained for the financial year	415	(8)	407	327
	Profit on ordinary activities before tax includes:				
	for acquired operations (excluding integrated businesses)			7	8
14	**Earnings per ordinary share**			65.2p	56.5p

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

Consolidated Balance Sheet

For the year ended 31 December 1997

Notes		1997 £m	1997 £m	1996 £m	1996 £m
	Assets				
	Cash and balances at central banks		**329**		228
15	Treasury bills and other eligible bills		**1,628**		111
16	Loans and advances to banks		**8,993**		2,825
17	Loans and advances to customers		**72,834**		64,227
18	Net investment in finance leases		**4,655**		4,310
19	Debt securities		**46,454**		39,730
20	Equity shares and other variable yield securities		**83**		44
21	Long term assurance business		**649**		555
22	Interests in associated undertakings		**21**		8
25	Tangible fixed assets		**698**		689
26	Operating lease assets		**67**		26
27	Other assets		**2,273**		1,509
28	Prepayments and accrued income		**2,023**		1,880
21	Assets of long term assurance funds		**10,101**		7,869
	Total assets		**150,808**		124,011
	Liabilities				
29	Deposits by banks		**24,536**		17,718
30	Customer accounts		**61,675**		49,678
31	Debt securities in issue		**40,201**		35,193
	Dividend proposed		**290**		245
32	Other liabilities		**2,678**		2,980
34	Accruals and deferred income		**2,842**		2,591
35	Provisions for liabilities and charges		**1,144**		970
38	Subordinated liabilities including convertible debt		**2,463**		2,374
21	Liabilities of long term assurance funds		**10,101**		7,869
			145,930		119,618
39	Called up share capital – ordinary shares	**141**		141	
	– preference shares	**325**		200	
39	Share premium account	**1,460**		1,441	
40	Reserves	**308**		230	
40	Profit and loss account	**2,644**		2,381	
41	Shareholders' funds including non-equity interests		**4,878**		4,393
	Total liabilities		**150,808**		124,011
	Memorandum items				
	Contingent liabilities				
43	Guarantees and assets pledged as collateral security		**1,915**		2,570
44	Other contingent liabilities		**779**		138
			2,694		2,708
45	Commitments		**2,164**		2,910

Approved by the Board on 25 February 1998 and signed on its behalf by:

Lord Tugendhat
Chairman

Peter G Birch
Chief Executive

Ian Harley
Finance Director

Company Balance Sheet

For the year ended 31 December 1997

Notes		1997 £m	1997 £m	1996 £m	1996 £m
	Assets				
	Cash and balances at central banks		**315**		227
16	Loans and advances to banks		**586**		580
17	Loans and advances to customers		**60,636**		59,565
19	Debt securities		**2,567**		1,863
20	Equity shares and other variable yield securities		**23**		21
23	Shares in Group undertakings		**2,435**		2,445
22	Interests in associated undertakings		**24**		22
25	Tangible fixed assets		**611**		626
27	Other assets		**444**		414
28	Prepayments and accrued income		**560**		419
	Total assets		**68,201**		66,182
	Liabilities				
29	Deposits by banks		**8,324**		9,936
30	Customer accounts		**51,011**		47,321
31	Debt securities in issue		**43**		645
	Dividend proposed		**290**		245
32	Other liabilities		**735**		760
34	Accruals and deferred income		**1,032**		874
35	Provisions for liabilities and charges		**145**		120
38	Subordinated liabilities including convertible debt		**2,477**		2,363
			64,057		62,264
39	Called up share capital – ordinary shares	**141**		141	
	– preference shares	**325**		200	
39	Share premium account	**1,460**		1,441	
40	Profit and loss account	**2,218**		2,136	
41	Shareholders' funds including non-equity interests		**4,144**		3,918
	Total liabilities		**68,201**		66,182
	Memorandum items				
	Contingent liabilities				
43	Guarantees and assets pledged as collateral security		**85,639**		62,196
44	Other contingent liabilities		**16**		19
			85,655		62,215
45	Commitments		**289**		211

Approved by the Board on 25 February 1998 and signed on its behalf by:

Lord Tugendhat
Chairman

Peter G Birch
Chief Executive

Ian Harley
Finance Director

Statement of Total Recognised Gains and Losses

For the year ended 31 December 1997

	1997 *£m*	*1996* *£m*
Profit attributable to the shareholders of Abbey National plc	954	767
Translation differences on foreign currency net investment	(5)	(26)
Exchange adjustments on US dollar preference shares	(4)	4
Total recognised gains relating to the year	945	745

Consolidated Cash Flow Statement

For the year ended 31 December 1997

Notes		*1997* *£m*	*1996* *£m*
48a	**Net cash inflow from operating activities**	7,658	4,427
	Returns on investments and servicing of finance		
	Interest paid on subordinated liabilities	(176)	(144)
	Preference dividends paid	(23)	(13)
	Net cash outflow from returns on investments and servicing of finance	(199)	(157)
	Taxation		
	UK corporation tax paid	(163)	(153)
	Overseas tax paid	(21)	(11)
	Total taxation paid	(184)	(164)
	Capital expenditure and financial investment		
	Purchases of investment securities	(18,577)	(15,641)
	Sales of investment securities	6,583	10,444
	Redemptions and maturities of investment securities	5,866	2,237
	Purchases of tangible fixed assets	(182)	(151)
	Sales of tangible fixed assets	38	46
	Transfers to life assurance funds	(14)	(41)
	Net cash outflow from capital expenditure and financial investment	(6,286)	(3,106)
48e, g	**Acquisitions and disposals**	(237)	(1,001)
	Equity dividends paid	(387)	(309)
	Net cash inflow (outflow) before financing	365	(310)
	Financing		
	Issue of ordinary share capital	15	12
	Issue of preference share capital	125	224
	Issue of loan capital	70	311
	Repayments of loan capital	(8)	(21)
48c	**Net cash inflow from financing**	202	526
48b	**Increase in cash**	567	216

The format and composition of the cash flow statement has been changed to comply with the revisions to Financial Reporting Standard (FRS) 1, 'Cash flow statements', which includes a new definition of cashflows.

The restatement of comparatives for the year ended 31 December 1996 has resulted in the reclassification of an increase of £691 million in cash equivalents, which are now excluded from the definition of cash, into Net cash inflow from operating activities.

Accounting Policies

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

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

Basis of consolidation
The Group accounts comprise the accounts of the Company and all its subsidiary undertakings. The accounting reference date of the Company and its subsidiary undertakings is 31 December, with the exception of a number of leasing, investment, insurance and funding companies, which, because of commercial considerations, have various accounting reference dates. In addition, certain subsidiaries which were acquired before 31 December 1997 currently have accounting reference dates other than 31 December. The accounts of these subsidiaries have been consolidated on the basis of the interim accounts for the period to 31 December 1997.

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

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

Goodwill
Goodwill arising on consolidation as a result of the acquisition of subsidiary and associated undertakings and goodwill arising on the purchase of businesses are taken directly to reserves in the year in which they occur. On disposal of subsidiary and associated undertakings and businesses, the goodwill previously taken to reserves is charged to the profit and loss account balanced by an equal credit to reserves. Where the directors believe that the purchased goodwill in continuing businesses has suffered a permanent diminution in value, a similar charge to the profit and loss account and credit to reserves is made.

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

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

Premises	
Freehold buildings:	1%
Long and short leasehold premises:	Over the remainder of the lease, with a maximum of 100 years. Acquisition premiums are depreciated over the period to the next rent review.
Equipment	
Office fixtures, equipment and furniture:	12.5%
Computer equipment:	
Mainframes	25%
Peripherals	20%

No depreciation is provided on freehold land.

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

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

Lending-related fees and commissions payable and discounts

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

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

Deferred income

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

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

Securities

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

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

The cost of securities which are not held for the purpose of investment is not disclosed as it cannot be determined without unreasonable expense. Income on investments in equity shares and variable yield securities is recognised as and when received and included within Dividend income.

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

Securities used in moneybroking business are shown within Other securities. Where securities are used in stocklending or sale and repurchase businesses, corresponding amounts are shown within Deposits by banks and Customer accounts. Income earned on these securities is included within Interest receivable, and associated funding costs are shown within Interest payable.

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

Securities sold subject to agreements to repurchase are retained on the balance sheet where the risks and rewards of ownership of the securities remain with the Group. Similarly, securities purchased subject to a commitment to resell are treated as collateralised lending transactions where the Group does not acquire the risks and rewards of ownership. The difference between sale and repurchase prices for such transactions is charged or credited to the profit and loss account over the life of the relevant transactions, within Interest receivable and Interest payable.

Debt securities in issue

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

Derivatives

Transactions are undertaken in derivative financial instruments ('derivatives'), which include interest rate swaps, cross currency swaps, credit derivatives, futures, options and similar instruments, for trading and non-trading purposes.

Derivatives classified as trading are held for market making or portfolio management purposes within the Group's trading books. Trading book activity is the buying and selling of financial instruments in order to take advantage of short term changes in market prices or for market making purposes in order to facilitate customer requirements. Trading derivatives are carried at fair value in the balance sheet within Other assets and Other liabilities, with all gains and losses taken directly to the profit and loss account and reported within Dealing profits.

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

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

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

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

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

Equipment leased to customers

Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. The net investment in finance leases represents total minimum lease payments less gross earnings allocated to future periods. Income from finance leases is credited to the profit and loss account using the actuarial after tax method to give a constant periodic rate of return on the net cash investment.

Provisions for bad and doubtful debts

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

Securitisations

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

Long term assurance business

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

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

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

Foreign currency translation

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

Exchange differences arising on the translation of foreign currency borrowings used to hedge investments in overseas undertakings are taken directly to reserves and offset against the corresponding exchange differences arising on the translation of the investments.

Pensions

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

Cash

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

Notes to the Accounts

1. Segmental analysis

	UK Retail Banking £m	Finance House £m	General Insurance £m	Life Assurance £m	Treasury & Offshore £m	Continental Europe £m	Group Central Holdings £m	Group Total £m
1997								
Net interest income before exceptional item	1,335	305	(3)	(9)	305	16	73	2,022
Other income and charges before exceptional item	259	4	144	180	88	2	59	736
Total operating income	1,594	309	141	171	393	18	132	2,758
Profit (loss) before taxation and exceptional items	722	152	104	165	308	(30)	3	1,424
Adjustment to net investment in finance leases	–	–	–	–	(133)	–	–	(133)
Adjustment to income from long term assurance business	–	–	–	(12)	–	–	–	(12)
Profit (loss) before taxation	722	152	104	153	175	(30)	3	1,279
Includes for: acquired operations	–	–	–	–	7	–	–	7
Total assets	60,652	4,825	112	10,915	70,538	1,325	2,441	150,808
Net assets	486	406	224	563	1,343	906	950	4,878
1996								
Net interest income	1,189	246	(3)	(7)	291	16	62	1,794
Other income and charges	247	8	104	154	36	4	2	555
Total operating income	1,436	254	101	147	327	20	64	2,349
Profit (loss) before taxation and integration costs	685	133	64	139	259	(28)	(24)	1,228
Integration costs in continuing businesses	(60)	–	–	–	(1)	–	–	(61)
Profit (loss) before taxation	625	133	64	139	258	(28)	(24)	1,167
Includes for acquired operations (excluding integrated businesses)	–	8	–	–	–	–	–	8
Total assets	59,634	4,560	93	8,527	47,810	1,288	2,099	124,011
Net assets	458	317	109	440	1,286	967	816	4,393

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

a) A new segment, General Insurance, has been disclosed. This segment reflects the results of the Group's general insurance business, previously classified within UK Retail Banking.

b) A further new segment, Group Central Holdings, has been disclosed. This segment contains the following elements:

Group central costs, which were previously shown within UK Retail Banking;

Earnings on the difference between the Group's actual regulatory capital and the required regulatory capital allocated to segments;

The results of certain small non-core business activities, which have been reclassified from the Other Operations segment. The Other Operations category now no longer exists.

c) The results of centralised lending businesses have been reclassified from UK Retail Banking to Consumer Credit. The Consumer Credit segment has been renamed Finance House and now includes First National Bank (FNB), HMC, the mortgage loan portfolio of Abbey National Mortgage Finance, and the Abbey National-branded unsecured personal loan asset.

1. Segmental analysis (continued)

In addition, changes have been made to the method of calculating certain adjustments. The adjusted results continue to reflect the regulatory capital notionally absorbed by each business segment, based on the Group's Bank of England regulatory requirements. Previously, the Group's actual level of regulatory capital was allocated across the segments, and the notional adjustment was made using average LIBOR. Under the new method, the Group's required level of regulatory capital, as set by the Bank of England, is allocated across the segments. In addition, a notional adjustment is made to allocate the earnings on the hedging of the Group reserves. Earnings on surplus capital, and the effect of any difference between actual and target gearing, are shown within Group Central Holdings.

The effect on the results for the year ended 31 December 1997 is as follows:

	1997 Previously reported basis £m	*Reclassification £m*	*Notional adjustment £m*	*1997 Revised basis £m*
Profit before taxation and exceptional items				
UK Retail Banking	**870**	**(213)**	**65**	**722**
Finance House	**111**	**33**	**8**	**152**
General Insurance	**–**	**102**	**2**	**104**
Life Assurance	**181**	**–**	**(16)**	**165**
Treasury & Offshore	**293**	**–**	**15**	**308**
Continental Europe	**(48)**	**–**	**18**	**(30)**
Other	**17**	**(17)**	**–**	**–**
Group Central Holdings	**–**	**95**	**(92)**	**3**
	1,424	**–**	**–**	**1,424**

The comparative segmental results for the year ended 31 December 1996 have been restated as follows:

	1996 Previously reported basis £m	*Reclassification £m*	*Notional adjustment £m*	*1996 Revised basis £m*
Profit before taxation and integration costs				
UK Retail Banking	736	(96)	45	685
Finance House	98	32	3	133
General Insurance	–	63	1	64
Life Assurance	151	–	(12)	139
Treasury & Offshore	256	–	3	259
Continental Europe	(19)	–	(9)	(28)
Other	6	(6)	–	–
Group Central Holdings	–	7	(31)	(24)
	1,228	–	–	1,228

No separate geographical analysis is presented because the only significant non-UK businesses are shown in the Continental Europe business segment.

2. Interest receivable and similar income arising from debt securities

	1997 £m	*1996 £m*
Income from listed and registered securities	**1,724**	1,792
Income from unlisted securities	**284**	224
	2,008	2,016

Preference dividends of £106m (1996: £88m) are included in income from unlisted securities.

3. Other interest receivable and similar income

	1997 £m	1996 £m
On secured advances	**4,653**	3,890
On unsecured advances	**464**	294
On finance leases (before leasing adjustment: see note 4)	**309**	244
On stock lending and sale and repurchase business	**194**	14
On other interest earning assets and investments	**203**	102
	5,823	4,544

Interest receivable on secured advances has been reduced by £227m (£187m) in respect of the charge for lending-related fees and discounts payable, which are charged against interest income over the period of time which the Group has the right to recover the incentives in the event of early redemption. The movements on such incentives are as follows (see also note 28):

	Group			Company		
	Interest rate discounts £m	Cashbacks £m	Total £m	Interest rate discounts £m	Cashbacks £m	Total £m
At 1 January 1997	101	265	366	101	265	366
Expenditure incurred in the year	136	175	311	136	174	310
Transfer to profit and loss account	(139)	(88)	(227)	(139)	(88)	(227)
At 31 December 1997	98	352	450	98	351	449

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

4. Exceptional items

1997: Corporation tax changes

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

Those elements of the above package which have not yet been enacted are considered highly likely to be so, although there is some uncertainty as to the final details of the proposals and the effects they may have. Accordingly, best estimates of the likely effects of the package of measures on the accounts have been included and are shown in the profit and loss account as exceptional items.

Adjustment to net investment in finance leases

In common with the industry, the changes in corporation tax result in a reduction in value of the Group's net investment in finance leases. The effect for the Group is an estimated reduction in interest receivable on finance leases of £133 million. Tax variation clauses in the leases, which preserve the lessors' post tax rate of return over the life of the leases, result in lower gross rental income when tax rates are reduced. A compensating reduction in the deferred tax liability has been recognised (see note 36) and shown as a reduction in the tax charge. Group profit after tax and earnings per ordinary share are unaffected.

Adjustment to income from long term assurance business

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

1996: Integration costs in continuing businesses

Integration costs of £61 million related to the integration of the business of the former National and Provincial Building Society into existing businesses of the Abbey National Group in 1996, and comprised £46 million of reorganisation and restructuring costs and £15 million of branch closure costs.

5. Interest payable

	1997 £m	1996 £m
On retail customer accounts	**2,402**	1,873
On stock lending and sale and repurchase business	**280**	27
On other deposits and loans	**3,127**	2,866
	5,809	4,766
Including:		
Amounts payable on subordinated liabilities	**193**	167

6. Dividend income

	1997 £m	1996 £m
Income from equity shares and other variable yield securities	**3**	3

7. Other operating income

	1997 £m	1996 £m
Deferred income release (see note 34)	**24**	14
Profits less losses on disposal of investment securities	**10**	–
Other	**49**	40
	83	54

8. Administrative expenses: Other administrative expenses

	1997 £m	1996 £m
Staff costs (1):		
Wages and salaries	**455**	374
Social security costs	**39**	32
Other pension costs	**40**	41
	534	447
Property and equipment expenses:		
Rents payable	**60**	47
Rates payable	**26**	21
Hire of equipment	**6**	6
Other property and equipment expenses	**69**	55
	161	129
Other administrative expenses (2) (3)	**401**	308
	1,096	884

Notes:

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

	1997 £m	1996 £m
Staff costs:		
Wages and salaries	**36**	31
Social security costs	**3**	2
Other pension costs	**4**	3
	43	36

(2) Incremental expenditure required to upgrade software and computer systems in preparation for Year 2000 and Economic and Monetary Union (EMU) is as follows:

	Year 2000 £m	EMU £m
Expenditure charged to the profit and loss account (within Other administrative expenses)	22	3
Capital expenditure (within Tangible fixed assets)	11	2

8. Administrative expenses: Other administrative expenses (continued)

(3) Includes the following amounts in respect of payments to the auditors, Coopers & Lybrand:

	1997 £m	1996 £m
Audit services	**2.1**	2.0
Reporting accountants and other regulatory reporting	**2.2**	1.7
Sub-total: Audit and similar services	**4.3**	3.7
Tax services	**0.7**	0.5
Consultancy and advisory services	**1.9**	0.7
Sub-total: Other services	**2.6**	1.2
	6.9	4.9

Included within the remuneration for audit services is the audit fee for the Company of £0.9m (£0.8m).

Of the fees payable to the Group's auditors for audit services £2.0m (£1.9m) related to the United Kingdom.

9. Employees

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

	1997	1996
UK Retail Banking	**16,483**	14,532
Finance House	**2,301**	2,020
General Insurance	**798**	613
Life Assurance	**1,736**	1,515
Treasury & Offshore	**621**	340
Continental Europe	**468**	432
Group Central Holdings	**3,057**	2,807
	25,464	22,259

10. Provisions for bad and doubtful debts

	On advances secured on residential properties £m	On other secured advances £m	On unsecured advances £m	Total £m
Group				
At 1 January 1997				
General	67	11	17	95
Specific	145	202	92	439
Exchange adjustments	(2)	(10)	–	(12)
Transfer from profit and loss account	20	2	99	121
Irrecoverable amounts written off	(46)	(62)	(78)	(186)
At 31 December 1997	184	143	130	457
Being for the Group:				
General	84	13	20	117
Specific	100	130	110	340
Including for the Company:				
At 1 January 1997				
General	43	1	9	53
Specific	99	16	59	174
At 31 December 1997				
General	49	1	11	61
Specific	61	3	81	145

10. Provisions for bad and doubtful debts (continued)

	On advances secured on residential properties %	On other secured advances %	On unsecured advances %	Total %
Capital provisions as a percentage of loans and advances to customers				
Group				
At 31 December 1997				
UK	0.3	0.9	3.5	0.5
Non-UK	1.8	38.7	1.3	7.7
At 31 December 1996				
UK	0.3	10.8	4.5	0.7
Non-UK	2.3	37.3	25.0	10.0
Company				
At 31 December 1997	0.2	3.1	5.8	0.3
At 31 December 1996	0.2	6.9	5.2	0.4

Analysis of movements on suspended interest	£m	£m	£m	£m
Group				
At 1 January 1997	73	115	9	197
Exchange adjustments	(3)	(6)	–	(9)
Amounts suspended in the period	6	23	6	35
Irrecoverable amounts written off	(26)	(10)	(6)	(42)
At 31 December 1997	50	122	9	181
Including for the Company:				
At 1 January 1997	51	3	5	59
At 31 December 1997	34	3	6	43
The value of loans and advances at 31 December 1997 on which interest is suspended is as follows:				
Group				
Loans and advances to customers	540	382	122	1,044
Provisions on these amounts	(100)	(130)	(83)	(313)
Company				
Loans and advances to customers	404	17	64	485
Provisions on these amounts	(61)	(3)	(55)	(119)

Analysis of Group non-performing loans and advances

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

	1997 £m	1996 £m
Loans and advances on which a proportion of interest has been suspended and/or on which specific provision has been made	**892**	1,034
Loans and advances 90 days overdue on which no interest has been suspended and on which no specific provision has been made	**1,216**	1,385
Non-accruing loans and advances	**208**	312
Total non-performing loans and advances	**2,316**	2,731
Non-performing loans and advances as a percentage of total loans and advances to customers	**3.16%**	4.22%
Provisions as a percentage of total non-performing loans and advances	**19.73%**	19.55%

11. Tax on profit on ordinary activities

	1997 £m	1996 £m
UK Corporation tax:		
Current at 31.5% (33%)	**319**	249
Prior years	**(159)**	(148)
Double tax relief	**(18)**	(13)
Advance corporation tax written back	**–**	(7)
Deferred tax:		
Current year	**10**	150
Prior years	**142**	148
Tax on franked investment income	**4**	11
Overseas taxation	**28**	13
	326	403

The deferred tax charge for the year includes a credit of £137m in respect of the taxation effect of exceptional items as explained in note 4.

The adjustments in respect of prior years arise mainly because certain subsidiary undertakings have accounting reference dates other than 31 December.

12. Profit on ordinary activities after tax

The profit after tax of the Company attributable to the shareholders is £555m (£421m). As permitted by section 230 of the Companies Act 1985, the Company's profit and loss account has not been presented in these accounts.

13. Dividends

	1997 Pence per share	1996 Pence per share	1997 £m	1996 £m
Ordinary shares				
Interim (paid)	**10.20**	8.70	**144**	115
Final (proposed)	**20.50**	17.40	**290**	245
	30.70	26.10	**434**	360
Preference shares (non-equity)			**35**	13
			469	373

Preference share dividends include an exchange loss of £4m (1996: exchange gain of £4m) in respect of the US dollar preference shares. See note 39 for further details of the terms of these shares.

14. Earnings per ordinary share

Earnings per ordinary share have been calculated by dividing the profit attributable to the shareholders of Abbey National plc, after preference dividends, of £919m (£754m) by the average number of ordinary shares in issue of 1,409m (1,335m).

15. Treasury bills and other eligible bills

	Group 1997		Group 1996	
	Book value £m	Market value £m	Book value £m	Market value £m
Investment securities				
Treasury bills and similar securities	**9**	**9**	9	9
Other securities				
Treasury bills and similar securities	**388**	**388**	102	102
Other eligible bills	**1,231**	**1,231**	–	–
	1,619	**1,619**	102	102
	1,628	**1,628**	111	111

15. Treasury bills and other eligible bills (continued)

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

	Group £m
At 1 January 1997	9
Additions	35
Disposals	(35)
At 31 December 1997	9

16. Loans and advances to banks

	Group 1997 £m	*Group 1996* £m	*Company 1997* £m	*Company 1996* £m
Items in the course of collection	**256**	209	**252**	207
Amounts due from subsidiaries	**–**	–	**315**	361
Stock lending and sale and repurchase business	**3,809**	364	**–**	–
Other loans and advances	**4,928**	2,252	**19**	12
	8,993	2,825	**586**	580
Repayable:				
On demand	**2,938**	568	**334**	373
In not more than three months	**5,525**	1,847	**252**	207
In more than three months but not more than one year	**64**	169	**–**	–
In more than one year but not more than five years	**437**	223	**–**	–
In more than five years	**29**	18	**–**	–
	8,993	2,825	**586**	580

The Group has entered into reverse sale and repurchase agreements. The total amount of collateralised loans which are included within stock lending and sale and repurchase business above is £556m (£364m). The total nominal value of assets acquired as collateral via such agreements amounted to £522m (£350m).

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

	Group 1997 £m	*Group 1996* £m	*Company 1997* £m	*Company 1996* £m
Fixed rate	**6,956**	2,158	**8**	1
Variable rate	**1,781**	458	**326**	372
Items in the course of collection (non-interest bearing)	**256**	209	**252**	207
	8,993	2,825	**586**	580

The Group's policy is to hedge all fixed rate loans and advances to banks to floating rates using derivative instruments, or by matching with other on-balance sheet interest rate exposures. See note 47, Derivatives, 'Non-trading derivatives' for further information.

17. Loans and advances to customers

	Group 1997 £m	*Group 1996* £m	*Company 1997* £m	*Company 1996* £m
Advances secured on residential properties	**61,864**	60,271	**58,333**	57,474
Stock lending and sale and repurchase business	**6,657**	–	**–**	–
Other secured advances	**495**	1,136	**114**	228
Unsecured loans	**3,651**	2,623	**1,480**	1,204
Collateralised and guaranteed mortgage loans	**167**	197	**–**	–
Amounts due from subsidiaries	**–**	–	**709**	659
	72,834	64,227	**60,636**	59,565
Repayable:				
On demand or at short notice	**9,433**	3,268	**2,910**	3,143
In not more than three months	**1,476**	825	**504**	509
In more than three months but not more than one year	**1,312**	1,112	**865**	768
In more than one year but not more than five years	**4,650**	4,385	**3,562**	3,355
In more than five years	**56,420**	55,171	**53,001**	52,017
Less: provisions	**(457)**	(534)	**(206)**	(227)
	72,834	64,227	**60,636**	59,565

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

17. Loans and advances to customers (continued)

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

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Fixed rate	**20,219**	11,338	**12,571**	10,214
Variable rate	**53,072**	53,423	**48,271**	49,578
Provisions	**(457)**	(534)	**(206)**	(227)
	72,834	64,227	**60,636**	59,565

The Group's policy is to hedge all fixed rate loans and advances to customers using derivative instruments, or by matching with other on-balance sheet interest rate exposures. See note 47, Derivatives, 'Non-trading derivatives' for further information.

18. Net investment in finance leases

	Group 1997 £m	Group 1996 £m
Amounts receivable	**10,316**	9,315
Less: deferred income	**(5,661)**	(5,005)
	4,655	4,310
Repayable:		
In not more than three months	**20**	29
In more than three months but not more than one year	**50**	57
In more than one year but not more than five years	**262**	307
In more than five years	**4,323**	3,917
	4,655	4,310
Cost of assets acquired for the purpose of letting under finance leases in the year	**545**	1,541
Gross rentals receivable	**393**	351
Commitments as lessor for the purchase of equipment for use in finance leases	**160**	231
Amounts outstanding subject to a sub-participation	**216**	216

The effect of the changes to corporation tax announced in 1997 is described in note 4.

19. Debt securities

	Group 1997		Group 1996		Company 1997		Company 1996	
	Book value £m	Market value £m	Book value £m	Market value £m	Book value £m	Market value £m	Book value £m	Market value £m
Investment securities								
Issued by public bodies:								
Government securities	**7,924**	**8,315**	7,716	8,190	**1,655**	**1,661**	397	404
Other public sector securities	**2,490**	**2,521**	4,023	4,082	**29**	**29**	29	29
	10,414	**10,836**	11,739	12,272	**1,684**	**1,690**	426	433
Issued by other issuers:								
Bank and building society certificates of deposit	**257**	**257**	221	221	**–**	**–**	–	–
Other debt securities	**21,560**	**21,744**	14,853	15,080	**883**	**883**	1,183	1,183
	21,817	**22,001**	15,074	15,301	**883**	**883**	1,183	1,183
Sub-total	**32,231**	**32,837**	26,813	27,573	**2,567**	**2,573**	1,609	1,616

19. Debt securities (continued)

	Group 1997		*Group 1996*		*Company 1997*		*Company 1996*	
	Book value £m	*Market value £m*	*Book value £m*	*Market value £m*	*Book value £m*	*Market value £m*	*Book value £m*	*Market value £m*
Other securities								
Issued by public bodies:								
Government securities	**635**	**635**	1,343	1,343	**–**	**–**	254	254
Other public sector securities	**–**	**–**	32	32	**–**	**–**	–	–
	635	**635**	1,375	1,375	**–**	**–**	254	254
Issued by other issuers:								
Bank and building society certificates of deposit	**6,429**	**6,429**	1,615	1,615	**–**	**–**	–	–
Other debt securities	**7,159**	**7,159**	9,927	9,927	**–**	**–**	–	–
	13,588	**13,588**	11,542	11,542	**–**	**–**	–	–
Sub-total	**14,223**	**14,223**	12,917	12,917	**–**	**–**	254	254
Total	**46,454**	**47,060**	39,730	40,490	**2,567**	**2,573**	1,863	1,870

The investment securities held by the Company include subordinated investments in subsidiaries of £882m (£482m) and are included within Other debt securities.

Other securities comprise assets held for trading purposes, amounting to £9,261m (£10,947m), and £4,962m (£1,971m) held for liquidity management purposes.

	Group 1997		*Group 1996*		*Company 1997*		*Company 1996*	
	Book value £m	*Market value £m*	*Book value £m*	*Market value £m*	*Book value £m*	*Market value £m*	*Book value £m*	*Market value £m*
Analysed by listing status:								
Investment securities								
Listed in the UK	**5,481**	**5,583**	7,172	7,257	**1,654**	**1,660**	397	404
Listed or registered elsewhere	**22,201**	**22,629**	15,991	16,598	**–**	**–**	–	–
Unlisted	**4,549**	**4,625**	3,650	3,718	**913**	**913**	1,212	1,212
	32,231	**32,837**	26,813	27,573	**2,567**	**2,573**	1,609	1,616
Other securities								
Listed in the UK	**1,097**	**1,097**	334	334	**–**	**–**	254	254
Listed or registered elsewhere	**7,110**	**7,110**	10,142	10,142	**–**	**–**	–	–
Unlisted	**6,016**	**6,016**	2,441	2,441	**–**	**–**	–	–
	14,223	**14,223**	12,917	12,917	**–**	**–**	254	254
Total	**46,454**	**47,060**	39,730	40,490	**2,567**	**2,573**	1,863	1,870

	Group 1997 £m	*Group 1996 £m*	*Company 1997 £m*	*Company 1996 £m*
Book value				
Analysed by maturity:				
Due within one year	**9,891**	4,273	**813**	254
Due in more than one year but not more than five years	**15,490**	14,508	**835**	1,572
Due in more than five years but not more than ten years	**9,111**	10,304	**191**	37
Due in more than ten years	**11,962**	10,645	**728**	–
	46,454	39,730	**2,567**	1,863

19. Debt securities (continued)

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

	Cost £m	Provisions £m	Net book value £m
Group			
At 1 January 1997	26,837	(24)	26,813
Exchange adjustments	(363)	–	(363)
Acquisitions of subsidiary undertakings	6	–	6
Additions	18,492	–	18,492
Disposals	(6,887)	–	(6,887)
Redemptions and maturities	(5,866)	–	(5,866)
Transfers from other securities	55	–	55
Transfer from profit and loss account	–	(3)	(3)
Amortisation of premiums	(16)	–	(16)
At 31 December 1997	32,258	(27)	32,231
Company			
At 1 January 1997	1,609	–	1,609
Additions	2,359	–	2,359
Disposals	(641)	–	(641)
Redemptions and maturities	(700)	–	(700)
Amortisation of premiums	(60)	–	(60)
At 31 December 1997	2,567	–	2,567

The total net book value of debt securities held for investment purposes at 31 December 1997 includes unamortised discounts of £196m (1996: premiums of £30m) for the Group, and unamortised premiums of £80m (£30m) for the Company.

The Group enters into sale and repurchase agreements. The total nominal value of assets so transferred and which are included above is £2,560m (£749m) including, for the Company, nil (nil). Collateral associated with these transactions of £2,600m (£737m) for the Group and nil (nil) for the Company is included in Deposits by banks.

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

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

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

20. Equity shares and other variable yield securities

	Group 1997		Group 1996		Company 1997		Company 1996	
	Book value £m	Market value £m	Book value £m	Market value £m	Book value £m	Market value £m	Book value £m	Market value £m
Listed in the UK	28	64	27	50	19	52	20	40
Listed elsewhere	41	26	1	1	3	3	–	–
Unlisted	14	14	16	16	1	1	1	1
	83	104	44	67	23	56	21	41

Included within unlisted securities of the Group are variable yield securities held by Abbey National Unit Trust Managers Ltd and Abbey National Treasury Services plc for purposes other than investment, having book and market values of £4m (£8m) and £1m (nil) respectively. All other equity shares and variable yield securities are held for investment purposes.

20. Equity shares and other variable yield securities (continued)

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

	Group Cost & Book value £m	Company Cost & Book value £m
At 1 January 1997	36	21
Exchange adjustments	(1)	–
Additions	49	2
Disposals	(6)	–
At 31 December 1997	78	23

21. Long term assurance business

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

	1997 £m	1996 £m
Value of shareholders' interest in the long term assurance funds	649	555

The value of the long term assurance business is calculated by discounting the proportion of surplus which is projected to accrue to shareholders in future years from business currently in force, and adding the shareholders' interest in the surplus retained within the long term assurance funds. The basis on which this value is determined is reviewed regularly in the light of the experience of the business and expectations regarding future economic conditions. The principal economic assumptions used have not changed from 1996 and are as follows:

	%
Risk adjusted discount rate (net of tax)	10.0
Return on equities (gross of tax)	9.0
Return on gilts (gross of tax)	7.5
Inflation	4.0

While the assumed return on equities is unchanged, a provision has been made for the effect on pension funds of the loss of tax credits on dividends from UK equity investments (see below).

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

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

21. Long term assurance business (continued)

The income from life assurance business which is included as Other operating income in the consolidated profit and loss account is calculated as follows:

	1997 £m	1996 £m
Value of shareholders' interest in the long term assurance funds at 31 December	**649**	555
Value of shareholders' interest in the long term assurance funds at 1 January	**555**	425
Increase in value of long term assurance business	**94**	130
Transfers into long term assurance funds	**(14)**	(41)
Acquisitions of subsidiary undertakings/purchase of business	**–**	(25)
Net increase in value of long term assurance business	**80**	64
Surplus transferred from long term funds	**12**	24
Income after tax from long term assurance business	**92**	88
Income before tax from long term assurance business	**135**	133

Income before tax from long term assurance business comprises:

	£m	£m
Income from long term assurance business	**147**	133
Provision against embedded value profits	**(12)**	–
	135	133

Following the changes to pension fund taxation announced in the 1997 budget a provision of £12m before tax has been made against the embedded value profits for the Life Assurance subsidiaries in 1997. This has been calculated as the discounted value of the loss of tax credits on dividends from UK equity investments. The provision has been shown as an exceptional item in the Group profit and loss account under Other operating income. See note 4.

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

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

	1997 £m	1996 £m
Investments	**5,690**	4,406
Assets held to cover linked liabilities	**3,839**	2,862
Debtors and prepayments	**214**	235
Other assets	**358**	366
Assets of the long term assurance funds	**10,101**	7,869
Technical provisions	**4,100**	3,485
Technical provisions for linked liabilities	**3,853**	2,894
Fund for future appropriations	**1,016**	659
Other creditors	**1,132**	831
Liabilities of the long term assurance funds	**10,101**	7,869

22. Interests in associated undertakings

The movement in interests in associated undertakings was as follows:

	Group £m	Company £m
At 1 January 1997	8	22
Additions	13	2
At 31 December 1997	21	24

22. Interests in associated undertakings (continued)

The principal associated undertakings at 31 December 1997 are:

	Nature of business	*Issued share capital*	*Group interest (%)*	*Group's share of results based on accounts for the year ended*
Travellers Exchange Corporation plc	Foreign currency services	166,588 £1 ordinary shares	33	31 December
		2,500,000 £1 preference shares	60	
Commercial Union Underwriting Ltd	Insurance underwriting services	100 £1 ordinary A shares	15	31 December
		40,000,000 £1 ordinary B shares	21	
DAH Holdings Ltd	Private banking	62,995 US$1 ordinary A shares	24.5	31 December
		182,045 US$1 ordinary convertible B shares		
Willis National Holdings Ltd	Personal finance	1,000 £1 ordinary shares	49	31 December

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

All associated undertakings are unlisted.

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

23. Shares in Group undertakings

	1997 Cost & Book value £m	*1996 Cost & Book value £m*
Subsidiary undertakings		
Banks	**442**	451
Others	**1,993**	1,994
	2,435	2,445

The movement in shares in Group undertakings was as follows:

	Company £m
At 1 January 1997	2,445
Exchange adjustments	(69)
Additions	363
Disposals	(283)
Amounts written off	(21)
At 31 December 1997	2,435

Abbey National plc entered into the following transactions:

On 24 July, Abbey National plc acquired Cater Allen Holdings PLC. The amount paid in consideration for the issued share capital was £193m of which £191m was payable in cash and £2m in the form of loan notes. In addition, acquisition costs of £2m were incurred. The company was subsequently sold to Abbey National Treasury Services plc.

On 6 May, the investment in HMC Group PLC was transferred to First National Bank Plc.

On 7 May, Abbey National plc purchased for cash the remaining 25% interest in Abbey National General Insurance Services Ltd for £4m.

Subscriptions for additional share capital in subsidiary undertakings during the year amounted to £166m.

23. Shares in Group undertakings (continued)

Subsidiaries of Abbey National plc entered into the following transactions:

On 20 February, First National Bank Plc acquired County Factors Ltd, a company providing debt factoring services. The amount payable in consideration for the issued share capital of the company was £5m, inclusive of acquisition costs, and was payable in cash.

On 30 July, Abbey National France SA purchased for cash the assets and business of Eole Finance, a specialist French consumer credit company. The amount payable at the balance sheet exchange rate, was £38m.

On 31 October, First Scottish Searching Services Ltd, a subsidiary of First National Bank Plc, acquired Crofts Dunlop Ltd, a company providing company search services. The amount payable in consideration for the issued share capital of the company was £1m, inclusive of acquisition costs, and was payable in cash.

All of the above transactions are included in the consolidated accounts as acquisitions. Further disclosures relating to these transactions can be found in note 24, Summary of the effect of acquisitions and note 48, Consolidated cash flow statement.

On 4 August, Abbey National Independent Consulting Group Ltd disposed of its subsidiary undertaking Abbey National Independent Financial Advisers Ltd (ANIFA) in return for a minority interest in a newly formed undertaking, Willis National Holdings Limited.

The value of the investment in the share capital of Abbey National Beta Investments Ltd has been written down by £21m as a result of a review which identified a permanent diminution in value.

The principal subsidiaries of Abbey National plc at 31 December 1997 are listed below, all of which are directly held except where indicated.

	Nature of business	*Country of incorporation or registration*
Abbey National General Insurance Services Ltd	General insurance	England & Wales
Abbey National Independent Consulting Group Ltd	Personal finance	England & Wales
Abbey National Leasing Companies* (25 companies)	Leasing	England & Wales
Abbey National Mortgage Finance plc	Personal finance	England & Wales
Abbey National Treasury Services plc	Treasury operations	England & Wales
Cater Allen Holdings PLC*	Personal finance and treasury operations	England & Wales
First National Bank Plc*	Personal finance and commercial lending	England & Wales
HMC Group PLC*	Personal finance	England & Wales
Wagon Finance Ltd*	Personal finance	England & Wales
Abbey National France SA	Personal finance	France
Abbey National (Gibraltar) Ltd*	Personal finance	Gibraltar
Carfax Insurance Ltd	Insurance	Guernsey
Abbey National Treasury International Ltd*	Personal finance and treasury operations	Jersey
Abbey National Life plc	Insurance	Scotland
Abbey National PEP Managers Ltd*	PEP management	Scotland
Abbey National Unit Trust Managers Ltd*	Unit trust management	Scotland
Scottish Mutual Assurance plc*	Insurance	Scotland
Abbey National Bank SAE	Personal finance	Spain
Abbey National North America Corporation	Funding	United States

* Subsidiary held indirectly through subsidiary companies.

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

24. Summary of the effect of acquisitions

The following table summarises the effect of all acquisitions of subsidiary undertakings and purchases of businesses in the year ended 31 December 1997:

	Book value before acquisition £m	Accounting policy adjustments £m	Revaluation adjustments £m	Total fair value adjustments £m	Fair value at acquisition £m
Treasury bills and other eligible bills	542	–	–	–	542
Loans and advances to banks	5,813	–	–	–	5,813
Loans and advances to customers	7,029	–	–	–	7,029
Debt securities	5,540	–	–	–	5,540
Tangible fixed assets	5	–	(1)	(1)	4
Other assets	186	–	(1)	(1)	185
Total assets	19,115	–	(2)	(2)	19,113
Deposits by banks	8,250	–	–	–	8,250
Customer accounts	10,569	–	–	–	10,569
Other liabilities	147	1	36	37	184
Total liabilities excluding shareholders' funds	18,966	1	36	37	19,003
Net assets acquired	149	(1)	(38)	(39)	110
Total fair value of the consideration and costs of acquisition					239
Goodwill on acquisition of subsidiary undertakings					129

The only significant undertaking included in the above table is Cater Allen Holdings PLC and its subsidiaries and its profit after tax for the period 1 May 1997 to 23 July 1997 was £2m, and for the year ended 30 April 1997, £13m.

The revaluation adjustments to Other liabilities include provisions for litigation proceedings against certain Cater Allen operations and the estimated costs of resources required to address operational difficulties within City Deal Services Ltd, which were in existence at the time of the acquisition. In accordance with FRS 7, 'Fair Values in Acquisition Accounting', these costs have been provided on a provisional basis. Adjustments will be made to the fair value and goodwill, if necessary, as the extent of any actual liabilities become clear during 1998.

25. Tangible fixed assets

	Group			Company		
	Premises £m	Equipment £m	Total £m	Premises £m	Equipment £m	Total £m
Cost						
At 1 January 1997	440	761	1,201	409	693	1,102
Acquistions of subsidiary undertakings	2	9	11	–	–	–
Disposal of subsidiary undertaking	–	(3)	(3)	–	–	–
Additions	28	102	130	13	83	96
Disposals	(19)	(34)	(53)	(19)	(23)	(42)
At 31 December 1997	451	835	1,286	403	753	1,156
Depreciation						
At 1 January 1997	60	452	512	58	418	476
Acquisitions of subsidiary undertakings	1	6	7	–	–	–
Disposal of subsidiary undertaking	–	(2)	(2)	–	–	–
Charge for the year	9	89	98	8	78	86
Disposals	(2)	(25)	(27)	(1)	(16)	(17)
At 31 December 1997	68	520	588	65	480	545
Net book value						
At 31 December 1997	383	315	698	338	273	611
At 31 December 1996	380	309	689	351	275	626

25. Tangible fixed assets (continued)

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
The net book value of premises comprises:				
Freeholds	**310**	303	**275**	285
Long leaseholds	**28**	20	**18**	10
Short leaseholds	**45**	57	**45**	56
Land and buildings occupied for own activities:				
Net book value at 31 December	**299**	321	**261**	304
The net book value of equipment includes:				
Assets held under finance leases	**2**	7	**–**	3
Depreciation charge for the year on these assets	**5**	4	**3**	4
Capital expenditure which has been contracted, but has not been provided in the accounts	**11**	32	**9**	32

26. Operating lease assets

Equipment leased to customers under the terms of operating leases are classified as Operating lease assets, having previously been classified as Tangible fixed assets. They are shown as a separate category of asset since they are held for a different purpose. The opening balance of Tangible fixed assets has been restated to reflect the change in classification. Income in respect of Operating lease assets and the depreciation charge for the period are both included within Other operating income.

	Group £m
Cost	
At 1 January 1997	31
Additions	57
Disposals	(12)
At 31 December 1997	76
Depreciation	
At 1 January 1997	5
Charge for the year	8
Disposals	(4)
At 31 December 1997	9
Net book value	
At 31 December 1997	67
At 31 December 1996	26

	Group 1997 £m	Group 1996 £m
Capital expenditure which has been contracted, but has not been provided in the accounts	**9**	6

27. Other assets

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Development properties	**14**	26	**–**	–
Foreign exchange and interest rate contracts (see note 47)	**599**	700	**35**	15
Other	**1,660**	783	**409**	399
	2,273	1,509	**444**	414

Other assets of the Group include £118m (£89m) in respect of unamortised commissions payable to introducers in respect of obtaining certain lending business. The charge for the period is £59m (£40m).

The figure for development properties includes completed properties of £12m (£19m) and work in progress of £2m (£7m).

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

28. Prepayments and accrued income

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Accrued interest due from subsidiaries	–	–	25	17
Unamortised lending-related fees (see note 3)	450	366	449	366
Other accrued interest	1,541	1,490	61	18
Prepayments and other accruals	32	24	25	18
	2,023	1,880	560	419

29. Deposits by banks

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Items in the course of transmission	314	336	313	337
Amounts due to subsidiaries	–	–	7,791	9,321
Stock lending and sale and repurchase business	7,974	737	–	–
Other deposits	16,248	16,645	220	278
	24,536	17,718	8,324	9,936
Repayable:				
On demand	3,422	530	7,763	9,274
In not more than three months	17,765	13,575	320	377
In more than three months but not more than one year	2,992	3,221	112	127
In more than one year but not more than five years	209	125	10	25
In more than five years	148	267	119	133
	24,536	17,718	8,324	9,936

30. Customer accounts

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Retail deposits	47,690	45,119	44,722	43,581
Amounts due to subsidiaries	–	–	4,732	2,178
Stock lending and sale and repurchase business	9,259	–	–	–
Other customer accounts	4,726	4,559	1,557	1,562
	61,675	49,678	51,011	47,321
Repayable:				
On demand	47,124	42,376	42,981	44,135
In not more than three months	9,254	3,937	4,477	679
In more than three months but not more than one year	4,267	2,460	2,907	1,858
In more than one year but not more than five years	314	420	28	238
In more than five years	716	485	618	411
	61,675	49,678	51,011	47,321

Included in Group customer accounts are amounts due to associated undertakings of £6m (£1m).

31. Debt securities in issue

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Bonds and medium term notes	21,661	18,542	3	3
Other debt securities in issue	18,540	16,651	40	642
	40,201	35,193	43	645

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Bonds and medium term notes are repayable:				
In not more than three months	1,588	2,008	–	–
In more than three months but not more than one year	5,518	4,218	3	–
In more than one year but not more than two years	4,012	3,242	–	3
In more than two years but not more than five years	6,063	4,342	–	–
In more than five years	4,480	4,732	–	–
	21,661	18,542	3	3

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Other debt securities in issue are repayable:				
In not more than three months	14,971	12,920	5	468
In more than three months but not more than one year	3,515	3,637	20	144
In more than one year but not more than two years	32	38	15	15
In more than two years but not more than five years	–	34	–	15
In more than five years	22	22	–	–
	18,540	16,651	40	642

32. Other liabilities

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Creditors and accrued expenses	708	740	369	393
Short positions in government debt securities held for investment purposes	287	355	–	–
Income tax	207	169	207	169
Corporation tax	266	299	158	194
Foreign exchange and interest rate contracts (see note 47)	1,208	1,408	1	–
Obligations under finance leases (see note 33)	2	9	–	4
	2,678	2,980	735	760

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

33. Obligations under finance leases

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Amounts payable:				
In not more than one year	2	5	–	2
In more than one year but not more than five years	–	4	–	2
	2	9	–	4

34. Accruals and deferred income

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Accrued interest due to subsidiaries	–	–	**113**	113
Other accrued interest	**2,561**	2,362	**919**	761
Deferred income	**281**	229	**–**	–
	2,842	2,591	**1,032**	874

See Accounting Policies, page 54, for a description of the accounting treatment of deferred income from certain residential mortgage lending. The balance of such deferred income included above is £276m (£228m). The amount taken to the profit and loss account during the year was £24m (£14m).

35. Provisions for liabilities and charges

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Deferred taxation (note 36)	**1,046**	889	**104**	63
Other provisions for liabilities and charges (note 37)	**98**	81	**41**	57
	1,144	970	**145**	120

36. Deferred taxation

	Group £m	Company £m
At 1 January 1997	889	63
Acquisitions of subsidiary undertakings	6	–
Disposal of subsidiary undertaking	1	–
Transfer from profit and loss account	152	41
Other movements	(2)	–
At 31 December 1997	1,046	104

The transfer from the profit and loss account includes the adjustment made to reflect the impact of the changes in corporation tax on the value of the Group's net investment in finance leases. See note 4.

The amounts provided and total potential liability are:

	Amount provided		Total potential liability	
	Group £m	Company £m	Group £m	Company £m
Tax effect of timing differences due to:				
Excess of capital allowances over depreciation	15	16	15	16
Capital allowances on finance lease receivables	892	–	892	–
Other	139	88	139	88
	1,046	104	1,046	104

37. Other provisions for liabilities and charges

	Pension and other similar obligations (1) £m	Provisions for contingent liabilities and commitments £m	Other provisions (2) £m	Total £m
Group				
At 1 January 1997	32	22	27	81
Acquisitions of subsidiary undertakings	–	26	8	34
Disposal of subsidiary undertaking	–	(1)	(3)	(4)
Transfer from profit and loss account	38	16	15	69
Pension contributions/provisions utilised	(58)	(7)	(17)	(82)
At 31 December 1997	12	56	30	98
Company				
At 1 January 1997	31	9	17	57
Transfer from profit and loss account	35	15	11	61
Pension contributions/provisions utilised	(55)	(3)	(19)	(77)
At 31 December 1997	11	21	9	41

(1) In addition to Pension and other similar obligations included in the above table, a balance in respect of the pension surplus acquired with the purchase of the business of N&P is included within Other assets. This balance, which was £26m as at 31 December 1997, is being amortised over the remaining service lives of employees contributing to the scheme, and £2m was charged to the profit and loss account in the year ended 31 December 1997 (five months to 31 December 1996, £1m).

(2) Other provisions include amounts in respect of possible compensation payable as a result of the review of business involving the transfers from occupational to personal pension schemes and the opting-out of and the non-joining of occupational pension schemes. The provisions for the Group excluding Life Assurance are included within Other provisions. Amounts provided in respect of Life Assurance are charged to Income from long term assurance business and carried against the asset Long term assurance business in the balance sheet. In addition, provisions have been made for the administrative costs of carrying out the review, which are included within Provisions for contingent liabilities and commitments as at 31 December 1997.

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

	Group excluding Life Assurance £m	Life Assurance £m	Group £m	Company £m
At 1 January 1997	16	10	26	12
Disposals of subsidiary undertakings	(3)	–	(3)	–
Transfer from profit and loss account	12	2	14	9
Provisions utilised	(13)	(2)	(15)	(14)
At 31 December 1997	12	10	22	7

Following the disposal of ANIFA to Willis National Holdings Ltd, which is included in the accounts as an associated undertaking, £3m of the Group provision in respect of pension mis-selling was transferred to Willis National Holdings Ltd. Under the terms of the disposal agreement, Abbey National Independent Consulting Group Ltd is required to indemnify Willis National Holdings Ltd in the event of any shortfall in the provision transferred, or is entitled to a repayment reflecting any surplus provision arising upon completion of the review.

38. Subordinated liabilities including convertible debt

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Dated subordinated liabilities:				
Subordinated floating rate note 1997	–	8	–	–
Registered junior subordinated fixed rate note 1999 (US $81m)	49	–	49	–
Registered junior subordinated fixed rate note 1999 (US $26m)	16	–	16	–
Registered junior subordinated fixed rate note 1999 (US $7m)	5	–	5	–
9.00% Subordinated guaranteed bond 2002 (LUX Fr 1,000m)	16	19	–	–
Subordinated loan stock 2002*	–	–	17	17
Subordinated guaranteed note 2002 (US $75m)	46	44	–	–
Subordinated floating rate note 2002 (US $75m)*	–	–	46	44
8.00% Subordinated guaranteed bond 2002 (NLG 200m)	60	68	–	–
Subordinated loan 2002 (US $112m)*	–	–	68	66
10.375% Subordinated guaranteed bond 2002	100	100	–	–
10.512% Subordinated loan stock 2001*	–	–	100	100
Subordinated floating rate note 2003 (US $100m)	61	58	–	–
Subordinated floating rate note 2003 (US $100m)*	–	–	61	58
Subordinated floating rate note 2004 (US $137m)	83	80	–	–
Subordinated floating rate note 2004*	–	–	83	83
Subordinated floating rate note 2004 (CAN $100m)	42	43	–	–
Subordinated floating rate note 2004 (US $74m)*	–	–	45	43
8.75% Subordinated guaranteed bond 2004	151	151	–	–
Subordinated floating rate note 2004*	–	–	150	150
8.2% Subordinated bond 2004 (US $500m)	304	292	–	–
Subordinated floating rate note 2004 (US $500m)*	–	–	304	292
6.69% Subordinated bond 2005 (US $750m)	454	436	454	436
10.75% Subordinated bond 2006	100	101	100	101
Subordinated guaranteed floating rate note 2009 (Swiss Fr 130m)	55	57	–	–
Subordinated floating rate note 2009 (US $102m)*	–	–	62	60
11.50% Subordinated guaranteed bond 2017	152	152	–	–
11.59% Subordinated loan stock 2017*	–	–	150	150
10.125% Subordinated guaranteed bond 2023	152	152	–	–
10.18% Subordinated loan stock 2023*	–	–	150	150
Undated subordinated liabilities:				
10.0625% Exchangeable subordinated capital securities	199	198	199	198
7.35% Subordinated step-up perpetual notes (US $500m)	302	289	302	289
5.56% Subordinated guaranteed bond (YEN 15 billion)	70	76	70	76
5.50% Subordinated guaranteed notes (YEN 5 billion)	23	25	23	25
4.00% Subordinated perpetual notes (YEN 5 billion)	23	25	23	25
	2,463	2,374	2,477	2,363

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

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

The 10.0625% Exchangeable subordinated capital securities are exchangeable into fully paid 10.375% non-cumulative non-redeemable sterling preference shares of £1 each, at the option of Abbey National. Exchange may take place on any interest payment date providing that between 30 and 60 days notice has been given to the holders. The holders will receive one new sterling preference share for each £1 principal amount of capital securities held. The rights attaching to these preference shares would be the same as those detailed in note 39.

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

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

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

39. Called up share capital and share premium account

	Ordinary shares of 10 pence each £m	Preference shares of £1 each £m	Preference shares of US$0.01 each £m	Total £m
Authorised share capital				
At 31 December 1996	175	1,000	6	1,181
At 31 December 1997	175	1,000	6	1,181
Issued and fully paid share capital				
At 1 January 1997	141	200	–	341
Issued under employee share option schemes	–	–	–	–
Issue of preference shares	–	125	–	125
At 31 December 1997	141	325	–	466
Share premium account				
At 1 January 1997	1,320	9	112	1,441
Shares issued	15	–	–	15
Exchange adjustments	–	–	4	4
At 31 December 1997	1,335	9	116	1,460

The authorised share capital of Abbey National is £1,181m (£1,181m) which includes £175m (£175m) ordinary share capital (comprising 1,750 million ordinary shares of 10 pence each) and £1,006m (£1,006m) preference share capital (comprising 1 billion shares of £1 each and 1 billion shares of US $0.01 each).

Under the Company's Executive, Employee and Sharesave schemes, employees hold options to subscribe for 25,903,757 (27,930,883) ordinary shares at prices ranging from 149.0 to 1353.11 pence per share, exercisable up to 2007. During the year 5,479,678 (3,181,557) ordinary shares were issued on the exercise of options for a consideration of £15m (£8m).

As of 31 December 1997 there were 2,388,528 shareholders. The following table shows an analysis of their holdings:

	Ordinary shares of 10 pence each		Preference shares of £1 each		Preference shares of US$0.01 each	
Size of shareholding	Shareholders	Shares	Shareholders	Shares	Shareholders	Shares
1-100	1,568,697	152,800,259	–	–	6	576
101 - 1,000	788,203	334,661,893	9	7,068	30	15,370
1,001+	30,693	925,184,414	885	324,992,932	5	7,984,054
	2,387,593	1,412,646,566	894	325,000,000	41	8,000,000

39. Called up share capital and share premium account (continued)

Sterling preference shares

On 9 June 1997, Abbey National plc issued 125 million non-cumulative non-redeemable 8.625% Sterling preference shares of £1 each for a consideration of approximately £125m for the purpose of strengthening the Group's capital base. The terms of these preference shares are identical to the issues made in February 1996 and October 1995, except that the first dividend has been accrued from 9 June 1997, and are described below.

Holders of the sterling preference shares are entitled to receive a bi-annual non-cumulative preferential dividend payable in sterling out of the distributable profits of the Company. The rate per annum will ensure that the sum of the dividend payable on such date and the Associated Tax Credit (as defined in terms of the sterling preference shares) represents an annual rate of 8.625% per annum of the nominal amount of shares issued in 1997, and an annual rate of 10.375% for shares issued in 1995 and 1996.

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

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

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

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

US dollar preference shares

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

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

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

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

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

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

40. Reserves and profit and loss account

	Profit and loss account		Non-distributable reserve	
	Group £m	Company £m	Group £m	Company £m
At 1 January 1997	2,381	2,136	230	–
Profit retained for the financial year	407	86	–	–
Goodwill taken to profit and loss account reserve during the year	(139)	(4)	–	–
Exchange adjustments	(5)	–	–	–
Transfer from profit and loss account	–	–	78	–
At 31 December 1997	2,644	2,218	308	–

Goodwill taken to profit and loss account reserve during the year includes £129m on acquisitions of subsidiary undertakings (see note 24) and £10m of other amounts including goodwill on the purchase of a minority interest in a subsidiary undertaking.

The cumulative amount of goodwill taken directly to the profit and loss account reserve by the Group to 31 December 1997 and not subsequently recognised in the profit and loss account is £1,193m (£1,054m), and by the Company is £528m (£524m).

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

Exchange gains arising from foreign currency borrowings used to hedge investments in overseas Group undertakings of £69m (£129m) have been taken to the reserves of the Group and gains of £69m (£133m) have been taken to the reserves of the Company. These exchange movements are matched by corresponding exchange movements on the investments in the accounts of the Company, and exchange movements on the net assets of overseas Group undertakings in the Group accounts.

41. Reconciliation of movements in shareholders' funds

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Profit attributable to the shareholders of Abbey National plc	**954**	767	**555**	421
Dividends (see note 13)	**(469)**	(373)	**(469)**	(373)
	485	394	**86**	48
Other recognised net gains and losses relating to the year	**(5)**	(26)	–	–
Increases in ordinary share capital including share premium	**15**	474	**15**	474
Increases in preference share capital including share premium	**129**	220	**129**	220
Goodwill taken to profit and loss account reserve during the year	**(139)**	(610)	**(4)**	(524)
Net addition to shareholders' funds	**485**	452	**226**	218
Shareholders' funds at 1 January	**4,393**	3,941	**3,918**	3,700
Shareholders' funds at 31 December	**4,878**	4,393	**4,144**	3,918
Equity shareholders' funds	**4,428**	4,072	**3,694**	3,597
Non-equity shareholders' funds	**450**	321	**450**	321
At 31 December	**4,878**	4,393	**4,144**	3,918

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

42. Assets and liabilities denominated in foreign currency

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

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Assets	**42,489**	38,228	**2,918**	2,833
Liabilities	**47,332**	42,526	**2,371**	2,612

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

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

	Group 1997 £m	*Group 1996 £m*	*Company 1997 £m*	*Company 1996 £m*
Guarantees given by Abbey National plc of subsidiaries' liabilities	**–**	–	**85,637**	62,188
Guarantees given to third parties	**913**	1,759	**2**	8
Mortgaged assets granted to secure future obligations to third parties who have provided security to the leasing subsidiaries	**1,002**	811	**–**	–
	1,915	2,570	**85,639**	62,196

The Company has unconditionally and irrevocably guaranteed all the obligations of Abbey National Treasury Services plc, Abbey National Funding plc, Abbey National North America Corporation, Abbey National Bank SAE, Abbey National Treasury International Ltd, Abbey National (Gibraltar) Ltd, Abbey National France SA, Abbey National Funding (Jersey) Ltd, Abbey National Treasury (IOM) Ltd, Abbey National Second Capital BV, Cater Allen Bank (Jersey) Ltd, Cater Allen Bank (Isle of Man) Ltd, Cater Allen Ltd and Cater Allen International Ltd. The Company has also guaranteed certain liabilities of Abbey National First Capital BV, Abbey National Sterling Capital plc, Abbey National Homes Ltd, Solarlaser Ltd, Abbey National Beta Investments Ltd and Abbey National Life plc.

44. Memorandum items: Other contingent liabilities

	Group 1997 £m	*Group 1996 £m*	*Company 1997 £m*	*Company 1996 £m*
Other contingent liabilities	**779**	138	**16**	19

The principal other contingent liabilities are as follows:

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

Repayment of certain tax credits
Abbey National Treasury Services plc has received a demand from an overseas tax authority for an amount of £106m (at the balance sheet exchange rate) (1996: £118m) relating to the repayment of certain tax credits received and related charges. The subsidiary has been advised that it has strong grounds to challenge the validity of the demand and accordingly no specific provision has been made.

Pension transfers and opt-outs
The Group continues to review business involving the transfer from occupational to personal pension schemes and the opting out and non-joining of occupational pension schemes. The Group has carried out a review of the potential exposures in respect of such business as at 31 December 1997, in accordance with the relevant regulator's guidelines, using the most up to date information available. Taking into consideration the uncertainties regarding this issue, provisions in respect of possible compensation to customers have been reviewed and adjusted where considered appropriate, and are included in note 37.

45. Memorandum items: Commitments
The table below shows the contract or principal amount of commitments other than those relating to derivative financial instruments (see note 47).

	Group 1997 £m	*Group 1996 £m*	*Company 1997 £m*	*Company 1996 £m*
Forward asset purchases and forward deposits placed	**–**	552	**–**	–
Formal standby facilities, credit lines and other commitments to lend:				
One year and over	**984**	1,526	**–**	–
Less than one year	**1,088**	764	**255**	178
Other commitments	**92**	68	**34**	33
	2,164	2,910	**289**	211

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

46. Operating leases

	Group				Company			
	1997 Property £m	*1997 Equipment £m*	*1996 Property £m*	*1996 Equipment £m*	*1997 Property £m*	*1997 Equipment £m*	*1996 Property £m*	*1996 Equipment £m*
Further rental commitments under operating leases expiring:								
In not more than one year	**1**	**3**	3	4	**1**	**3**	3	3
In more than one year but not more than five years	**6**	**8**	3	9	**6**	**7**	2	9
In more than five years	**44**	**1**	49	–	**39**	**–**	43	–
	51	**12**	55	13	**46**	**10**	48	12

As at 31 December 1997 the Group held various leases on land and buildings, many for extended periods, and other leases for equipment, which require the following aggregate rental payments:

	Group 1997 £m	*Company 1997 £m*
Year ended 31 December		
1998	**62**	**59**
1999	**59**	**54**
2000	**56**	**51**
2001	**56**	**50**
2002	**54**	**49**
Total thereafter	**427**	**382**

	1997 £m	*1996 £m*
Group rental expense comprises:		
In respect of minimum rentals	**56**	56
Less sub-lease rentals	**(3)**	(2)
	53	54

47. Derivatives

Derivative financial instruments ('derivatives') are contracts or agreements whose value is derived from one or more underlying indices or asset values inherent in the contract or agreement. Derivatives are used for trading and non-trading purposes. These terms are defined in Accounting Policies: Derivatives on page 55.

Non-trading derivatives

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

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

47. Derivatives (continued)

Activity	Risk	Type of Hedge
Management of the return on variable rate assets funded by shareholders' funds and net non-interest bearing liabilities.	Reduced profitability due to falls in interest rates.	Receive fixed interest rate swaps. Purchased interest rate floors.
Fixed-rate lending.	Sensitivity to increases in interest rates.	Pay fixed interest rate swaps. Purchased interest rate caps.
Fixed-rate retail and wholesale funding.	Sensitivity to falls in interest rates.	Receive fixed interest rate swaps.
Equity-linked retail funding.	Sensitivity to increases in equity market indices.	Receive equity swaps.
Management of other net interest income on retail activities.	Sensitivity of returns to changes in interest rates.	Interest rate swaps and caps/floors according to the type of risk identified.
Fixed rate asset investments.	Sensitivity to increases in interest rates.	Pay fixed interest rate swaps.
Investment in foreign currency assets.	Sensitivity to strengthening of sterling against other currencies.	Cross-currency swaps. Foreign currency funding.
Profits earned in foreign currencies.	Sensitivity to strengthening of sterling against other currencies.	Forward foreign exchange contracts. Purchased options.
Investment in, and issuance of, products with embedded options.	Sensitivity to changes in underlying rate and rate volatility causing option exercise.	Interest rate swaps plus caps/floors, and other matched options.
Investment in, and issuance of, bonds with put/call features.	Sensitivity to changes in rates causing option exercise.	Swaptions*.
Firm commitments (e.g. asset purchases, issues arranged).	Sensitivity to changes in rates between arranging a transaction and completion.	Hedges are arranged at the time of commitments if there is exposure to rate movements.

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

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

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

Trading Derivatives

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

47. Derivatives (continued)

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

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

ANTS also has a mandate to transact in credit default swaps, spread put options and credit linked notes. Limits are set per deal and there is also a total portfolio limit. Market Risk mandates have also been approved for each credit derivative type, which sets out instrument definition, consideration of market risk sensitivities and reporting requirements. ANTS acts as principal under this mandate, and takes a fee for guaranteeing the counterparty against the default of the senior obligations of a third party.

Derivatives used in trading activities are stated at fair value.

Quantitative disclosures

The table below shows the contract or underlying principal amounts, and replacement costs of non-trading and trading derivatives analysed by type of contract. Contract or underlying principal amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The replacement cost represents the cost of replacing contracts with positive values, calculated at market rates current at the balance sheet date.

	Group 1997 Contract or underlying principal amounts £m	*Group 1997 Positive fair values £m*	*Group 1997 Negative fair values £m*	*Group 1996 Contract or underlying principal amounts £m*	*Group 1996 Positive fair values £m*	*Group 1996 Negative fair values £m*
Non-trading derivatives:						
Exchange rate contracts						
Cross currency swaps	**13,173**	**256**	**718**	10,850	372	501
Forward foreign exchange	**6,891**	**13**	**13**	6,545	12	–
	20,064	**269**	**731**	17,395	384	501
Interest rate contracts						
Interest rate swaps	**58,847**	**857**	**1,044**	56,563	1,278	1,508
Caps, floors and swaptions	**5,790**	**4**	**–**	7,174	2	2
Futures (exchange traded)	**5,283**	**11**	**–**	2,725	1	–
Forward rate agreements	**575**	**–**	**–**	519	1	1
	70,495	**872**	**1,044**	66,981	1,282	1,511
Equity contracts						
Equity swaps	**155**	**46**	**1**	–	–	–
Equity options	**62**	**–**	**–**	–	–	–
	217	**46**	**1**	–	–	–
Total	**90,776**	**1,187**	**1,776**	84,376	1,666	2,012

Included in the above analysis of non-trading derivatives are exchange rate contracts and interest rate contracts with underlying principal amounts of £1,540m (£782m) and £25,243m (£21,692m) respectively, which were undertaken by Group entities with ANFP. The total net positive fair value of such contracts amounted to £173m (nil).

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

47. Derivatives (continued)

	Group 1997 Contract or underlying principal amounts £m	Group 1997 Positive fair values £m	Group 1997 Negative fair values £m	Group 1996 Contract or underlying principal amounts £m	Group 1996 Positive fair values £m	Group 1996 Negative fair values £m
Trading derivatives:						
Exchange rate contracts						
Cross currency swaps	**1,238**	**98**	**135**	1,344	115	131
Forward foreign exchange	**94**	**–**	**9**	–	–	–
	1,332	**98**	**144**	1,344	115	131
Interest rate contracts						
Interest rate swaps	**55,435**	**1,024**	**1,043**	44,254	961	1,185
Forward rate agreements	**7,730**	**2**	**2**	7,184	4	3
Futures (exchange traded)	**1,673**	**–**	**–**	8,160	–	1
Caps, floors and swaptions	**7,492**	**55**	**61**	4,998	44	–
	72,330	**1,081**	**1,106**	64,596	1,009	1,189
Equity contracts: futures	**4**	**–**	**–**	7	–	–
Total	**73,666**	**1,179**	**1,250**	65,947	1,124	1,320
Effect of netting		**(1,029)**	**(1,029)**		(865)	(865)
Translation differences on foreign exchange derivatives used for hedging purposes		**332**	**804**		350	945
Unamortised premiums		**117**	**10**		91	8
Fair values of contracts between ANFP and other Group entities		**–**	**173**		–	–
Amount included in Other assets/Other liabilities		**599**	**1,208**		700	1,408

Positive fair values arise where gross positive fair values exceed gross negative fair values on a contract by contract basis. This equates to net replacement cost. Negative fair values arise where gross negative fair values exceed gross positive fair values on a contract by contract basis. The totals of positive and negative fair values arising on trading derivatives as at 31 December 1997 have been netted where the Group has a legal right of offset with the relevant counterparty.

As at the balance sheet date, the Company held non-trading interest rate swaps, forward foreign exchange contracts and equity swaps with underlying principal amounts of £25,432m (£23,755m), £4,174m (nil) and £156m (nil) respectively. The net replacement cost of these contracts was £441m (£522m), nil (nil) and £35m (nil) at 31 December 1997.

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

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

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

	1997 Contract or underlying principal amounts £m	1997 Net replacement cost £m	1996 Contract or underlying principal amounts £m	1996 Net replacement cost £m
Derivatives maturing:				
In not more than one year	**31,380**	**180**	31,555	398
In more than 1 year but not more than 5 years	**42,109**	**576**	36,452	650
In more than 5 years	**12,004**	**420**	13,644	617
	85,493	**1,176**	81,651	1,665

For a discussion of risk management of derivatives within the trading and non-trading portfolios see page 22 of the Operating and Financial Review.

48. Consolidated cash flow statement

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

	1997 £m	1996 £m
Profit on ordinary activities before tax	**1,279**	1,167
Decrease (increase) in interest receivable and prepaid expenses	**(181)**	28
Increase (decrease) in interest payable and accrued expenses	**265**	(521)
Provisions for bad and doubtful debts	**121**	127
Provisions for contingent liabilities and commitments	**16**	4
Net advances written off	**(186)**	(155)
Increase in the value of long term assurance business	**(129)**	(97)
Depreciation	**106**	93
Profit on sale of tangible fixed assets and investments	**(18)**	(3)
Exceptional items	**145**	18
Effect of other deferrals and accruals of cash flows from operating activities	**32**	71
Net cash inflow from trading activities	**1,450**	732
Net decrease (increase) in loans and advances	**(1,372)**	1,390
Net increase in investment in finance leases	**(480)**	(1,466)
Net decrease (increase) in bills and securities	**3,197**	(3,180)
Net decrease in deposits and customer accounts	**(169)**	(3,193)
Net increase in debt securities in issue	**4,784**	6,920
Net increase (decrease) in other liabilities less assets	**(127)**	901
Exchange movements	**375**	2,323
Net cash inflow from operating activities	**7,658**	4,427

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

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

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

	1997 Cash & balances with central banks £m	1997 Loans & advances to other banks repayable on demand £m	1996 Cash & balances with central banks £m	1996 Loans & advances to other banks repayable on demand £m
At 1 January	**228**	**568**	145	435
Net cash inflow	**101**	**466**	83	133
At 31 December	**329**	**1,034**	228	568

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

The Group is required to maintain balances with the Bank of England which at 31 December 1997 amounted to £240m (£221m). These are shown in loans and advances to banks, and are not included in cash for the purposes of the cash flow statement.

c) Analysis of changes in financing during the year

	1997 Share capital inc. Share premium £m	1997 Subordinated liabilities £m	1996 Share capital inc. Share premium £m	1996 Subordinated liabilities £m
At 1 January	**1,782**	**2,374**	1,088	2,127
Net cash inflow from financing	**140**	**62**	236	290
Shares issued for a non-cash consideration	**–**	**–**	462	–
Effect of foreign exchange rate changes	**4**	**27**	(4)	(157)
Acquisitions of subsidiary undertakings	**–**	**–**	–	114
At 31 December	**1,926**	**2,463**	1,782	2,374

48. Consolidated cash flow statement (continued)

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

	1997 £m	1996 £m
Net assets acquired:		
Treasury bills and other eligible bills	542	–
Loans and advances to banks	5,813	1,367
Loans and advances to customers	7,029	12,201
Debt securities	5,540	693
Tangible fixed assets	4	117
Other assets	185	532
Deposits by banks	(8,250)	(6)
Customer accounts	(10,569)	(10,229)
Debt securities in issue	–	(2,178)
Subordinated liabilities	–	(114)
Other liabilities	(184)	(1,498)
Goodwill on acquisitions	129	606
	239	1,491
Satisfied by:		
Unsecured interest bearing loan notes	2	–
Cash	237	1,012
Deferred consideration	–	5
Shares issued	–	462
Dividend on shares issued	–	7
Provisions for additional consideration	–	5
	239	1,491

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

	1997 £m	1996 £m
Cash consideration	237	1,012
Cash acquired	(1)	(11)
Net outflow of cash in respect of acquisitions of subsidiary and associated undertakings/purchase of business	236	1,001

The subsidiary undertakings acquired during the year utilised £15m of the Group's net cash inflow from operating activities.

f) Sale of subsidiary undertakings

	1997 £m	1996 £m
Net assets disposed of:		
Tangible fixed assets	1	–
Other assets	9	–
Cash at bank and in hand	1	–
Creditors	(5)	–
Other liabilities	(4)	–
	2	–
Profit on disposal	2	–
Consideration received	4	–
Satisfied by:		
Cash	–	–
Other assets	4	–

g) Analysis of the net outflow of cash in respect of the sale of subsidiary undertakings

	1997 £m	1996 £m
Cash received as consideration	–	–
Cash disposed of	1	–
Net outflow of cash in respect of sale of subsidiary undertakings	1	–

49. Retirement benefits

The Abbey National Amalgamated Pension Fund is the principal pension scheme within the Group, covering 54% of the Group's employees, and is a funded defined benefits scheme.

The latest formal actuarial valuation carried out by an independent professionally qualified actuary was made as at 31 March 1996, at which date the market value of the scheme assets was £774m.

The valuation was prepared by using the projected unit funding method. As a result of this valuation, and subsequent assessment as at 31 December 1996, a funding level of 108% was disclosed. The regular employer's contribution rate in respect of benefits accruing after the valuation date is 21.9% of pensionable salaries.

A review of the pension scheme valuation was carried out as at 31 March 1997 by the appointed actuary, at which date the market value of the scheme assets was £787m, and the funding level 114%. The review was carried out using the same actuarial method and main long term financial assumptions as in the formal valuation.

The main long term financial assumptions used in the valuation and review were:

	% Nominal per annum
Investment return	9.0
Equity dividend growth	4.5
Pension increases	4.25
General salary increases	6.5
General price inflation	4.5

The pension cost of £22m (£32m) reflects the regular contribution rate less an amount in respect of the surplus being recognised over the expected remaining service lives of the members of the fund in accordance with SSAP 24 'Accounting for Pension Costs'. Contributions of £40m (£44m) were made to the fund in 1997 and a provision of £13m (£32m) has been included in the balance sheet. Formal actuarial valuations of the assets and liabilities of the scheme to determine its financial position are carried out on a triennial basis and, in addition, there is an annual review by the appointed actuary. The results of these reviews are included in the accounts. The next formal valuation will be made not later than as at 31 March 1999.

The Abbey National Group Pension Scheme covers 14% of the Group's employees, and is also a defined benefits scheme. This Scheme was first established in 1996 and accordingly, no formal actuarial valuation has yet taken place. The first formal valuation will be made as at 31 March 1999. A pension cost of £4m (nil) has been charged to the profit and loss account reflecting the regular contribution rate of 10.2% of pensionable salaries.

The National and Provincial Building Society Pension Fund is a funded defined benefits scheme which covers 10% of the Group's employees, and includes employees who joined the Group with the transfer of the business of N&P. The latest actuarial valuation was made as at 31 March 1997 using the projected unit funding method and disclosed a funding level of 104%. A pension cost of £7m has been charged to the profit and loss account in respect of the year ended 31 December 1997 (five months to 31 December 1996, £3m), and contributions to the fund for the period were £8m (£5m). Included in Other assets as at 31 December 1997 was an amount of £26m (£28m) in respect of the unamortised pension scheme surplus assessed at the date the business of N&P was purchased. This was based on an actuarial assessment of the scheme at that date and is included in the balance sheet in accordance with FRS7. This balance is being amortised over the average remaining service lives of employees in the scheme, and £2m was charged to the profit and loss account in the year ended 31 December 1997 (five months to 31 December 1996, £1m).

The First National Finance Corporation Pension and Life Assurance Plan covers certain employees of First National Finance Corporation plc and its subsidiaries amounting to 4% of the Group's employees and is also a funded defined benefits scheme. The latest actuarial valuation was made as at 1 May 1996 and disclosed a funding level of 122.5%.

The Scottish Mutual Assurance plc Staff Pension Scheme covers certain employees of the Life Assurance Division amounting to 5% of the Group's employees and is also a funded defined benefits scheme. The latest actuarial valuation was made as at 31 December 1994 and disclosed a funding level of 122%.

50. Directors' emoluments and interests

Further details of directors' emoluments and interests are included in the Report of the Personnel and Remuneration Committee on pages 32 to 41. These details include an analysis of salary and other payments and benefits by director on page 37, an analysis of directors' share interests and share options on pages 39 to 40 and details of the directors' conditional rights over the Company's shares under the Long Term Incentive Plan on page 41.

Ex-gratia pensions paid to former directors of Abbey National plc in 1997, which have been provided for previously, amounted to £160,300 (£166,038). The Board has determined that it will no longer award any new such ex-gratia pensions and accordingly, no charge (nil) to the profit and loss account has been made in respect of them.

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

	Number of persons	*Aggregate amount outstanding £000*
Directors		
Loans	10	966
Quasi loans	4	8
Credit transactions	–	–
Officers		
Loans	31	2,836
Quasi loans	8	8
Credit transactions	21	417

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

Further disclosures relating to these transactions, as required under FRS 8, 'Related party disclosures' are given in note 51.

51. Related party disclosures

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

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

	1997		*1996*	
	No. of directors and executive officers (1)	*Amounts in respect of directors, executive officers (1) and their close family members £000*	*No. of directors and executive officers (1)*	*Amounts in respect of directors, executive officers (1) and their close family members £000*
Secured loans, unsecured loans and overdrafts				
Amounts advanced during the year	13	824	9	11
Capital amounts repaid during the year	7	516	6	217
Balances outstanding as at 31 December 1997	13	1,068	14	828
Deposit, investment, bank and instant access accounts				
Amounts deposited in the year	13	2,572	16	1,183
Amounts withdrawn in the year	8	1,458	17	987
Balances outstanding as at 31 December 1997	16	1,666	18	1,221
Life assurance policies and investments				
Premiums paid/amounts invested during the year	1	18	4	233
Total sum insured/value of investment	3	213	4	426

51. Related party disclosures (continued)

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

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

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

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

b) Transactions with associated undertakings

Abbey National plc acts as agent for Commercial Union Underwriting Ltd (CUUL), under which it passes insurance premiums to CUUL and earns an agent's margin. The agency margin amounted to £120m (£108m) for the year ended 31 December 1997.

Abbey National plc has a joint venture agreement with Commercial Union Assurance plc (CU). During the year, CU contributed £8m (nil) for certain pre set-up costs for insurance operations.

On 4 August 1997, Abbey National Independent Consulting Group Ltd acquired a 49% share in Willis National Holdings Ltd, a company offering independent financial advice. The Group earns a commission on insurance premiums, for which it pays professional service fees. The net income from such fees amounted to £1m (nil).

Abbey National has a one-third share in Travellers Exchange Corporation plc (Travelex). Travelex and Abbey National plc have an agreement to develop the foreign currency business in Abbey National's branches. The Group's share of the profits arising from this agreement amounted to £2m (nil) for the year ended 31 December 1997.

In February 1997, Abbey National plc entered into a joint venture agreement with Safeway plc with the launch of the ABC Bonus Account Card. Customer accounts are all managed by Abbey National plc, with a share of profits being paid to Safeway. During the year ended 31 December 1997, nil (nil) was paid to Safeway plc.

Balances outstanding between the Group and associated companies as at 31 December 1997 are detailed in note 17 and note 30.

c) Transactions with long term assurance funds

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

As at 31 December 1997, Group entities owed £258m (£188m) to, and were owed £27m (£89m) by the long term assurance funds. Of these respective amounts £257m (£184m) relates to amounts deposited by the long term assurance funds with Abbey National plc or Abbey National Treasury Services plc, and £2m (£47m) relates to amounts owed by the long term assurance funds to Abbey National plc. The remaining amounts represent balances between the long term assurance funds and the shareholders' funds of the life assurance businesses within the Group.

Included in fees and commissions receivable in the year is an amount of £21m (£19m) receivable from the long term assurance fund of Abbey National Life in respect of life assurance products sold through the retail branch network.

During the year Abbey National Financial Investment Services plc incurred costs amounting to £86m (£72m) on behalf of the long term assurance funds. All such costs were recharged to the long term assurance funds.

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

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

The value of the funds' holdings in internally managed unit trusts amounted to £632m (£593m) at 31 December 1997. The unit trusts are managed by Abbey National Unit Trust Management Ltd, Scottish Mutual International Fund Managers Ltd and Scottish Mutual International Managers Ltd.

Group Financial Summary - Profit and Loss Accounts

	1997 Before exceptional items £m	1997 Exceptional items £m	1997 Total £m	1996 Total £m	1995 Total £m	1994 Total £m	1993 Total £m
Net interest income	**2,022**	**(133)**	**1,889**	1,794	1,584	1,394	1,338
Other income and charges	**736**	**(12)**	**724**	555	399	365	376
Operating expenses	**(1,194)**	**–**	**(1,194)**	(1,038)	(870)	(755)	(763)
Provisions for bad and doubtful debts	**(121)**	**–**	**(121)**	(127)	(72)	(74)	(218)
Provisions for contingent liabilities and commitments	**(16)**	**–**	**(16)**	(4)	(7)	–	–
Amounts written off fixed asset investments	**(3)**	**–**	**(3)**	(13)	(8)	2	1
Loss on disposal/reorganisation of estate agency business	**–**	**–**	**–**	–	–	–	(30)
Profit on ordinary activities before tax	**1,424**	**(145)**	**1,279**	1,167	1,026	932	704
Tax on profit on ordinary activities	**(463)**	**137**	**(326)**	(403)	(344)	(322)	(314)
Profit on ordinary activities after tax	**961**	**(8)**	**953**	764	682	610	390
Minority interests - equity	**1**	**–**	**1**	3	1	–	–
Profit attributable to the shareholders of Abbey National plc	**962**	**(8)**	**954**	767	683	610	390
Transfer to non-distributable reserve	**(78)**	**–**	**(78)**	(67)	(59)	(65)	(32)
Dividends - ordinary and preference shares	**(469)**	**–**	**(469)**	(373)	(290)	(233)	(184)
Profit retained for the financial year	**415**	**(8)**	**407**	327	334	312	174
Profit on ordinary activities before tax and exceptional items includes for:							
operations acquired in the year excluding integrated businesses			**7**	8	9	22	–
operations discontinued in 1995 (with prior year comparative)			**–**	–	(8)	(9)	–
operations discontinued in 1993			**–**	–	–	–	(2)
Earnings per ordinary share (pence)			**65.2p**	56.5p	51.7p	46.5p	29.7p
Dividends per ordinary share (pence)							
Net			**30.70p**	26.10p	21.75p	17.75p	14.0p
Gross equivalent			**38.38p**	32.63p	27.19p	22.19p	17.5p
Dividend cover (times)			**2.1**	2.1	2.4	2.6	2.1

The Group financial summary is based on the audited consolidated financial statements of the Abbey National Group for the five years ended 31 December 1997, and has been derived from the consolidated financial statements for each of the relevant years.

For a description of exceptional items see note 4 to the accounts. Operating expenses in 1996 include costs of £61m incurred in the integration of the business of the National and Provincial Building Society (N&P).

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

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

Group Financial Summary - Balance Sheets

	1997 £m	1996 £m	1995 £m	1994 £m	1993 £m
Assets					
Cash, treasury bills and other eligible bills	**1,957**	339	391	598	757
Loans and advances to banks	**8,993**	2,825	3,579	2,906	3,556
Loans and advances to customers	**72,834**	64,227	51,090	48,484	45,049
Net investment in finance leases	**4,655**	4,310	2,844	2,278	2,253
Securities and investments	**46,537**	39,774	35,297	32,374	25,312
Long term assurance business	**649**	555	425	352	287
Tangible fixed assets	**698**	689	585	534	509
Operating lease assets	**67**	26	–	–	–
Other assets	**4,317**	3,397	3,403	2,701	2,208
Assets of long term assurance funds	**10,101**	7,869	5,518	4,230	3,871
Total assets	**150,808**	124,011	103,132	94,457	83,802
Liabilities					
Deposits by banks	**24,536**	17,718	19,393	17,826	16,368
Customer accounts	**61,675**	49,678	40,962	38,056	36,143
Debt securities in issue	**40,201**	35,193	26,095	23,852	19,030
Other liabilities	**6,954**	6,786	5,096	5,269	4,136
Subordinated liabilities including convertible debt	**2,463**	2,374	2,127	1,520	868
Liabilities of long term assurance funds	**10,101**	7,869	5,518	4,230	3,871
	145,930	119,618	99,191	90,753	80,416
Non-equity shareholders' funds	**450**	321	101	–	–
Equity shareholders' funds	**4,428**	4,072	3,840	3,704	3,386
Total liabilities	**150,808**	124,011	103,132	94,457	83,802

Supplementary Financial Information

For the year ended 31 December 1997

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

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

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

Average Balance Sheet

	1997 Average balance £m	*1997 Interest £m*	*1997 Average rate %*	*1996 Average balance £m*	*1996 Interest £m*	*1996 Average rate %*	*1995 Average balance £m*	*1995 Interest £m*	*1995 Average rate %*
Assets									
Treasury bills and other eligible bills									
UK	**811**	**28**	**3.51**	77	–	0.44	246	5	1.96
Non-UK	**21**	**2**	**7.02**	11	1	6.79	7	–	4.97
Loans and advances to banks									
UK	**4,250**	**230**	**5.41**	3,968	217	5.48	4,277	278	6.51
Non-UK	**308**	**23**	**7.39**	337	25	7.30	324	24	7.25
Loans and advances to customers									
UK	**67,214**	**5,097**	**7.58**	55,712	3,968	7.12	48,658	3,888	7.99
Non-UK	**1,273**	**82**	**6.50**	1,347	108	7.98	1,344	110	8.17
Lease receivables									
UK	**4,500**	**306**	**6.81**	3,663	243	6.62	2,507	177	7.05
Non-UK	**31**	**1**	**2.81**	42	2	4.58	30	1	4.34
Debt securities									
UK	**40,200**	**2,707**	**6.73**	35,720	2,337	6.54	33,600	2,320	6.90
Non-UK	**2,833**	**182**	**6.42**	2,219	145	6.55	1,351	91	6.77
Total average interest earning assets and interest income	**121,441**	**8,658**	**7.13**	103,096	7,046	6.83	92,344	6,894	7.47
Allowance for loan losses	**(663)**	**–**	**–**	(682)	–	–	(555)	–	–
Non-interest earning assets									
Long term assurance fund assets	**8,737**	**–**	**–**	6,409	–	–	4,625	–	–
Other	**6,372**	**–**	**–**	5,348	–	–	4,796	–	–
Total average assets and interest income	**135,887**	**8,658**	**6.37**	114,171	7,046	6.17	101,210	6,894	6.81
Non-UK assets as a percentage of total	**3.50%**	**–**	**–**	3.46%	–	–	3.21%	–	–
Total average interest earning assets and net interest income	**121,441**	**2,038**	**1.68**	103,096	1,815	1.76	92,344	1,579	1.71
Net interest (income) expense allocated to dealing profits	**–**	**(16)**	**–**	–	(21)	–	–	5	–
Net interest income before exceptional items (Consolidated Profit and Loss Account)	**–**	**2,022**	**–**	–	1,794	–	–	1,584	–

	Average Balance Sheet								
	1997 Average balance £m	1997 Interest £m	1997 Average rate %	1996 Average balance £m	1996 Interest £m	1996 Average rate %	1995 Average balance £m	1995 Interest £m	1995 Average rate %
Liabilities and shareholders' funds									
Deposits by banks									
UK	19,358	1,178	6.08	20,114	1,197	5.95	19,496	1,303	6.69
Non-UK	650	39	5.94	493	28	5.69	720	46	6.40
Customer accounts - retail demand deposits									
UK	24,559	961	3.91	23,798	809	3.40	21,725	1,038	4.78
Non-UK	445	22	4.94	175	8	4.70	116	6	5.37
Customer accounts - retail time deposits									
UK	19,353	1,328	6.86	15,112	883	5.85	14,382	939	6.53
Non-UK	1,552	96	6.22	1,114	67	6.03	922	63	6.78
Customer accounts - wholesale deposits									
UK	7,959	370	4.65	4,080	229	5.62	2,486	154	6.21
Non-UK	181	11	6.28	282	17	5.85	245	15	5.96
Bond and medium term notes									
UK	21,176	1,432	6.76	16,965	1,106	6.52	14,317	911	6.36
Non-UK	253	14	5.44	233	15	6.31	377	20	5.36
Other debt securities in issue									
UK	11,595	745	6.43	8,968	549	6.13	7,760	533	6.86
Non-UK	4,869	245	5.04	3,287	169	5.12	2,795	171	6.13
Dated and undated loan capital and other subordinated liabilities									
UK	1,779	136	7.63	1,476	107	7.25	951	65	6.82
Non-UK	668	43	6.42	726	47	6.41	796	51	6.38
Total average interest bearing liabilities and interest expense	114,397	6,620	5.79	96,823	5,231	5.40	87,088	5,315	6.10
Non-interest bearing liabilities									
Long term assurance fund liabilities	8,737	–	–	6,409	–	–	4,625	–	–
Other	7,959	–	–	6,656	–	–	5,588	–	–
Shareholders' funds	4,794	–	–	4,283	–	–	3,909	–	–
Total average liabilities, shareholders' funds and interest expense	135,887	6,620	4.87	114,171	5,231	4.58	101,210	5,315	5.25
Non-UK liabilities as a percentage of total	7.50%	–	–	5.53%	–	–	6.53%	–	–
Interest income as a percentage of average interest earning assets			7.13			6.83			7.47
Interest expense as a percentage of average interest bearing liabilities			5.79			5.40			6.10
Interest spread			1.34			1.43			1.37
Net interest margin			1.68			1.76			1.71

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

The average balance sheet for 1997 includes amounts relating to collateral paid or received in respect of stock borrowing or lending transactions of Cater Allen Holdings PLC, acquired in July 1997. Such average balances amount to £287 million within Loans and advances to banks, and £1,920 million within Loans and advances to customers with corresponding balances in Deposits by banks and Customer accounts - wholesale respectively. Such balances typically yield low amounts of interest, and therefore have the effect of reducing average yields.

Differences between UK GAAP and US GAAP

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

Goodwill/core deposit intangible

UK GAAP

Goodwill arising on consolidation as a result of the acquisition of subsidiary and associated undertakings and goodwill arising on the purchase of businesses are taken direct to reserves in the year in which they occur. On disposal of a business, the goodwill previously taken to reserves is recognised in the profit and loss account balanced by an equal credit to reserves. Where the directors believe that the purchased goodwill in continuing businesses has suffered a permanent diminution in value, a similar recognition in the profit and loss account and credit to reserves is made.

US GAAP

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

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

The net assets of businesses acquired have been restated for all material differences between UK and US GAAP that existed on acquisition. This has resulted in adjustments to the fair value of net assets transferred, with corresponding adjustments to goodwill of £36 million in 1997, £15 million in 1996, and £70 million in 1992 relating to the acquisitions of Cater Allen, National and Provincial Building Society and Scottish Mutual Assurance plc respectively, for US GAAP purposes.

Comparative figures for goodwill, net assets of businesses acquired and the shareholders' interest in long term assurance business have been restated for the correction of related errors in prior years' disclosures identified in the current year.

Pension costs

UK GAAP

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

US GAAP

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

Leasing

UK GAAP

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

US GAAP

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

Loan origination fees

UK GAAP

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

US GAAP

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

Shareholders' interest in long term assurance business

UK GAAP

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

US GAAP

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

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

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

Comparative figures for goodwill, net assets of businesses acquired and the shareholders' interest in long term assurance business have been restated for the correction of related errors in prior years' disclosures identified in the current year.

Stock-Based Compensation

UK GAAP

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

US GAAP

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

Dividend payable

UK GAAP

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

US GAAP

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

Investments in securities

UK GAAP

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

US GAAP

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

In previous years, unrealised gains and losses on derivative financial instruments hedging available for sale securities were excluded from shareholders' funds for US GAAP purposes. Following an exercise to refine the Group's reporting of derivative financial instruments, the 1996 comparative has been restated. The 1995 comparative has not been restated as the adjustment cannot be determined without unreasonable expense.

Deferred tax

UK GAAP

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

US GAAP

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

Provisions against lending losses

UK GAAP

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

US GAAP

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

Future developments

In 1997, the UK Accounting Standards Board issued FRS 10, 'Goodwill and Intangible Assets'. Under FRS 10, goodwill and intangible assets acquired after 1 January 1998 must be capitalised on the balance sheet and amortised through the profit and loss account over their useful economic lives, generally not exceeding 20 years. Goodwill acquired prior to 1998 will continue to be carried in reserves to the extent that it is not permanently impaired.

SFAS No. 127, an amendment to SFAS No. 125, 'Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities', deferred the effective date for certain requirements of SFAS No. 125, until 1998. Abbey National has reviewed SFAS No. 125, as amended by SFAS No. 127, and considers that it is unlikely to have a material effect on the reconciliation of net income and shareholders' funds between UK and US GAAP.

SFAS No. 132, 'Employers' Disclosures about Pensions and Other Postretirement Benefits', revises the disclosure requirements of SFAS No. 87 relating to pension and other post retirement plans. SFAS No. 132 is required to be adapted in respect of accounting periods beginning after December 15, 1997. Abbey National is currently reviewing the standard to determine what effect it may have on the level of additional disclosure provided.

Differences between UK and US accounting principles

The following table summarises the significant adjustments to consolidated net income and shareholders' funds which would result from the application of US GAAP instead of UK GAAP. Where applicable, the adjustments are stated gross of tax with the tax effect being included within the deferred tax effects of US/UK GAAP adjustments to net income and shareholders' funds.

	1997 £m	1996 £m	1995 £m
Profit attributable to the shareholders of Abbey National plc	**954**	767	683
Preference dividends	**(35)**	(13)	(2)
Consolidated Net Income of Abbey National plc (UK GAAP)	**919**	754	681
Goodwill	**(44)**	(33)	(18)
Core deposit intangible	**(45)**	(19)	–
Pensions cost	**(26)**	(6)	(13)
Leasing	**(13)**	(12)	(16)
Loan origination fees	**(9)**	(17)	2
Shareholders' interest in long term assurance business	**(35)**	(59)	(46)
Stock-based compensation costs	**(3)**	(8)	–
Deferred tax effect of the above US/UK GAAP adjustments	**23**	33	24
Deferred tax	**14**	3	1
Consolidated Net Income of Abbey National plc (US GAAP)	**781**	636	615
per 10 pence ordinary share	**55.4p**	47.6p	46.7p

	1997 £m	1996 £m	1995 £m
Shareholders' funds including non-equity interests (UK GAAP)	**4,878**	4,393	3,941
Goodwill	**794**	735	459
Core deposit intangible	**253**	298	–
Net assets of businesses acquired	**(49)**	(85)	(70)
Pensions cost	**(64)**	(38)	(32)
Leasing	**(81)**	(68)	(56)
Loan origination fees	**(26)**	(17)	–
Shareholders' interest in long term assurance business	**(157)**	(178)	(132)
Stock-based compensation costs	**(11)**	(8)	–
Share premium	**11**	8	–
Dividend payable	**290**	245	191
Unrealised surplus on securities available for sale	**628**	783	706
Unrealised deficit on derivatives hedging securities available for sale	**(478)**	(673)	–
Deferred tax effect of US/UK GAAP adjustments to net income	**149**	126	93
Deferred tax effect of US/UK GAAP adjustments charged directly to shareholders' funds	**(53)**	(56)	(248)
Deferred tax	**43**	29	22
Shareholders' funds including non-equity interests (US GAAP)	**6,127**	5,494	4,874

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