Alliance & Leicester plc

Registered in England & Wales
No. 3263713

Annual Report & Accounts

For the Year Ended
31 December 2008

Contents

Chief Executive's Review

Overview

2008 was a challenging year for Alliance & Leicester and the wider financial services market. On 10 October 2008, the acquisition of Alliance & Leicester by Santander formally completed and, in January 2009, Alliance & Leicester was transferred into Abbey. Following the acquisition a new management structure was announced. Alliance & Leicester's previous Chief Executive, David Bennett, joined the Board at Abbey to help oversee the integration, as well as taking charge of the intermediary channels in both banks. The two banks are now managed by a combined Board and Executive Committee.

The combination of Abbey, which includes Bradford & Bingley's savings business and branches, and Alliance & Leicester builds a UK operation with over 1,300 branches and together these businesses are the third largest deposit taker and second largest mortgage provider in the UK.

Business Performance

Prior to the acquisition by Santander, in 2008 the business actively sought to reduce customer loans and advances, with balances ending lower by £3.7bn. This trend was a result of continued prudent lending policies, focus on good quality low loan-to-value ('LTV') lending and the goal of improving the funding mix of customer loans. Residential mortgage balances fell by £5bn to £37.7bn and unsecured personal loans fell by £0.5bn to £3.4bn.

Retail customer deposits increased by £1.7bn, of which £1.3bn were attracted since the acquisition by Santander. This clearly demonstrates that Alliance & Leicester, as part of Abbey and the Santander Group, is seen as a safe haven for UK depositors. Alliance & Leicester also received more banking 'Best Buy' mentions than any other provider, helping to support strong current account openings of just under 300,000 accounts, and achieve business banking account openings of c. 34,000 which was slightly ahead of 2007.

Funding and Capital Strength

The recent market turmoil is unprecedented. Since August 2007, the global financial system has experienced difficult credit and liquidity conditions and disruptions leading to less liquidity, greater volatility and general widening of spreads. In September 2008, global financial markets deteriorated sharply following the bankruptcy filing by Lehman Brothers Holdings Inc. In the days that followed, it became apparent that a number of other major financial institutions, including some of the largest global commercial banks, investment banks, mortgage lenders, mortgage guarantors and insurance companies, were experiencing significant difficulties.

The UK Government initiative announced in early October 2008, including the provision of liquidity and funding support and facilities to enable banks to raise new capital to strengthen their capital base, was welcomed by Alliance & Leicester. Alliance & Leicester has been managing its balance sheet prudently, having reduced customer loans and advances and increased customer deposits. Alliance & Leicester did not use the UK Government recapitalisation scheme, nor do we expect to in the future. In 2008, Santander's commitments to the UK Government and regulators to improve the combined Tier 1 ratio of Abbey and Alliance & Leicester plc were met using the additional £1bn of capital announced at the time of the acquisition of Alliance & Leicester, which was transferred into Abbey from Santander. This capital has, in turn, been transferred to Alliance & Leicester plc in late December as planned.

In 2009, with respect to liquidity and funding arrangements, rather than capital, we expect to remain flexible in our approach. We believe that the current arrangements with the Bank of England, European Central Bank and US Federal Reserve, as well as the UK Credit Guarantee Scheme that are available to the UK banking industry will help the banking sector to meet liquidity and funding needs.

Key Financial Highlights

Alliance & Leicester's statutory loss before tax was £1,288m (2007: £399m profit), and a loss attributable to ordinary shareholders of £954m (2007: £256m profit). This was in line with expectations at the time of acquisition by Santander. These losses were impacted by the effects of market dislocation, particularly treasury impairment losses of £485m (2007: £153m) related to the Treasury portfolio, as well as other mark-to-market losses of £114m (2007: £42m) and reorganisation and other items of £890m (2007: £(62)m) including refinements to accounting estimates reflecting the state of the UK economy. These effects are included in non-trading adjustments which totalled £1,489m and are considered separately below.

On a trading basis (management's preferred profit measure and representing a baseline against which future performance will be measured, described in the Business Review – Summary on page 10 which excludes non-trading adjustments) profit before tax was £201m compared to £532m in 2007.

Summary Highlights

> Personal Financial Services trading income was £1.1bn, £231m lower than 2007. Income in Corporate Banking was slightly ahead of 2007 but Retail Banking and Treasury were significantly lower. This was mainly due to the higher cost of strategic funding and maintaining higher liquidity levels in Treasury, and lower fee income in Retail Banking largely relating to unsecured personal loans.

> Personal Financial Services trading expenses of £720m (2007: £700m) grew in line with inflation.

> Personal Financial Services trading impairment losses on loans and advances were £180m (2007: £100m) reflecting recent market conditions.

> Credit quality in customer loans & advances remained strong, with the average loan to value (LTV) on new residential mortgage business in 2008 at 63% compared to 67% in 2007. The average LTV of stock increased slightly to 49% (December 2007: 46%) reflecting the fall in house prices partially offset by active management of new business LTVs. Performance of the secured portfolio continues to be better than CML industry averages.

> Non-trading costs were £1,489m (2007: £133m) consisting of Treasury portfolio impairment losses of £485m (2007: £153m) as a result of the effects of market dislocation on trading and investment prices, including widening credit spreads, as well as hedging and certain other mark-to-market variances of £114m (2007: £42m) principally reflecting mark-to-market losses due to widening credit spreads, and reorganisation and other items of £890m (2007: £(62)m) including refinements to accounting estimates reflecting the state of the UK economy, and the write-off of a software project discontinued following the acquisition by Santander.

Looking Ahead to 2009

Alliance & Leicester was acquired by Santander in October 2008 and subsequently transferred into Abbey in January 2009. Alliance & Leicester's acquisition is part of Santander's UK growth strategy. The combination of Abbey, which includes Bradford & Bingley's savings business and branches, and Alliance & Leicester is a powerful platform for growth in the UK. The combination of the three UK businesses means we have market shares in excess of 10% in branches, savings, current accounts and mortgages.

As part of this process, Alliance & Leicester has given a full and unconditional guarantee in respect of the unsubordinated liabilities of Abbey National plc incurred prior to 31 July 2012 under a deed poll guarantee entered into by Alliance & Leicester on 19 March 2009. Abbey National plc has given a reciprocal guarantee in respect of the unsubordinated liabilities of Alliance & Leicester incurred prior to 31 July 2012 on the same date.

In addition, the transfer of Alliance & Leicester accelerates Abbey's growth in the SME market by two to three years, with the addition of 20 corporate centres and around 100,000 SME customers.

Our strategy will be to focus on delivering excellent customer service, drive efficiencies and reinvest in innovative value-for-money products, which in turn will drive cross-sales to our UK customers, and increase customer loyalty.

In order to continue growing our business and enable further investment in frontline services and branches, we will be transferring Alliance & Leicester onto Santander's proprietary IT platform, Partenon in 2009.

We expect Alliance & Leicester to continue to be profitable on a trading basis under Santander's ownership.

Summary

2009 will undoubtedly be a very challenging year. Despite this, we are cautiously optimistic about our business prospects and have begun to benefit from being part of the Santander Group, which means that our UK business is well-positioned for the challenges and opportunities ahead.

António Horta-Osório
Chief Executive

Forward Looking Statements

Alliance & Leicester plc and its subsidiaries (together 'Alliance & Leicester') may from time to time make written or oral forward-looking statements. Examples of such forward-looking statements include, but are not limited to:

- projections or expectations of revenues, costs, profit (or loss), earnings (or loss) per share, dividends, capital structure or other financial items or ratios;
- statements of plans, objectives or goals of Alliance & Leicester or its management, including those related to products or services;
- statements of future economic performance; and
- statements of assumptions underlying such statements.

Words such as 'believes', 'anticipates', 'expects', 'intends', 'aims', 'plans', 'targets' and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

By their very nature, forward-looking statements cannot be objectively verified, are speculative and involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. Alliance & Leicester cautions readers that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements made by Alliance & Leicester or on Alliance & Leicester's behalf. Some of these factors are considered in detail in the Risk Management section on page 16 and the Risk Factors section on page 102 and may include:

- inflation, interest rate, exchange rate, basis spread, market and monetary fluctuations;
- lack of liquidity in funding markets and sources of funding in periods of economic and political crisis;
- the effect of, and changes to, government supervision and regulation of financial services institutions;
- extraordinary governmental actions as a result of current market turmoil, including nationalisation of financial services institutions;
- the effects of market conditions and extent of economic activity in the UK and other geographical markets;
- the length and severity of current market turmoil and its impact on credit quality, consumer confidence, market volatility, loan delinquencies and defaults;
- the effects of counterparty defaults on the financial services industry;
- the effects of competition in the geographic and business areas in which Alliance & Leicester conducts operations;
- changes in consumer spending, saving and borrowing habits in the UK;
- illiquidity and downward price pressure in UK real estate markets;
- the impact of lower than expected investment returns on the funding of private and public sector defined benefit pensions;
- the effects of changes in laws, regulations, taxation or accounting standards or practices, or the effects of the interpretation of laws by the courts;
- the ability to increase market share and control expenses;
- the timely development of and acceptance of new Alliance & Leicester products and services and the perceived overall value of these products and services by customers;
- acquisitions and disposals;
- the ability to realise anticipated saving and operational benefits from the integration with Abbey National plc and its subsidiaries;
- technological changes;
- the possibility of foreign exchange controls, expropriation, nationalisation or confiscation of assets in countries in which Alliance & Leicester conducts operations;
- consumer perception as to the continuing availability of credit and price competition; and
- Alliance & Leicester's success at managing the risks of the foregoing.

Alliance & Leicester cautions that the foregoing list of important factors is not exhaustive. When relying on forward-looking statements to make decisions with respect to Alliance & Leicester, investors and others should carefully consider the foregoing factors and other uncertainties and events. Such forward-looking statements speak only as of the date on which they are made and are based on the knowledge, information available and views taken on the date on which they are made; such knowledge, information and views may change at any time. Alliance & Leicester does not undertake any obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Business Overview

This Business and Financial Review contains forward-looking statements that involve inherent risks and uncertainties. Actual results may differ materially from those contained in such forward-looking statements. See 'Forward-Looking Statements' on page 4.

General

Alliance & Leicester plc (the 'Company') and its subsidiaries (together, 'Alliance & Leicester' or the 'Group') operate primarily in the UK, under UK law and regulation and are part of Banco Santander, S.A. (together with its subsidiaries 'Santander'). Alliance & Leicester is a significant financial services provider in the UK, operating across the full range of personal financial services.

The registered office of the Company is Carlton Park, Narborough, Leicester LE19 0AL.

Summary history

The Alliance & Leicester Building Society ('the Society') was formed in 1985 with the merger of two long-standing building societies, the Alliance Building Society and the Leicester Building Society. In 1997, the Society transferred its entire business to Alliance & Leicester plc as part of the conversion and listing on the London Stock Exchange and Alliance & Leicester plc commenced trading as a bank. A list of Alliance & Leicester plc's principal subsidiaries and their country of incorporation can be found on page 79.

On 10 October 2008, Banco Santander, S.A. completed the acquisition of the entire issued ordinary share capital of Alliance & Leicester plc, implemented by means of a scheme of arrangement under Section 425 of the Companies Act 1985, making the Company a wholly-owned subsidiary of Banco Santander, S.A.. Banco Santander, S.A. is one of the largest banks in the world by market capitalisation. Founded in 1857, Banco Santander, S.A. has more than 80 million customers, over 14,000 branches and a presence in over 40 countries.

In December 2008, following the acquisition by Banco Santander, S.A. of Alliance & Leicester plc, Abbey National plc injected approximately £950m of capital into Alliance & Leicester plc through a subscription of: (i) 234,113,712 new Alliance & Leicester plc ordinary shares for cash at £2.99 per ordinary share; (ii) US$220m undated subordinated notes issued by Alliance & Leicester plc; and (iii) euro 115m undated subordinated notes issued by Alliance & Leicester plc. Previously, in October 2008, Abbey National plc subscribed for US$100m undated floating rate subordinated notes issued by the Company. As a result of the subscription of ordinary shares, Abbey National plc held 35.6% of the issued share capital of Alliance & Leicester plc at 31 December 2008.

On 9 January 2009, in order to optimise the capital, liquidity funding and overall financial efficiency of the enlarged Group, Banco Santander, S.A. transferred all of its Alliance & Leicester plc shares to Abbey National plc in exchange for newly issued Abbey National plc ordinary shares. Accordingly, Abbey National plc is now the immediate parent company of Alliance & Leicester plc.

Corporate purpose and strategy

Alliance & Leicester's purpose is to maximise value for its shareholder, Abbey National plc, by focusing on offering a full commercial banking service in the UK providing value-for-money products to customers.

Executive responsibility

Alliance & Leicester's management structure is headed by António Horta-Osório, Chief Executive, and consists of a number of business and support divisions. The business divisions consist of:

- **Retail Banking** – offers residential mortgages, savings and banking and other personal financial products to customers throughout the United Kingdom. This division is headed by António Horta-Osório. Alison Britain is responsible for the Retail Distribution channel, premium banking and e-commerce, while David Bennett is responsible for the Intermediary channel.
- **Corporate Banking** – offers banking services principally to small and mid-sized UK companies. It also contains operations in run down. This division is headed by Miguel Ángel Rodríguez-Sola.
- **Treasury & Group Items** – manages the liquidity and wholesale funding requirements of the Company and the Treasury assets which are in run down. This division is headed by António Lorenzo.

The support divisions consist of:

- **Retail Products and Marketing** – responsible for integrating and gaining the maximum value from Alliance & Leicester's products, marketing and brand communications to serve Alliance & Leicester's customers better. This division is headed by Nathan Bostock. On 25 February 2009, the Company announced that he would be leaving the Company on 1 June 2009.
- **Human Resources** – responsible for delivering the human resources strategy and personnel support. It also includes the learning function. This division is headed by Nathan Bostock.
- **Manufacturing** – responsible for all information technology, cost control and operations activity, including service centres. This division is headed by Juan Olaizola.
- **Risk** – responsible for ensuring that the Board and senior management team of Alliance & Leicester are provided with an appropriate risk policy and control framework, and to report any material risk issues to the Risk Committee and the Board. The division is headed by Juan Colombás.
- **Internal Audit** – responsible for supervising the compliance, effectiveness and efficiency of Alliance & Leicester's internal control systems to manage its risks. This division is headed by Jorge de la Vega.

Business Overview continued

In addition there are a number of corporate units:

> **Finance, Strategy, and Planning** – This unit reports to António Lorenzo.
> **Corporate Services** – This unit includes Legal, Secretariat, Compliance, Universities and Communications and reports to Karen Fortunato.
> **Service Quality** – This unit reports to Miguel-Ángel Rodríguez-Sola.

Competition

Competitive environment, future trends and outlook

The economic environment in 2008 was very difficult, with falling house and share prices, rising unemployment, and difficulties facing banks, homeowners and savers. In the US, some financial institutions collapsed and others were bought out. The UK's retail banks also underwent significant changes, with Northern Rock plc and Bradford & Bingley plc taken into public ownership (with the exception of the retail deposits, branch network and related employees of Bradford & Bingley plc which were transferred to Abbey National plc). The UK Government also subscribed for substantial holdings of shares in Royal Bank of Scotland Group plc and Lloyds Banking Group plc, and some other banks and building societies were bought out. The UK Government continues to support UK banks during the current market turmoil through the Special Liquidity Scheme, the Asset Protection Scheme, the Credit Guarantee Scheme and the UK Banking Act 2009.

Alliance & Leicester's main competitors are other UK retail banks, building societies and other financial services providers such as insurance companies, supermarket chains and large retailers. The market has been highly competitive, driven largely by market incumbents. Management expects such competition to continue in response to competitor behaviour, consumer demand, technological changes, the impact of consolidation, regulatory actions and other factors.

2009 is expected to be a challenging year for the UK economy. The expectation is for continuing rising unemployment, falling house prices and a further deterioration in the UK economy that will present challenges to banks, homeowners and savers. Alliance & Leicester continues to benefit from the strength of its parent company, Abbey National plc, and as part of the Santander Group, management remains confident of Alliance & Leicester's strength and potential to continue growing despite challenging conditions in some of its core personal financial services markets. A detailed description of management's basis for concluding that Alliance & Leicester remains a going concern is set out in the Directors' Report – Going Concern on pages 36 to 37.

Personal Financial Services ('PFS')

The overview below reflects the reporting structure in place during 2008 in accordance with which the segmental information in the Business and Financial Review has been presented. In this report, the Retail Banking, Corporate Banking, and Treasury & Group Items segments are referred to as the Personal Financial Services businesses. There are no other businesses outside of PFS.

Retail Banking

Retail Banking consists of residential mortgages, savings, personal loans and current accounts, plus other personal financial products.

Residential Mortgages

Following the transfer of Alliance & Leicester to Abbey National plc in January 2009, together they are the second largest provider of residential mortgages in the UK measured by outstanding balances, providing mortgage loans for house purchases as well as home improvement loans to new and existing mortgage customers.

Mortgage loans are offered in two payment types. Repayment mortgages require both principal and interest to be repaid in monthly instalments over the life of the mortgage. Interest-only mortgages require monthly interest payments and the repayment of principal at the end of the mortgage term, which can be arranged via a number of investment products including Individual Savings Accounts and pension policies, or by the sale of the property.

Alliance & Leicester's mortgage loans are usually secured by a first mortgage over property and are typically available over a 25-year term, with no minimum term. Variable rate products charge interest at variable rates determined at the discretion of Alliance & Leicester by reference to the general level of market interest rates and competitive forces in the UK mortgage market. Fixed rate products offer a predetermined interest rate, generally fixed for between two and five years, after which they bear interest at standard variable rates. The majority of new mortgage business is through fixed rate business, normally with an incentive period for the first two to five years, and variable rate mortgages including trackers which track the Bank of England base rate. In line with the rest of the UK mortgage market, a significant proportion (although reduced compared with the previous period) of mortgages are repaid at the end of the fixed or incentive period, with the customer moving to a new incentive product, or staying on Alliance & Leicester's standard variable rate.

Business Overview continued

Savings
Alliance & Leicester provides a wide range of retail savings accounts, including on-demand accounts, notice accounts, investment accounts and Individual Savings Accounts. Interest rates on savings in the UK are primarily set with reference to the general level of market interest rates and the level of competition for such funds.

Personal Loans
Alliance & Leicester offers unsecured personal loans. Unsecured personal loan interest rates are fixed for the length of the loan and are available for periods of up to five years to repay.

Current Accounts
Alliance & Leicester provides a wide range of current account products to personal customers.

Other Personal Financial Products
Alliance & Leicester also provides a range of insurance, investment products and credit cards to its customers. These products are supplied and managed by a number of third party providers.

Corporate Banking (formerly known as Commercial Banking)
Corporate Banking provides a range of banking services, including loans, deposits, trade finance and supplier payment solutions principally to small and medium-sized UK companies. It also provides a full service small and medium-size enterprise (SME) operation, enabling it to compete in the UK's mid-corporate business banking segment.

Treasury & Group Items
Treasury and Group Items consists of Asset and Liability Management ('ALM'), Group Capital and Funding. ALM is responsible for managing the Group's structural balance sheet shape and, in conjunction with Risk Division, tactical liquidity risk management (see the Risk Management section for further details on Liquidity Risk Management). This includes short-term and medium-term funding, covered bond and securitisation programmes and capital management activities. As part of the integration of the Company into Abbey National plc group, liquidity and funding requirements will be sourced from Abbey National plc. This is discussed further in the Risk Management section. ALM's responsibilities also include the Company's product and structural exposure to interest rates. ALM recommends and helps to implement Board, Asset and Liability Management Committee and Risk Committee policies for all aspects of balance sheet management – formulating guidance for, and monitoring, the overall balance sheet shape, including maturity profile. The segmental analysis for Treasury includes income and expenses arising from treasury assets and liabilities, including those assets in run down.

Business Review – Summary

The results discussed below are not necessarily indicative of Alliance & Leicester's results in future periods. The following information contains certain forward-looking statements. See 'Forward-Looking Statements' on page 4. The following discussion is based on, and should be read in conjunction with, the Consolidated Financial Statements elsewhere in this Annual Report and Accounts.

Executive Summary

Alliance & Leicester has prepared this Business and Financial Review in a manner consistent with the way management views Alliance & Leicester's business as a whole. As a result, Alliance & Leicester presents the following key sections to the Business and Financial Review:

> **Business Review Summary** – this contains an explanation of the basis of Alliance & Leicester's results and any potential changes to that basis in the future; a summary Income Statement with commentary; a summary of the nature of adjustments between Alliance & Leicester's statutory basis of accounting (as described in the Accounting Policies section on pages 50 to 65) and Alliance & Leicester's management basis of accounting (known as the 'trading' basis) and a description of key performance indicators;

> **Personal Financial Services** – this contains a summary of the results, and commentary thereon, by Income Statement line item on a trading basis for each segment; and

> **Other Material Items** – this contains information about the statutory to trading basis adjustments.

Basis of results presentation

The Group's business is managed and reported on the basis of the following segments:

> Retail Banking;

> Corporate Banking;

> Treasury & Group Items.

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

Critical Factors Affecting Results

Critical accounting policies and areas of significant management judgement

The preparation of Alliance & Leicester's Consolidated Financial Statements requires management to make estimates and judgements that affect the reported amount of assets and liabilities at the date of the Consolidated Financial Statements and the reported amount of income and expenses during the reporting period. Management evaluates its estimates and judgements on an ongoing basis. Management bases its estimates and judgements on historical experience and on other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Estimates and judgements that are considered important to the portrayal of Alliance & Leicester's financial condition including, where applicable, quantifications of the effects of reasonably possible ranges of such estimates and judgements, are set out in the Accounting Policies in the Consolidated Financial Statements.

Impact of the current credit environment

Further information about the impact of the current credit environment is contained in the Annual Report and Accounts of Abbey National plc, in addition to the information relating to the valuation of financial instruments included in the Group's critical accounting policies disclosures referred to above.

Current and future accounting developments under IFRS

Details can be found in the Accounting Policies on page 50 to the Consolidated Financial Statements.

Group Summary

Summarised consolidated statutory income statement and selected ratios

	2008 £m	2007 £m
Net interest income	**384**	801
Non-interest income	**440**	625
Total operating income	**824**	1,426
Administration expenses	**(927)**	(643)
Depreciation and amortisation	**(114)**	(131)
Total operating expenses excluding provisions and charges	**(1,041)**	(774)
Impairment losses on loans and advances	**(1,033)**	(253)
Provisions for other liabilities and charges	**(38)**	-
Total operating provisions and charges	**(1,071)**	(253)
(Loss)/profit before tax	**(1,288)**	399
Tax credit/(charge)	**370**	(103)
(Loss)/profit for the year from continuing operations	**(918)**	296
Tier 1 capital ratio (%)	**7.9**	9.4
Core Tier 1 capital ratio (%)	**5.3**	6.9
Risk weighted assets (£m)	**23,836**	24,082

2008 compared to 2007

Loss before tax of £1,288m compares to a profit of £399m in 2007. Material movements by line include:

> Net interest income of £384m compared to £801m in 2007 decreased by £417m. Treasury net interest income was significantly lower than 2007 due to higher funding costs and the costs associated with holding higher levels of liquidity. In addition, the mortgage effective interest rate assumptions were adjusted, reflecting the change in approach to the management of the mortgage portfolio going forward, effectively reducing the amount of future earnings recognised, resulting in a £187m reduction in net interest income.

> Non-interest income of £440m compared to £625m in 2007 decreased by £185m. The reduction was mainly due to higher mark-to-market losses in Treasury and lower fee income from unsecured personal loans.

> Administration expenses of £927m compared to £643m in 2007 increased by £284m. The majority of this increase was due to redundancy costs and the write-off of the intangible asset and associated costs relating to the development of a new banking IT platform which will not be put in place following acquisition by Santander. Alliance & Leicester will implement Partenon, Santander's banking system.

> Depreciation and amortisation of £114m compared to £131m in 2007.

> Impairment losses on loans and advances of £1,033m compared to £253m in 2007 increased by £780m. The impact of the volatile financial markets combined with economic slowdown in the UK, has resulted in a significant increase in impairment provisions across Treasury, Retail Banking and Corporate Banking. In addition, the Group elected to apply the amendment to IAS 39 regarding the reclassification of financial assets out of 'fair value through profit & loss' and 'available-for-sale' categories into 'loans & receivables'. For further information, see Note 18 to the Consolidated Financial Statements. Any impairments relating to these assets is included above. However, if these assets had remained as 'available-for-sale', the pre-tax 'available-for-sale' reserve would have been a charge of £1,018m.

> Provisions for other liabilities and charges were £38m in 2008, relating to product misselling.

Business Review – Summary continued

Adjustments between the statutory basis and the trading basis

Alliance & Leicester's Board reviews discrete financial information for each of its segments that includes measures of operating results and assets. The segments are managed primarily on the basis of their results, which are measured on a 'trading' basis. The trading basis differs from the statutory basis as a result of the application of various adjustments, as presented below.

Management considers that the trading basis provides the most appropriate way of reviewing the performance of the business. The adjustments are:

> **Reorganisation and other items** – Comprise implementation costs in relation to the strategic change cost reduction projects, costs arising from the acquisition by Banco Santander S.A., refinement of the credit provisioning methodology and effective interest rate assumptions described in Note 2 and 8 respectively, as well as certain other costs and income of a one-off nature. Management needs to understand the underlying drivers of the cost base that will remain after these exercises are complete, and does not want this view to be clouded by these costs, which are managed independently.

> **Depreciation of operating lease assets** – The operating lease businesses are managed as financing businesses and, therefore, management needs to see the margin earned on the businesses. Residual value risk is separately managed. As a result, the depreciation is netted against the related income.

> **Hedging and certain other mark-to-market variances** – The Balance Sheet and Income Statement are subject to mark-to-market volatility including that arising from the accounting for elements of derivatives deemed under IFRS to be ineffective as hedges. Where appropriate, such volatility is separately identified to enable management to view the underlying performance of the business.

> **Treasury impairment losses** – During 2008, Alliance & Leicester incurred significant losses on its investment securities. These are managed separately and are considered exceptional due to their size and the current global credit crisis. Investments in structured investment vehicles were written off during 2008 and losses were incurred on some investments in bank floating rate notes.

For a detailed explanation of these items, see 'Other Material Items' in the Business and Financial Review.

Key performance indicators

Following the acquisition of the Group by Banco Santander, S.A. on 10 October 2008 and its transfer into Abbey in January 2009, a new management and organisational structure was announced. As part of this process, the Group's key performance indicators and targets are being reviewed, to ensure that they align appropriately with those of its parent company Abbey National plc. Going forward, key performance indicators may be set at the Abbey National Group level, rather than separately for the Group. It is expected that updated key performance indicators will be agreed later in the year.

Detailed information of the key performance indicators of the Abbey National Group, of which Alliance & Leicester became part in January 2009, is set out in the Business Review – Summary in the Abbey National plc 2008 Annual Report.

Business Review – Personal Financial Services

This section contains a summary of the results, and commentary thereon, by Income Statement line item on a trading basis for each segment within the Group, together with reconciliations from the trading basis to the statutory basis. Additional information is provided on the adjustments between the trading basis and the statutory basis in the Business Review – Other Material Items.

Profit/(loss) before tax by segment

31 December 2008	Retail Banking £m	Corporate Banking £m	Treasury & Group £m	Total £m
Net interest income/(expense)	**570**	**195**	**(112)**	**653**
Non-interest income/(expense)	**215**	**252**	**(19)**	**448**
Total trading income/(expense)	**785**	**447**	**(131)**	**1,101**
Total trading expenses	**(242)**	**(273)**	**(205)**	**(720)**
Impairment losses on loans and advances	**(129)**	**(51)**	**-**	**(180)**
Trading profit/(loss) before tax	**414**	**123**	**(336)**	**201**
Adjust for:				
– Reorganisation and other items	**(366)**	**(202)**	**(322)**	**(890)**
– Hedging and certain other mark-to-market variances	**-**	**-**	**(114)**	**(114)**
– Treasury impairment losses	**-**	**-**	**(485)**	**(485)**
Profit/(loss) before tax	**48**	**(79)**	**(1,257)**	**(1,288)**

31 December 2007	Retail Banking £m	Corporate Banking £m	Treasury & Group £m	Total £m
Net interest income	599	169	36	804
Non-interest income/(expense)	276	253	(1)	528
Total trading income	875	422	35	1,332
Total trading expenses	(242)	(273)	(185)	(700)
Impairment losses on loans and advances	(85)	(15)	-	(100)
Trading profit/(loss) before tax	548	134	(150)	532
Adjust for:				
– Reorganisation and other items	31	48	(17)	62
– Hedging and certain other mark-to-market variances	-	-	(42)	(42)
– Treasury impairment losses	-	-	(153)	(153)
Profit/(loss) before tax	579	182	(362)	399

2008 compared to 2007

> Retail Banking trading profit before tax of £414m fell by £134m compared to the previous year (2007: £548m). The main reason was lower income and a higher impairment loss charge. Trading income was lower mainly due to a fall in commission income from unsecured personal loans. Impairment charges rose due to increases in mortgage arrears levels.

> Corporate Banking trading profit before tax of £123m compares to a profit of £134m in 2007. The slight reduction in profit is mainly due to higher trading income partially off-set by an increase in the impairment loss charge. Trading income was up on 2007 due to a widening of margins and growth in corporate loans. The impairment charge was higher than 2007 due to the impact of the adverse economic conditions on the corporate sector.

> Treasury & Group trading loss before tax of £336m compares to a loss of £150m in 2007. The increase in the loss is primarily due to lower net interest income arising from higher funding and liquidity holding costs. Trading expenses were higher than in 2007 in part due to higher restructuring costs arising throughout 2008, and the non-recurrence of one-off benefits in 2007.

Business Review – Personal Financial Services continued

Business flows

Business flows relating to the Group are set out below. These flows are used by management to assess the sales performance of Alliance & Leicester, both absolutely and relative to its peers, and to inform management of product trends in the market.

	2008	2007
Mortgages:		
Gross mortgage lending	**£3.4bn**	£12.7bn
Net mortgage lending	**(£5.0bn)**	£4.8bn
Mortgage stock	**£37.7bn**	£42.7bn
Market share – mortgage stock	**3.1%**	3.6%
Retail deposits:		
Total net deposit flows	**£1.7bn**	£0.7bn
Deposit stock	**£24.7bn**	£22.9bn
Current accounts:		
New accounts opened (000)	**298**	301
Total number of active accounts (million)	**1.78**	1.72
Gross unsecured personal lending:		
Gross advances	**£1.4bn**	£2.3bn
Balances	**£3.4bn**	£3.9bn
Commercial lending:		
Balances	**£10.4bn**	£8.4bn
Business banking:		
New accounts opened (000)	**33.9**	33.7
Total number of active accounts (000)	**106.6**	92.4
Commercial customer deposit balances	**£5.2bn**	£3.9bn

Market shares are estimated internally, based on information from the Bank of England and The Council of Mortgage Lenders ('CML').

2008 compared to 2007

Mortgages

Gross mortgage lending of £3.4bn was £9.3bn lower than 2007, with an increased focus on improving the loan-to-value profile of new business and maintaining good margins, whilst reducing the overall balance sheet. The average loan-to-value on new lending fell from 67% in 2007 to 63% in 2008.

Retail Deposits

Total net retail deposit flows of £1.7bn were up on 2007 due to a stronger product range and also benefiting from the acquisition by Santander in the latter part of the year. Retail deposits grew by £1.3bn in the final quarter of 2008 driven by flows into the online eSaver and tracker products, together with fixed rate bonds with competitive six month, one-year and three-year offers.

Current Accounts

New accounts opened of 298,000 were only 3,000 fewer than 2007, supported by market leading rates on credit and debit interest ensuring a strong presence in best buy tables.

Unsecured Personal Loans

Total balances of £3.4bn were £0.5bn lower than at the end of 2007 reflecting the contracting market, and Alliance & Leicester's continued cautious stance, with lending criteria tightened during the year.

Commercial Lending

Commercial lending balances have increased by £2bn to £10.4bn, largely due to the appreciation of the US dollar and euro compared to sterling.

Business Banking

Business banking current account openings of 33,900 were slightly up on 2007. These openings helped increase the number of active accounts on the book from 92,400 to 106,600 in the year.

Commercial Deposits

Commercial customer deposit balances at £5.2bn were £1.3bn up on 2007. This increase reflects the focus on securing customer deposits by providing competitive rates, particularly on the base rate beater and fixed term deposit products.

Trading net interest income by segment

	2008 £m	2007 £m
Retail Banking	**570**	599
Corporate Banking	**195**	169
Treasury & Group	**(112)**	36
Trading net interest income	**653**	804
Adjust for:		
– Reorganisation and other items	**(269)**	(3)
Net interest income	**384**	801

2008 compared to 2007

Retail Banking net interest income fell by £29m to £570m (2007: £599m), due to lower income on savings, current accounts and unsecured personal loans partly off-set by higher mortgage income. Mortgage balances fell by £5bn but income increased due to the improved back book and new business margins.

Corporate Banking net interest income increased by £26m to £195m (2007: £169m). The increase is largely due to the growth in lending and business banking.

Treasury & Group net interest income fell by £148m to an expense of £112m (2007: £36m income). The fall is mainly due to higher funding costs and costs associated with holding higher levels of liquidity.

Trading non-interest income by segment

	2008 £m	2007 £m
Retail Banking	**215**	276
Corporate Banking	**252**	253
Treasury & Group	**(19)**	(1)
Trading non-interest income	**448**	528
Adjust for:		
– Reorganisation and other items	**40**	65
– Depreciation of operating lease assets	**66**	74
– Hedging and certain other mark-to-market variances	**(114)**	(42)
Non-interest income	**440**	625

2008 compared to 2007

Retail Banking trading non-interest income decreased to £215m (2007: £276m), due largely to lower insurance commission income on unsecured personal loans.

Corporate Banking trading non-interest income was broadly in line with 2007 at £252m (2007: £253m). Non-interest income from business banking was higher but this was off-set by lower income from lending activities.

Treasury & Group non-interest expense increased by £18m to £19m (2007: £1m). This was primarily due to fees related to Alliance & Leicester's funding requirements..

Total trading expenses by segment

	2008 £m	2007 £m
Retail Banking	**242**	242
Corporate Banking	**273**	273
Treasury & Group	**205**	185
Total trading expenses	**720**	700
Adjust for:		
– Reorganisation and other items	**255**	-
– Depreciation of operating lease assets	**66**	74
Expenses	**1,041**	774

Business Review – Personal Financial Services continued

2008 compared to 2007

Total trading expenses of £720m were £20m higher than the previous year (2007: £700m). This was mainly due to inflation. In addition, 2007 benefited from some one-off cost releases.

Retail Banking trading expenses of £242m were in line with 2007.

Corporate Banking trading expenses of £273m were in line with 2007. Lower post office counter costs were off-set by higher staff costs.

Treasury & Group trading expenses of £205m were £20m higher than 2007 reflecting both inflation and non-recurrence of one-off releases in 2007.

Trading impairment losses on loans and advances by segment

	2008 £m	2007 £m
Retail Banking	129	85
Corporate Banking	51	15
Trading impairment losses on loans and advances	**180**	100
Adjust for:		
– Reorganisation and other items	368	–
– Treasury impairment losses	485	153
Impairment losses on loans and advances	**1,033**	253

2008 compared to 2007

Retail Banking trading impairment losses were £44m higher than the previous year driven by signs of a deterioration in the mortgage portfolio. The charge for mortgages increased by £24m, largely arising from an increase in the provision due to falling house prices and fraud write-offs. The performance of the mortgage portfolio remains strong, and significantly better than CML averages. Provisions for unsecured personal loans and current accounts have increased due to the worsening economic conditions.

Corporate Banking trading impairment losses increased by £36m compared to 2007. This increase was due to the economic climate affecting Property, Commercial Vehicles and Business Banking sectors.

Non-performing loans

	2008 £m	2007 £m
Total non-performing loans ('NPLs')	873	384
Total loans and advances to customers	51,147	54,986
Total provisions (on a statutory basis)	582	163
NPLs as a % of loans and advances	**1.7%**	0.7%
Provisions as a % of NPLs	**67%**	42%

In 2008, the value of non-performing loans increased to £873m (2007: £384m). The main increase was in commercial loans. Provisions rose significantly primarily due to the deterioration of performance in the retail and corporate banking portfolios due to the current economic conditions. The above figures exclude the loan to the Conduit. The loan amounted to £0.9bn and is regarded as part of the Treasury portfolio even though it is disclosed within loans and advances to customers. Details of the Conduit can be found on page 30 of the Risk Management Report.

Other Material Items

Adjustments between the statutory basis and the trading basis

The Company's Board reviews discrete financial information for each of its segments that includes measures of operating results and assets, which are measured on a 'trading' basis. The trading basis differs from the statutory basis as a result of the application of various adjustments, as presented below, and described in the Business Review – Summary. Management considers that the trading basis provides the most appropriate way of reviewing the performance of the business.

The trading adjustments consist of:

Reorganisation and other items

	2008 £m	2007 £m
Cost reduction programme	**(62)**	(22)
Retail and Corporate credit provisions	**(368)**	-
Misselling remediation and administration costs	**(47)**	-
Adjustment of mortgage effective interest rate assumptions	**(187)**	-
Acquisition costs and other one-off items	**(226)**	84
	(890)	62

These costs comprise implementation costs in relation to cost reduction projects, asset write-downs, the acquisition by Banco Santander S.A. as well as certain other costs and income of a one-off nature.

Following the acquisition by Santander a further cost reduction programme is now taking place. The increase in costs to £62m is mainly redundancy costs following the acquisition.

The amount of credit provisions included as non trading of £368m (2007: £nil) represents refinements to accounting estimates reflecting the state of the UK economy and are in line with expectations at the time of the acquisition by Santander.

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

Misselling remediation and administration costs mainly relate to a provision for the misselling of payment protection insurance on unsecured personal loans.

Acquisition costs are mainly the write down of intangible assets, largely relating to software, that have no future value, and capitalised funding costs written off as funding transactions are terminated following funding now being provided by Abbey.

Hedging and certain other mark-to-market variances

	2008 £m	2007 £m
	(114)	(42)

The Balance Sheet and Income Statement are subject to a certain amount of mark-to-market volatility including from the accounting for elements of derivatives deemed under IFRS to be ineffective as hedges. In 2008, the impact of this volatility of £114m (2007: £42m) was mainly due to mark-to-market losses on treasury assets including structured investment vehicles, due to widening asset spreads.

Treasury impairment losses

	2008 £m	2007 £m
	(485)	(153)

During 2008, the Group incurred £485m of impairment losses on its trading and investment securities. These are considered significant and reflect the current global credit crisis. Investments in structured investment vehicles were written off during 2008 and losses were incurred on some investments in bank floating rate notes. For more information see the Risk Management Report on pages 26 to 30. In addition, the Group elected to apply the amendment to IAS 39 regarding the reclassification of financial assets out of 'fair value through profit & loss' and 'available-for-sale' categories into 'loans & receivables'. For further information, see Note 18 to the Consolidated Financial Statements. Any impairments relating to these assets is included above. However, if these assets had remained as 'available-for-sale', the pre-tax 'available-for-sale' reserve would have been a charge of £1,018m, based on exit prices for these debt securities rather than their recoverable values.

Legal proceedings

Alliance & Leicester is party to various legal proceedings in the ordinary course of business, the ultimate resolution of which is not expected to have a material adverse effect on the financial position or the results of operations of Alliance & Leicester.

Audit fees

See Note 7 of the Consolidated Financial Statements.

Risk Management

The Risk Management report contains audited financial information except principally for the discussion of Operational Risk on page 19 that, in accordance with the guidance in paragraph BC65 of IFRS 7, is unaudited.

Summary

This Risk Management report describes the Risk Governance Framework of Alliance and Leicester plc (the 'Company', and together with its subsidiaries, the 'Group'), and includes more detail on the Company's key risks, on a segmental basis or aggregated where relevant. It is divided into the following sections:

Introduction - A description of the Group's Risk Governance Framework, including the three tiers of the Risk Governance structure. This can be found on pages 17 to 18;

Financial Risks and Risk Management - Group-wide disclosures about specific risks which do not originate in any single operating segment, such as operational risk and pension obligation risk, as well as Group-wide disclosures about market risk and concentrations of credit risk are described on pages 19 to 20.

Discussion of Key Risks by Operating Segment - Detailed discussions about risk exposures, measurement information and management policies presented by operating segment can be found on pages 21 to 30:

> **Risks in Retail Banking** – The risks in these segments are described on pages 21 to 24, including:
- **Credit risk**, including its management, an analysis of types and credit quality of retail lending, and disclosures relating to provisioning, arrears and recoveries.
- **Market risk**, including its management.

> **Risks in Corporate Banking** – The risk in this segment is described on pages 24 to 25, consisting of:
- **Credit risk**, including its management and mitigation.
- **Market risk**, including its management.

> **Risks in Treasury** – The risks in this segment are described on pages 26 to 30, including:
- **Credit risk**, including its management, mitigation, and the disclosure of exposure by rating and geography.
- **Market risk**, including its management, and disclosures on short-term market risk and structural market risk.

The Impact of the Current Credit Environment – Detailed disclosures can be found on pages 30 to 32, including a description of the Group's exposures to certain classes of financial assets and off-balance sheet entities.

Liquidity risk – A description of the liquidity risks the Group faces can be found on page 32.

Introduction

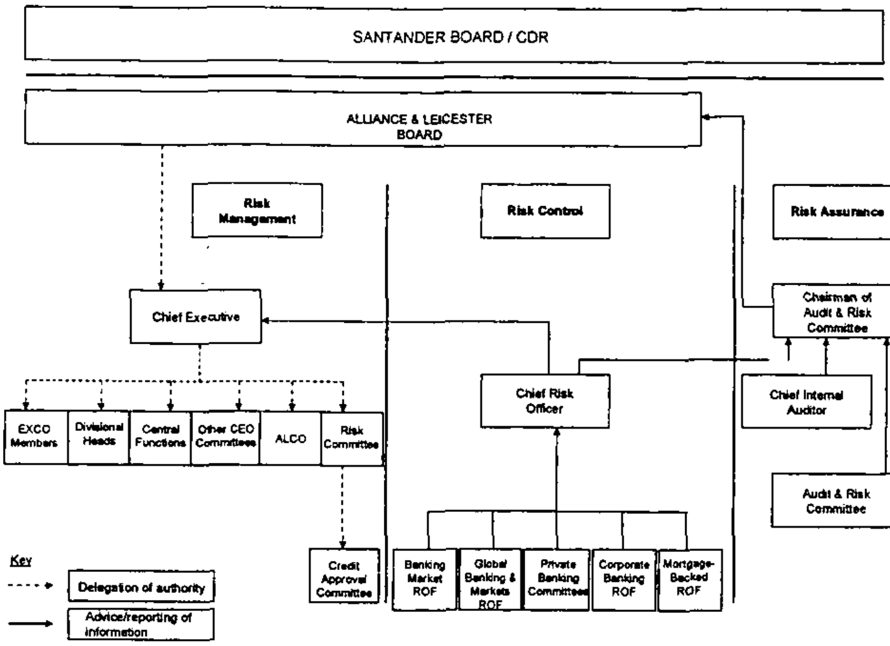
The Group accepts that risk arises from its full range of activities, and actively manages and controls it. The management of risk is an integral part of the Group's activities. Risk is defined as the uncertainty around the Group's ability to achieve its business objectives and execute its strategy effectively. Risk constitutes the Group's exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse impacts on profitability arising from different sources of uncertainty including Credit Risk (Retail), Credit Risk (Corporate), Credit Risk (Treasury), Market Risk, Operational Risk, Securitisation Risk, Concentration Risk, Liquidity Risk, Reputational Risk, Strategic Risk, Pension Obligation Risk, Group Risk and Regulatory Risk. Risk measurement is used to capture the source of the uncertainty and the magnitude of its potential effect on the profitability and solvency of the Group. Effective risk management and control is therefore of fundamental importance to the Group's long-term success.

Understanding and controlling risk is a business imperative. The Company's Risk Framework ensures that risk is managed and controlled on behalf of shareholders, customers, depositors, employees and the firm's regulators. Effective and efficient risk governance and oversight provide management with assurance that the Group's business activities will not be adversely impacted by risks that could have been reasonably foreseen. This in turn reduces the uncertainty of achieving the Group's strategic objectives.

Authority for Risk Management flows from the Alliance & Leicester plc Board of Directors to the Chief Executive and from him to specific individuals. Formal standing committees are maintained for effective management or oversight. Their authority is derived from the person they are intended to assist.

Risk Governance Framework

The diagram below shows the Risk Governance Framework in operation in respect of risk management and oversight.



The Risk Division at Banco Santander, S.A. reports to the President of the Comisión Delegada de Riesgos (Delegated Risk Committee or 'CDR').

The main elements of risk governance within the Group are as follows:

First tier of risk governance

Risk management is provided by the Board. It approves the Group's risk appetite in consultation with Banco Santander, S.A. as appropriate, approves the strategy for managing risk and is responsible for the Group's system of internal control. The Board is supported by the Chief Executive and Executive Management, who have primary responsibility for understanding, identifying, and owning the risks generated by their lines of business and establishing a framework for managing those risks within the Board-approved risk appetite of the Group. In addition, understanding, identifying, and owning the risks generated by the Group's operations are the responsibility of the Divisional Heads and central functions. These functions provide technical support and advice to assist in the management and control of risk. Within this tier, there is a process for transaction review and approval within certain thresholds, discharged by the Credit Approval Committee. Transactions reviewed which exceed the threshold limits set are subject to prior review by Banco Santander, S.A.'s Risk Division before final approval by the Credit Approval Committee.

Risk Committee

This is a management committee, established under the authority of and chaired by the Chief Executive. The Risk Committee reviews risk issues, gives advice and recommendations to the Chief Executive, the Executive Committee or other parties as appropriate as well as makes decisions on risk issues within its sphere of responsibility.

Second tier of risk governance

Risk control is provided by the Board independently supported by the Risk Division. The roles of the Chief Risk Officer and the Risk Division include development of risk measurement methodologies, risk approval, risk monitoring, risk reporting and escalation of risk issues in line with the relevant risk policy for all risks across all lines of Retail Banking, Corporate Banking and Treasury business.

Dedicated Business Risk Oversight Fora (ROFs) advise and support the Chief Risk Officer in fulfilling his risk control responsibilities and help to ensure that risks are suitably understood, managed and controlled.

The Risk Division provides independent challenge to all business areas in respect of risk management and compliance with policies and advises the business when they are approaching the limits of the Group's risk appetite.

The Board, as supported by the Risk Division, is responsible for ensuring compliance with Group policies and limits imposed by Banco Santander, S.A. including:

> Group-wide risk policies;
> Group-wide risk limits/parameters;
> Approval processes relating to transactions that exceed local risk limits;
> The systematic review of exposures to large clients, sectors, geographical areas and different risk types; and
> Reporting to Banco Santander, S.A.

Third tier of risk governance

Risk assurance provides independent objective assurance on the effectiveness of the management and control of risk across the Group. This is provided through the Non–Executive Directors, Internal Audit function and the Audit and Risk Committee.

Non-Executive Directors

The Non-Executive Directors are members of the Board who have a particular responsibility for constructively challenging and contributing to the development of strategy, scrutinising the performance of management in meeting agreed goals and objectives and monitoring reporting performance, and assuring themselves that the financial controls and systems of risk management are robust and defensible.

Internal Audit

The Internal Audit function supports the Audit and Risk Committee by providing independent and objective opinions on the effectiveness and integrity of the Group's risk governance arrangements. It does this via a systematic programme of risk-based audits of the controls established and operated by the 'first tier' risk management functions and those exercised by the 'second tier' risk control functions.

The audit opinions and underlying rationale of findings and recommendations form the basis upon which the Audit and Risk Committee can take reasonable (but not absolute) assurance that the risk governance arrangements are fit for purpose and working properly. The Audit and Risk Committee also receive reports from management, the risk control functions and the external auditors to help them to discharge their risk governance oversight responsibilities.

Audit and Risk Committee

The Audit and Risk Committee is made up of Non-Executive Directors, and is a committee of the Board. The Committee has responsibility for:

> The oversight of the risk governance framework;
> Review of the effectiveness of the Group's internal and external audit process;
> Review of control policies and procedures including regulatory compliance and financial reporting;
> The identification, assessment and reporting of risks; and
> The risk governance structure and associated compliance with risk control policies and procedures.

Financial Risks and Risk Management

The financial risks affecting the Group are discussed below. Risks are generally managed through tailored management policies within the business division or operating segment in which they are originated.

Group-wide disclosures including about specific risks which do not originate in any single operating segment, are described separately at the beginning of this section, apart from liquidity risk which is discussed at the end of the section, following the detailed disclosures about the impact of the current credit environment.

Following the Group-wide disclosures are detailed discussions about risk exposures, measurement information and management policies presented by operating segment, being Retail Banking, Corporate Banking and Treasury.

Financial Instruments

The Group uses financial instruments to manage the structural balance sheet exposures that arise from its banking activities, in accordance with Risk policies and the Asset and Liability Management Committee's direction. The Group also trades in financial instruments where it takes positions in traded and over the counter instruments, including derivatives, to take advantage of short-term market movements in the equity and bond markets and in currency and interest rates.

Operational Risk – Group-wide (unaudited)

Operational risk is the risk of loss to the Group, resulting from inadequate or failed internal processes, people and systems, or from external events. Such risks can materialise as frauds, process failures, system downtime or damage to assets due to fire, floods etc. When such risks materialise they have not only immediate financial consequences for the Group but also an effect on its business objectives, customer service, regulatory responsibilities and reputation. Operational risk exposures arise across the Group's business divisions and operating segments, and are managed on a consistent basis.

Managing operational risk (unaudited)

The Group undertakes extensive activity to minimise the impacts operational risks may have on business areas. An independent central operational risk function (Enterprise and Operational Risk) has responsibility for establishing the framework within which these risks are managed and is aligned to operational risk professionals within business areas to ensure consistent approaches are applied across the Group. The primary purpose of the framework, which is approved by the Risk Committee, is to define and articulate the Group-wide policy, processes, roles and responsibilities. The framework incorporates industry practice and regulatory requirements, particularly those emanating from the Basel Committee, European Union Directives and the UK Financial Services Authority.

The day-to-day management of operational risk is the responsibility of business managers who identify, assess and monitor the risks, in line with the processes described in the framework. The operational risk function ensures that all key risks are regularly reported to Risk Fora, the Risk Committee and Board.

Key operational risk activity in 2008 (unaudited)

During 2008, the Group has continued to respond to the developing operational risk environment with co-ordinated responses. The Group continues to perform detailed control reviews in response to major industry events.

Following many high profile customer data security lapses experienced by other organisations in the UK, the Group has taken proactive steps to minimise similar risks. A corporate information security programme has been established which involves the strengthening of controls for the management of sensitive data and includes the implementation of encryption standards across the Group. A review of trading controls was carried out in response to the incident at Société Générale and the opportunity was taken to further enhance trading controls even though it was confirmed that existing controls were robust in this area. To highlight awareness of such issues, operational risk training has been made available to management and staff involved in control functions throughout the Group. In line with UK Financial Services Authority guidance and industry practice, the Group has crisis management and disaster recovery arrangements to ensure that critical business processes are maintained in the event of an unforeseen interruption. Insurance policies are also purchased to provide cover for a range of potential operational risk losses. In response to the increased threats of terrorism, flooding, and pandemic disasters, contingency strategies continue to be refined and key progress has included the development of dispersed contingency sites and automated system switch over facilities.

The Group continues to strengthen its point of sale compliance and control procedures to minimise risk and serve its customers. To this end, work continues to progress in implementing new systems which are already successfully operating in Banco Santander, S.A. The increased use of data analytics and modelling for fraud prevention continues to have an impact in reducing exposure to third party fraud activity.

Credit Risk – Group-wide
Significant concentrations of credit risk

During 2008, the Group's exposures to credit risk derived from its three segments of Retail Banking, Corporate Banking, and Treasury. Within Retail Banking, the most significant exposures to credit risk derive from the residential mortgage portfolio and unsecured personal lending businesses. Within Corporate Banking, significant exposures also derive from the commercial loans portfolio. Within Treasury, significant exposures result from its asset portfolio.

The residential mortgage portfolio comprises loans to private individuals secured against residential properties in the UK. This is a prime portfolio with total balance sheet exposure of £37.7bn at 31 December 2008. The Unsecured Personal Loan portfolio comprises unsecured loans to private individuals issued in the UK. Total exposure stood at £3.4bn at 31 December 2008. The commercial loans portfolio in Corporate Banking comprises loans to companies and associated derivatives. The total exposure to this portfolio was £10.4bn at 31 December 2008.

Although Corporate Banking operations are based mainly in the UK, it has built up exposures to various entities around the world and is therefore exposed to concentrations of risk related to geographic area. A significant proportion of Corporate Banking exposures were to counterparties that reside in the EU. Treasury exposures result from its asset portfolio. At 31 December 2008 treasury investment securities stood at £14.3bn. Details on credit ratings and geographic analysis can be found on pages 27 to 30.

Risk Management continued

Maximum exposure to credit risk

The following table presents the amount that best represents the Group's estimated maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements:

	2008 £m	2007 £m
Trading assets	**-**	1,439
Loans and advances to banks	**1,239**	2,885
Derivative financial instruments	**2,876**	970
Financial assets designated at fair value	**63**	891
Available-for-sale securities	**1,658**	12,773
Loan and receivable securities	**14,250**	210
Loans and advances to customers	**51,402**	55,056
Other	**348**	497
Third party exposures[1]	**71,836**	74,721

(1) In addition the Group is exposed to credit risk in respect of guarantees granted, loan commitments and stock borrowing and lending agreements. The estimated maximum exposure to credit risk is described in Note 34 to the Consolidated Financial Statements on page 89.

In managing the gross exposures, the Group uses the policies and processes described in the credit risk sections below. Collateral is also held in the form of security over the mortgaged property and through market standard collateral agreements in its treasury business.

Basel II (unaudited)

The Group has applied the retail internal ratings-based (IRB) approach for credit risk to its key retail portfolios from 1 January 2007. The foundation internal ratings based approach has been applied to the majority of commercial loans and exposures to financial institutions from the same date. The remaining assets are currently on the standardised approach. The standardised approach has also been applied to Operational Risk from 1 January 2007.

Market risk – Group-wide

Market risk is the potential for loss of income or decrease in the value of net assets caused by movements in the levels and prices of financial instruments including interest rate and foreign currency risks. The Group accepts that market risk arises from its full range of activities. The Group aims to actively manage and control market risk by limiting the adverse impact of market movements whilst seeking to enhance earnings within clearly defined parameters. The Market Risk Manual, which is reviewed and approved by the Head of Wholesale Risk on an annual basis, sets the framework under which market risks are managed and controlled. Business area policies, risk limits and mandates are established within the context of the Market Risk Manual. Executive Directors are responsible for ensuring that they have sufficient expertise to manage the risks originated and retained with their business divisions. The business areas are responsible for ensuring that they have sufficient expertise to manage the risks associated with their operations. The independent Risk function, under the direction of the Head of Wholesale Risk, aims to ensure that risk-taking and risk control occur within the framework prescribed by the Market Risk Manual. The Risk function also provides oversight of all risk-taking activities through a process of reviews. The Group aims to ensure that exposure to market risks is measured and reported on an accurate and timely basis to senior management. In addition to the regular reporting for the purposes of active risk management, the Board also receives reporting of all significant market risk exposures on a monthly basis where actual exposure levels are measured against limits. Senior management recognise that different risk measures are required to best reflect the risks faced in different types of business activities. In measuring exposure to market risk, the Group uses a range of complementary measures, covering both value and income as appropriate.

Pension obligation risk – Group-wide

The Group has statutory funding obligations as the sponsoring employer for a defined benefit staff pension scheme. The scheme is managed by independent trustees in accordance with legislation and trust deeds and rules, for the benefit of members. The Group accepts that it is exposed to pension obligation risk that could give rise to an unexpected increase in the Group's obligations to fund the scheme, either because of a loss of net asset value or because of changes in legislation or regulatory action. The principal risks to the net asset value of the scheme are an increase in the value of the liabilities arising from adverse changes in the longevity, inflation, and scheme assets being adversely affected by market movements. Further information on pensions can be found in 'Critical Accounting Policies' within the Accounting Policies on page 64 and in Note 33 to the Consolidated Financial Statements.

Risk management

The Chief Financial Officer is responsible for managing the Group's exposure to pension obligation risk, in conjunction with the trustees. Further details of the funding arrangements for the pension schemes can be found on pages 87 to 89.

Risk Management in Retail Banking

Credit risk in Retail Banking

Credit risk is the risk that counterparties will not meet their financial obligations, which may result in the Group losing the principal amount lent, the interest accrued and any unrealised gains (less any security held). Credit risk occurs mainly in the Group's loan and investment assets (including residential mortgages and secured lending, personal and business banking), and in derivative contracts. The Group actively manages and controls credit risk.

Residential mortgages and secured lending

The Group lends on many types of property but only after a credit risk assessment of the borrower, including affordability modelling, and an assessment of the property are undertaken. The systems used to manage and monitor the quality of the mortgage assets are reviewed in accordance with policy to ensure they perform as expected. Residential lending is subject to lending policy and lending authority levels, which are used to structure lending decisions to the same high standard across the retail network, a process further improved by mortgage credit scoring, underwriter accreditation and regular compliance reviews. Details concerning the prospective borrower and the mortgage are subject to a criteria-based decision-making process. Criteria for assessment include credit references, loan-to-value ratio, borrower status, affordability and the mortgage credit score.

The majority of loans provided by the Group are secured on UK properties. All properties must be permanent in construction; mobile homes are not acceptable.

Prior to granting any first mortgage loan on a property, the Group has the property valued by an approved and qualified surveyor, who may be a Group employee. The valuation is based on set Royal Institute of Chartered Surveyors and Group guidelines. Normally, in the case of additional lending, when the total loan remains below 90% loan-to-value, the original property value is subject to indexation and no further survey is carried out. If the loan exceeds 90% loan-to-value, a revaluation is carried out by a qualified surveyor. In low risk re-mortgage cases where a reputable automated valuation within high confidence limits is available this may substitute for a surveyor's valuation.

Progressively stricter lending criteria are applied to mortgages above a loan-to-value of 75%. Only 2% of new secured loan advances in 2008 were made with a loan-to-value of more than 90%. Loans with higher loan-to-value ratios carry a higher risk due to the increased likelihood that liquidation of the collateral will not yield sufficient funds to cover the loan advanced and costs of liquidation. These loans generally attract higher margins as a result.

Mortgage credit quality(1)

	2008	2007
Loan-to-value analysis:		
New business		
> 90%	**2%**	8%
75% - 90%	**36%**	36%
< 75%	**62%**	56%
Average (at inception)	**63%**	67%
Average loan-to-value of stock (indexed)	**49%**	46%
New business profile:		
First-time buyers	**17%**	25%
Home movers	**44%**	45%
Remortgages	**25%**	24%
Further advances	**14%**	6%
Average earnings multiple	**3.1**	3.3

(1) Excludes any fees added to the loan, and only includes the drawn loan amount, not drawdown limits. Includes prime mortgage lending and excludes buy to let.

The residential mortgage portfolio has started to show an increasing trend of payment arrears with the deterioration in economic conditions. Credit quality remains strong, with the average loan to value ('LTV') on new business completions gradually reducing through the year, with the 4th quarter at 56% (Q3 08: 61% Q4 07: 65%). The indexed stock LTV increased to 49% as a result of declining house prices, mitigated by the reduction in new business LTVs. Credit criteria have been progressively tightened in response to the changing market environment. As a result, the LTV profile of new lending has improved significantly.

> Arrears more than 90 days past due have increased from 0.47% in December 2007 to 0.83% at the end of 2008. In the same period, industry arrears more than 90 days past due are forecast by the UK Council of Mortgage Lenders to have increased from 1.10% to 1.88%.

> Completions in excess of 75% LTV have fallen from 44% in 2007 to 38% in 2008.

Mortgage arrears and repossessions

Collections & Recoveries Department is responsible for all debt management initiatives on the secured portfolio for Retail Banking. Debt management strategies, which include negotiating repayment arrangements and concessions and debt counselling, can start as early as the day after a repayment is past due and will continue until legal action. Different collection strategies are applied to different segments of the portfolio subject to the perceived levels of risk, for example, loan-to-value, collections score and account characteristics.

Risk Management continued

If the agreed repayment arrangement is not maintained, legal proceedings may be taken and may result in the property being taken into possession. The Group sells the repossessed property at market price and uses the sale proceeds, net of costs, to pay off the outstanding value of the mortgage. The stock of repossessed properties held by the Group varies according to the number of new possessions and the buoyancy of the housing market.

The following tables set forth information on UK residential mortgage arrears, and properties in possession, at 31 December 2008 and 2007 for the Group compared to the industry average as provided by the Council of Mortgage Lenders ('CML'), as well as the carrying amount of assets obtained as collateral.

Mortgage arrears	Group[1][2] (Percentage of total mortgage loans by number)
31 to 60 days in arrears	
31 December 2007	0.65
31 December 2008	**0.76**
61 to 90 days in arrears	
31 December 2007	0.28
31 December 2008	**0.37**

	Group	CML[2](unaudited)
	(Percentage of total mortgage loans by number)	
3 to 6 months in arrears		
31 December 2007	0.29	0.62
31 December 2008	**0.47**	**1.01**
6 to 11 months in arrears		
31 December 2007	0.13	0.35
31 December 2008	**0.26**	**0.62**
12 months or more in arrears		
31 December 2007	0.05	0.13
31 December 2008	**0.10**	**0.25**

(1) Alliance & Leicester data is not readily available for arrears less than 31 days.
(2) Council of Mortgage Lenders data is not available for arrears less than 3 months – Data as at 31 December 2008.

Properties in possession	Group	CML[2](unaudited)
	(Percentage of total mortgage loans by number)	
31 December 2007	0.02	0.10
31 December 2008	**0.03**	**0.21**

Carrying amount of assets obtained as collateral	£m
31 December 2007	12
31 December 2008	**16**

Restructured loans

Some mortgage loans have had arrears capitalised. The value of capitalised arrears on loans was less than £1m in both 2008 and 2007.

Unsecured personal loans. The Group uses systems and processes to manage the risks involved in providing unsecured personal loans and overdraft lending or in granting bank account facilities. These include the use of application and behavioural scoring systems to assist in the granting of credit facilities as well as regular monitoring of scorecard performance and the quality of the unsecured lending portfolios. Behavioural scoring examines the lending relationships that a customer has with the Group and how the customer uses their bank account together with a monthly update of the customer's external borrowing via credit bureaux. This information generates a score that is used to assist in deciding the level of risk (in terms of overdraft facility amount, card facilities granted and preferred unsecured personal loan value) for each customer that the Group is willing to accept. Individual customer scores are normally updated on a monthly basis. The Group has successfully extended the use of behavioural scoring into other areas of the business, including the refinement of debt management strategies and bank account transaction processing.

Unsecured personal loan arrears

	2008 £m	2007 £m
Total unsecured personal loan arrears[1,2]	**213**	203
Total unsecured personal loan asset	**3,534**	4,041
Unsecured personal loan arrears as a % of asset	**6.03**	5.02

(1) Unsecured personal loans include current account customers.
(2) Unsecured personal loans are defined as the balances of accounts that are three or more months in arrears (> 4 instalments).

Provisions on loans and advances to customers

The charge for provisions on loans and advances to customers adjusts the balance sheet provisions to the level that management deems adequate to absorb actual and inherent losses in the Group's loan portfolio from homogeneous portfolios of assets and individually identified loans. A proportion of the Group's provisions on loans and advances to customers relate to loans and advances secured either by a first charge on residential property in the UK, or by other appropriate security depending on the nature of the loan.

The Group's provisioning policy is as follows. Further information is set out in the Accounting Policies in the Consolidated Financial Statements:

> **Observed provision** - an observed provision is established for all past due loans after a specified period of repayment default where it is likely that some of the capital will not be repaid or recovered through enforcement of any applicable security. The length of the default period depends on the nature of the advance and is generally no more than three months. Once a loan misses a payment (breach of contractual terms) an assessment of the likelihood of collecting the principal and overdue payments is made. This assessment is generally made using statistical techniques developed on previous experience and on projections of current market conditions to the time the loss is expected to crystallise. These techniques estimate the propensity of loans to go to write-off and as a separate exercise, the loss incurred on written off debt is monitored. For advances secured on residential property the propensity of loans to reach repossession is determined, with repossessed properties assessed on an individual basis through the use of external valuation, anticipated disposal costs and the current exposure.

> **Incurred but not yet observed provision** - an incurred but not yet observed provision is made against loans which have not missed a payment but are known from past experience to have deteriorated since the initial decision to lend was made. Based on historical evidence, the number of accounts likely to default in the future, as a result of events present at the balance sheet date, are identified through use of statistical techniques. During the year, these statistical techniques were expanded and enhanced. In particular, further detailed examination is now performed on the losses that emerge over a defined period of time after the reporting date called the emergence period. This period is determined to ensure that only those accounts which have credit deterioration at the reporting date are captured and excludes accounts which will suffer credit deterioration after the reporting period. The emergence period is two to three months for unsecured lending and 12 months for secured lending. The provision methodology outlined for observed provisions is then applied to accounts identified as impaired in the performing portfolios.

> **Amounts written off** - unsecured loans are written off when all internal avenues of collecting the debt have failed and the debt is passed onto external collection agencies. On secured loans, the write off takes place on ultimate realisation of collateral value, or from claiming on any mortgage indemnity guarantee or other insurance. All write offs are on a case by case basis, taking account of the exposure at the date of write-off, after accounting for the value from any collateral or insurance held against the loan. The write-off policy is regularly reviewed.

Security is realised in accordance with the Group's internal debt management programme. Contact is made with customers with the aim to achieve a realistic and sustainable repayment arrangement. Litigation and/or enforcement of security is usually carried out only when the steps described above have been undertaken without success. As a result of the write-off policy, the provisions will be made a significant time in advance of the related write-off on all products. The exception to this rule is the discovery of fraud, where the exposure is written off once full investigations have been completed and the probability of recovery is minimal. The time span between the discovery and write-off will be a short period and may not result in a provision being raised.

Movements in provisions for impairment losses on loans and advances

	2008 £m
Provisions at 1 January 2008	136
Amounts written off	
Advances secured on residential properties - UK	(10)
Unsecured personal advances - UK	(102)
Total amounts written off	(112)
Observed provisions charged against profit	
Advances secured on residential properties - UK	46
Unsecured personal advances - UK	202
Total observed provisions charged against profit	248
Incurred but not yet observed provisions charged against profit	26
Total provisions charged against profit	274
Provisions at the end of the year	298

Risk Management continued

Recoveries

	2008 £m
Advances secured on residential properties - UK	1
Unsecured personal advances - UK	13
Total amount recovered	14

Retail Banking non-performing loans and advances[1]

	2008 £m
Non-performing loans and advances that are impaired	186
Non-performing loans and advances that are not impaired	344
Total non-performing loans and advances[2]	530
Non-performing loans and advances as a percentage of loans and advances to customers[3]	1.29%
Provision as a percentage of total non-performing loans and advances	56.2%

(1) Loans and advances are classified as non-performing typically when the counterparty fails to make payments when contractually due for three months or longer.
(2) All non-performing loans are UK.
(3) Loans and advances to customers include residential mortgages, unsecured personal loans and current account overdrafts.

Accounting estimates have been refined reflecting the state of the UK economy as described in Note 8 to the financial statements. As a result, comparatives for 2007 are not available in the above format. Movement in provisions for 2007 can be found in Note 16 on page 75.

In 2008, non-performing loans and advances as a percentage of loans and advances to customers was 1.29%. This reflects the impact of the deteriorating market environment on the performance of the unsecured personal loan and residential mortgage portfolio and a refinement in accounting estimates.

Interest income recognised on Retail Banking loans that are more than three months in arrears amounted to £14m (2007: £25m).

Market risk in Retail Banking

Market risk is not taken within Retail Banking. Market risks arising in the Retail Banking division are transferred from the originating business to the Asset and Liability Management ('ALM') operation within Treasury and Group Items, where they can be managed in conjunction with exposures arising from the funding, liquidity or capital management activities. Funds received with respect to deposits taken are lent on to Treasury and Group Items on matching terms as regards interest rate repricing and maturity. Similarly, loans are funded through matching borrowings from Treasury and Group Items.

Risk Management in Corporate Banking
Credit risk in Corporate Banking

Credit risk is the risk that counterparties will not meet their financial obligations resulting in Corporate Banking losing the monies lent, including any interest accrued, or having to close out transactions prematurely, which may incur losses after realising collateral held. Credit risk arises by Corporate Banking making loans, investing in debt securities or other financial instruments or entering into financing transactions or derivative contracts.

Managing credit risk

The Board has approved a set of risk appetite limits to cover different types of risk, including credit risk, arising in Corporate Banking. Subsequent to its acquisition, the management of Corporate Banking credit risk has been aligned with the processes and procedures used within Abbey National's Corporate Banking unit. Alliance & Leicester's credit risk appetite is therefore now measured and controlled by a maximum Economic Capital value, which is defined as the maximum level of unexpected loss that Alliance & Leicester is willing to sustain over a one-year period. Within these limits, credit mandates and policies are approved to cover detailed industry, sector and product limits. All transactions falling within these mandates and policies are accommodated under credit limits approved by the appropriate credit authority. Specific approval is usually required by the Credit Approvals Committee (a specific committee established under the authority of the Chief Executive) for any transaction that falls outside the mandates.

Analysis of credit exposures and credit risk trends are provided each month to the Corporate Banking Risk Oversight Forum, with key issues escalated to the Risk Committee as required. Large Exposures (as defined by the UK Financial Services Authority) are reported quarterly to the Risk Committee and the UK Financial Services Authority.

Credit risk on derivative instruments is calculated using the potential future mark-to-market exposure of the instruments at a 97.5% (95% prior to acquisition) statistical confidence level and adding this value to the current value. The resulting 'loan equivalent' or credit risk is then included against credit limits, along with other non-derivative exposures. In addition, there is a policy framework to enable the collateralisation of derivative instruments including swaps. If collateral is deemed necessary to reduce credit risk, any unsecured risk threshold, and the nature of any collateral to be accepted, is determined by management's credit evaluation of the counterparty.

Corporate Banking has been targeted as an area where we aim to achieve controlled growth, mainly in the area of structured lending to the Real Estate, Education and Health sectors. Focus is being given to the control of credit risks within this expansion with, amongst other things, the development and implementation of robust Credit Policy Mandates and models covering both risk appetite and ratings.

The following tables provide details of provisions, recoveries, arrears and non-performing loans for the Corporate Banking portfolio as at 31 December 2008.

Movements in provisions for impairment losses on loans and advances:

	2008 £m
Provisions at 1 January 2008	27
Amounts written off	
Secured	(7)
Unsecured	(10)
Total amounts written off	(17)
Observed provisions charged against profit	
Secured	82
Unsecured	73
Total observed provisions charged against profit	155
Incurred but not yet observed provisions charged against profit	120
Total provisions charged against profit	275
Provisions at the end of the year	285

Recoveries

	2008 £m
Secured	-
Unsecured	1
Total amount recovered	1

Accounting estimates have been refined reflecting the state of the UK economy as described in Note 8 to the financial statements. As a result, comparatives for 2007 are not available in the above format. Movement in provisions for 2007 can be found in Note 16 on page 75.

Corporate Banking arrears

	2008 £m	2007 £m
Total Corporate lending arrears	89	39
Total Corporate lending assets	9,948	8,157
Corporate lending arrears as a % of asset	0.89	0.48

Corporate Banking non-performing loans and advances

	2008 £m	2007 £m
Non-performing loans and advances that are impaired	343	10
Non-performing loans and advances that are not impaired	-	-
Total non-performing loans and advances	343	10
Non-performing loans and advances as a percentage of loans and advances to customers	3.45	0.12
Provision as a percentage of total non-performing loans and advances	83	270

Market risk in Corporate Banking

Market risk is not taken within Corporate Banking. Market risks arising in the Corporate Banking division are transferred from the originating business to ALM within Treasury and Group Items, where they can be managed in conjunction with exposures arising from the funding, liquidity or capital management activities of ALM. Funds received with respect to deposits taken are lent on to Treasury and Group Items on matching terms as regards interest rate repricing and maturity. Similarly, loans are funded though matching borrowings from Treasury and Group Items.

Risk Management in Treasury

Credit risk in Treasury

Credit risk is the risk that counterparties will not meet their financial obligations resulting in Treasury losing the monies lent, including any interest accrued, or having to close out transactions prematurely, which may incur losses after realising collateral held. Credit risk arises by Treasury making loans, investing in debt securities or other financial instruments or entering into financing transactions or derivative contracts.

Managing credit risk in Treasury

The Alliance & Leicester Group Risk department has been integrated into the Abbey National plc Wholesale Credit Risk department where responsibility for the credit control of assets held by Treasury, as well as for all country, sovereign and financial institution exposures is managed. Risks are managed in accordance with limits, asset quality plans and criteria set out in the relevant policy statement.

Decisions are based on independent credit risk analysis, supplemented by the output of internal ratings tools and external rating agency analysis. An internal ratings model is used to grade financial institution exposures and to generate probability of default and expected loss. The Group uses external ratings supplemented by internal analysis to assess the risks associated with structured credit and securitisation investments. Individual exposures are reviewed at least annually. Asset quality monitoring is reported by regular executive and management reporting, and exception reporting against a range of asset quality triggers, which include expected loss analysis.

The Treasury investment portfolio is monitored for potential impairment as soon as an event occurs to suggest a counterparty's creditworthiness merits attention. Once specific events give rise to a reasonable expectation that future anticipated cash flows may not be received, the asset originating these doubtful cash flows will be deemed to be impaired.

For structured investment vehicles (SIVs), Collateralised Debt Obligations (CDOs) and Collateralised Loan Obligations (CLOs) impairment is deemed to have occurred when one or more of the following events have occurred:

- the vehicle has realised losses arising from sale of assets that make it probable that the note-holders will not receive principal and base coupon in full;
- the vehicle has been restructured and the terms of the restructuring make it probable that the note-holders will not receive principal and base coupon in full;
- the Group expects to participate in a restructuring or refinancing of the vehicle which has been proposed by the vehicle's manager or sponsor and the likely terms make it probable that the note-holders will not receive principal and base coupon in full;
- the vehicle has entered into enforcement; or
- the funding and market conditions are such that the vehicle is expected either to sell assets or restructure such that it is probable that the note-holders will not receive principal and base coupon in full.

Collateralised debt obligations (CDOs) containing sub-prime US mortgage assets and other structured credit assets are deemed impaired if estimated losses on the underlying assets exceed the level of credit support. Asset backed securities are assessed on an individual basis.

Credit risk mitigation

(i) Netting arrangements

The Group restricts its credit risk by entering into transactions under industry standard agreements which facilitate netting of transactions in the jurisdictions where netting agreements are recognised and have legal force. The netting arrangements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis. However, there is scope for the credit risk associated with favourable contracts to be reduced by netting arrangements embodied in the agreements to the extent that if an event of default occurs, all amounts with the counterparty under the specific agreement can be terminated and settled on a net basis. Derivatives, repurchase and reverse repurchase transactions, stock borrowing/lending transactions and securities financing transactions are governed by industry standard agreements that facilitate netting.

(ii) Collateralisation

The Group also mitigates its credit risk to counterparties with which it primarily transacts financial instruments through collateralisation, using industry standard collateral agreements. Under these agreements, net exposures with counterparties are collateralised with cash, securities or equities. Exposures and collateral are revalued daily and collateral is adjusted accordingly to reflect deficits/surpluses. Collateral taken must comply with collateral parameters policy. This policy is designed to control the quality and concentration risk of collateral taken such that collateral held can be liquidated when a counterparty defaults. Cash collateral in respect of derivatives held at the year-end was £566m.

Treasury investments

Investment securities

	Nominal £m	Fair value through reserves (pre-tax) £m	Fair value & impairment through income statements £m	Other £m	Balance sheet value as at 31.12.08 £m
Floating rate notes (FRN)	10,132	(182)	(55)	38	9,933
Asset backed securities (ABS)	4,001	(186)	(25)	(74)	3,716
Collateralised debt obligations (CDO)	366	(15)	(72)	(115)	164
Collateralised loan obligations (CLO)	352	(25)	(1)	(5)	321
Principal protected notes (PPN)	42	(6)	(5)	3	34
Other	138	-	(7)	14	145
Total	**15,031**	**(414)**	**(165)**	**(139)**	**14,313**

Investment securities include loan & receivable securities and financial assets designated at fair value.

Other includes discounts and premiums, accrued interest and amortisation of mark-to-market losses. The fair value of loan & receivable securities was £13.2bn compared to a balance sheet value of £14.3bn at 31 December 2008.

Analysis of provisions on investment securities

	2008 £m
Provisions as at 1 January	122
Charge for the year: Increase in impairment	414
Amounts written off in period	(411)
Provisions as at 31 December	125

Provisions on investment securities are all individual provisions. The total Treasury impairment loss charge for 2008 was £426m (Note 8). This includes a £12m charge for loans and advances to banks.

Investment securities by credit rating of the issuer or counterparty[1]

	FRN £m	Other £m	Total £m
AAA	-	3,809	3,809
AA	2,333	176	2,509
A	6,596	170	6,766
BBB	712	77	789
Below BBB	292	148	440
Total	**9,933**	**4,380**	**14,313**

(1) Internal ratings are applied to all exposures.

Floating Rate Notes

Country	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & impairment through income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Holding value as % of nominal value
UK	942	9	(21)	(17)	9	913	97
Italy	1,101	11	(10)	-	8	1,099	100
Spain	2,338	23	(43)	-	13	2,308	99
Rest of Europe	3,393	33	(62)	(38)	12	3,305	97
US	994	10	(36)	-	(10)	948	95
Rest of World	1,364	14	(10)	-	6	1,360	100
Total	**10,132**	**100**	**(182)**	**(55)**	**38**	**9,933**	**98**

Risk Management continued

Credit rating	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & impairment through income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Holding value as % of nominal value
AA	2,350	23	(24)	-	7	2,333	99
A	6,703	66	(127)	-	20	6,596	98
BBB	735	7	(27)	-	4	712	97
Below BBB	344	4	(4)	(55)	7	292	85
Total	10,132	100	(182)	(55)	38	9,933	98

Asset-Backed Securities

Country/Asset type	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & impairment through income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Holding value as % of nominal value
UK							
ABS	31	1	-	-	-	31	100
MBS	1,302	32	(29)	(11)	(7)	1,255	96
US							
ABS	962	24	(56)	-	(25)	881	92
MBS	393	10	(61)	(11)	(44)	277	70
Rest of Europe							
ABS	98	3	(3)	-	1	96	98
MBS	929	23	(34)	(3)	3	895	96
Rest of World							
ABS	36	1	-	-	-	36	100
MBS	250	6	(3)	-	(2)	245	98
Total	4,001	100	(186)	(25)	(74)	3,716	93

Credit Rating /Asset type	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & impairment through income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Holding value as % of nominal value
AAA							
ABS	1,052	26	(56)	-	(5)	991	94
MBS	2,613	66	(102)	(13)	(28)	2,470	95
AA							
ABS	18	-	-	-	(3)	15	83
MBS	105	3	(11)	-	(9)	85	81
A							
ABS	83	2	(3)	-	(13)	67	81
MBS	38	1	(8)	-	(1)	29	76
BBB							
ABS	17	-	-	-	(5)	12	71
MBS	33	1	(6)	-	(5)	22	67
Below BBB							
MBS	42	1	-	(12)	(5)	25	60
Total	4,001	100	(186)	(25)	(74)	3,716	93

Collateralised Debt Obligations

Country	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & Impairment through Income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Original exposure to sub-prime %	Original credit enhanceme nt %	Holding value as % of nominal value
UK	24	7	(6)	-	(1)	17	-	27	71
Rest of Europe	3	1	-	-	-	3	-	-	100
US	339	92	(9)	(72)	(114)	144	21	28	42
Total	366	100	(15)	(72)	(115)	164	19	27	45

Credit rating	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & Impairment through Income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Original exposure to sub-prime %	Original credit enhanceme nt %	Holding value as % of nominal value
AAA	147	40	(12)	-	(44)	91	1	34	62
AA	38	10	(1)	-	(19)	18	10	35	47
A	11	3	-	-	(7)	4	13	23	36
BBB	18	5	(2)	(1)	(8)	7	14	8	39
Below BBB	152	42	-	(71)	(37)	44	41	21	29
Total	366	100	(15)	(72)	(115)	164	19	27	45

Collateralised Loan Obligations

Country	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & Impairment through Income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Holding value as % of nominal value
UK	115	33	(5)	(1)	(1)	108	94
Rest of Europe	47	13	(7)	-	1	41	87
US	190	54	(13)	-	(5)	172	91
Total	352	100	(25)	(1)	(5)	321	91

Credit rating	Nominal £m	Nominal %	Fair value through reserves (pre-tax) £m	Fair value & Impairment through Income statements £m	Other £m	Balance sheet value as at 31.12.08 £m	Holding value as % of nominal value
AAA	276	78	(12)	(1)	(6)	257	93
AA	42	12	(7)	-	1	36	86
A	30	9	(4)	-	-	26	87
BBB	4	1	(2)	-	-	2	50
Below BBB	-	-	-	-	-	-	-
Total	352	100	(25)	(1)	(5)	321	91

Other

Other investments total £145m. The majority of these are Corporate lending transactions were completed by the Corporate Bank.

Risk Management continued

Secured Loan to Conduit
As at 31 December 2008:

Asset Type	Credit rating	Nominal value £m	Impairment £m	Original credit enhancement %	Original sub-prime exposure %	Original vintage Pre-2005 %	2005 %	2006 %	2007 %
ABS									
US RMBS	AAA	46	-	32	-	39	61	-	-
(ALT-A)	AA	5	-	18	-	-	-	-	-
Total ABS		51	-	30	-	35	55	-	-
CLO									
	AAA	442	-	24	-	99	-	-	1
	AA	33	-	29	-	82	18	-	-
	A	30	-	26	-	100	-	-	-
Total CLO		505	-	24	-	98	1	-	1
CDO									
ABS CDO	AAA	19	-	24	36	100	-	-	-
	AA	26	-	28	44	100	-	-	-
	BBB	28	4	26	45	100	-	-	-
	Below BBB	45	17	30	65	100	-	-	-
		118	21	28	51	100	-	-	-
Synthetic CDO									
	AAA	27	-	19	-	-	100	-	-
	A	76	6	10	-	32	68	-	-
	BBB	17	14	10	-	-	100	-	-
	Below BBB	34	31	6	-	-	100	-	-
		154	51	10	-	16	84	-	-
Other									
	AAA	73	-	45	-	45	-	55	-
	AA	17	-	61	-	-	41	59	-
	A	11	-	49	-	-	100	-	-
		101	-	48	-	32	18	50	-
Total CDO		373	72	26	16	47	40	13	-
Total Conduit assets		929	72			74	19	6	1

The Group's Conduit facility is currently funded by the Group via secured loans. The Group assesses impairment based on the performance of the underlying assets within the Conduit. The Conduit is not consolidated into the Group accounts on the basis that the Special Purpose Vehicles (SPVs) within the Conduit are not controlled by the Group.

Market risk

Market risk is the potential for loss of income or decrease in the value of net assets caused by movements in the levels and prices of financial instruments including interest rate and foreign currency risks. The Group's exposure to market risk is governed by a policy approved by the Asset and Liability Management Committee (ALCO) and ratified by the Risk Committee. The policy sets out the nature of risk which may be taken, and applicable maximum risk limits. The Group risk limits are allocated by ALCO to all business units.

Risk division monitors compliance with market risk limits and reports excesses to ALCO or Risk Committee.

Interest rate risk

Interest rate re-pricing risk mainly arises from mismatches between the re-pricing dates of the assets and liabilities on the Group's balance sheet, changes in the value of non-linear interest rate positions such as interest rate caps, and from the investment of the Group's reserves and non-interest and low interest rate liabilities. The Group has established a transfer pricing system which passes interest rate re-pricing risks that arise in the various Group businesses to Treasury. Treasury manages the Group's overall interest rate risk within policy limits. In addition, strategic hedges are agreed by the ALCO for the investment of the Group's reserves and non-interest and low interest rate liabilities. These hedges are transacted by Treasury.

Interest rate risk limits are expressed as the maximum principal amount which is re-priced during a given time period. In the case of Treasury, interest rate risk is measured and limited according to the market value impact of a one basis point shift in particular points on the yield curve. In addition, Value at Risk (VaR) is used to measure the Group's total exposure to interest rate risks. The VaR measurement methodology calculates the potential loss, in market value terms, from existing risk positions as a result of movement in market interest rates. A variance-covariance VaR model is used based on historical volatility and correlation data and measures VaR to 95% confidence over a one month holding period. A separate model is used to calculate the VaR on positions, such as interest rate options, whose market value varies with changes in interest rates in a non-linear way.

Although it is a useful tool in measuring risk, VaR does contain some limitations:

> It does not accurately measure extreme events;
> The use of a 95% confidence level does not by definition include losses beyond this level of confidence;
> It relies on the historical volatility and correlation data being similar to the volatility and correlation positions going forward.

The VaR of the Group's non-trading book exposures are shown below:

	Group		Company	
	2008 £m	2007 £m	**2008 £m**	2007 £m
Value at Risk	**21.6**	5.4	**18.5**	5.2

The above analysis excludes strategic hedges of Group reserves, non-interest and low interest rate liabilities. Interest rate exposures arising from basis risk, prepayment risk and pipeline risk are excluded from the above measure. These risks are measured using separate techniques and are regularly reported to the ALCO.

The Group's trading activities were conducted through the Group's Treasury division. Group Treasury's control of, and approach to, market risk, with respect to its trading book activities, is defined by market risk tolerance levels documented in a policy approved by the Group Risk Committee (GRC). Market Risk in the trading book is measured and controlled through stop loss limits and interest rate and credit spread sensitivity limits. During 2008, Treasury assets which gave rise to credit spread sensitivity in the trading books were reclassified for accounting purposes as 'Loans & Receivables'. Changes in fair value due to changes in credit spreads therefore ceased to impact profit or loss.

	Group & Company			
		2008		**2007**
	Sensitivity to a 1% change in interest rates £m	**Sensitivity to a 1bp change in credit spread £m**	**Sensitivity to a 1% change in interest rates £m**	**Sensitivity to a 1bp change in credit spread £m**
Highest	**1.1**	**0.2**	1.1	0.3
Lowest	**0.4**	**0.1**	0.5	0.2
Average	**0.6**	**0.1**	0.8	0.3
Exposure at 31 December	**0.8**	**0.1**	0.9	0.2

Foreign exchange risk

The Group's policy is to have no material open foreign currency positions. The Group offers foreign exchange services to customers through both Treasury and Corporate Bank operations. Detailed limits and controls are established within those businesses to control the exposure. Corporate Bank clears its positions with Treasury in accordance with the policy of transferring market risk positions to Treasury wherever possible. The foreign exchange risks arising from Treasury's wholesale funding and Treasury asset portfolio are hedged within Treasury's limits.

Equity risk

The Group's policy is to have no material exposure to equity price risk. Retail Banking sells third party stock market bonds. The equity and interest rate risks from these bonds are borne entirely by the third party. Alliance & Leicester International Limited sells stock market bonds to customers. Positions may arise in the management of such bonds due to mismatches between the hedging contracts and the underlying customer liabilities. Procedures are established to minimise these positions as tightly as is operationally practicable and to report open positions to ALCO on a monthly basis.

Inflation risk

The Group's policy is to have no material exposure to inflation risk. This risk arises due to the exposure to inflation linked bonds and loans in Corporate Banking. It is the Group's policy to fully hedge inflation risk, using inflation swaps or other effective hedge instruments.

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, which require no or little initial net investment and swaps are settled at a future date. They include interest rate, cross-currency swaps and forward rate agreements (see table below). Derivatives are used primarily for balance sheet management purposes.

The principal derivatives used in balance sheet risk management are interest rate swaps, forward rate agreements (FRAs), futures, interest rate options and foreign exchange contracts which are used to hedge the economic exposures arising from mortgage lending, personal and commercial loans, leasing, fixed rate savings products, funding and investment activities and foreign exchange services to customers.

The following table describes the significant activities undertaken, the related risks associated with such activities and the types of derivatives which are typically used in managing such risks. These risks may alternatively be managed using on-balance sheet instruments or natural hedges that exist in the balance sheet.

Risk Management continued

Activity	Risk	Type of hedge
Management of the return on variable rate assets financed by shareholders' funds and net non - interest-bearing liabilities.	Reduced profitability due to falls in interest rates.	Receive fixed interest rate swaps.
Equity linked investment products.	Sensitivity to changes in equity indices and interest rates.	Equity linked futures and options.
Management of repricing profile of wholesale funding.	Reduced profitability due to adverse movement in wholesale interest rates when large volumes of wholesale funding are repriced.	Forward rate agreements.
Fixed rate lending and investments.	Sensitivity to increases in interest rates.	Pay fixed interest rate swaps.
Fixed rate retail and wholesale funding.	Sensitivity to falls in interest rates.	Receive fixed interest rate swaps.
Management of other net interest income on retail activities.	Sensitivity of income to changes in interest rates	Interest rate swaps.
Investment and funding in foreign currencies.	Sensitivity to changes in foreign exchange rates.	Foreign exchange contracts, cross currency interest rate swaps.
Customer foreign exchange business.	Sensitivity to changes in foreign exchange rates.	Foreign exchange contracts.

Liquidity risk

Liquidity risk is the potential that the Group has insufficient financial resources to meet its payment obligations as they fall due, or can do so only at excessive cost. Liquidity risks arise throughout the Group's businesses. Its primary business activity is commercial banking and, as such, it engages in maturity transformation, whereby it raises funds that may be withdrawn at short notice and lends them to customers at longer terms.

Following Banco Santander, S.A.'s acquisition of Alliance & Leicester plc in October 2008, the liquidity risks of Alliance & Leicester plc and Abbey National plc have been managed on a combined basis. For further information, please refer to the liquidity risk discussion in the Risk Management Report of Abbey National plc's Consolidate Financial Statements. In 2008, Santander's commitments to the UK Government and regulators to improve the Tier 1 ratio of the combined UK businesses were met using the additional £1bn of capital announced at the time of the acquisition of Alliance & Leicester plc, which was transferred into Abbey from Santander. This capital was in turn transferred to Alliance & Leicester plc in late December as planned.

The majority of funding is raised from retail deposits with the balance raised in wholesale markets. Alliance & Leicester plc now sources its wholesale funding from Abbey National plc.

Maturities of financial liabilities

The table below analyses the maturities of the undiscounted cash flows relating to financial liabilities of the Group based on the remaining period to the contractual maturity date at the balance sheet date. Deposits by customers are largely made up of retail deposits. In particular the 'Demand' grouping includes current accounts and other variable rate savings products. The 'Up to 3 months' grouping largely constitutes wholesale funding of wholesale assets of a similar maturity. This table is not intended to show the liquidity of the Group.

Group

At 31 December 2008	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	1,279	6,908	544	3,006	-	11,737
Deposits by customers	28,436	8,050	3,179	114	91	39,870
Derivative financial instruments	-	405	436	400	198	1,439
Financial liabilities designated at fair value	-	321	336	26	70	753
Debt securities in issue	-	2,249	4,030	6,919	12,600	25,798
Subordinated liabilities	-	18	66	359	3,009	3,452
Total financial liabilities	**29,715**	**17,951**	**8,591**	**10,824**	**15,968**	**83,049**

Company

At 31 December 2008	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	1,907	8,345	548	2,962	-	13,762
Deposits by customers	30,524	7,616	2,962	101	91	41,294
Derivative financial instruments	-	421	457	492	196	1,566
Financial liabilities designated at fair value	-	321	336	26	70	753
Debt securities in issue	-	2,179	3,954	6,255	220	12,608
Subordinated liabilities	-	18	66	359	3,009	3,452
Funding for securitisations	-	72	79	684	12,753	13,588
Total financial liabilities	**32,431**	**18,972**	**8,402**	**10,879**	**16,339**	**87,023**

Group

At 31 December 2007	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	639	7,804	4,804	6,269	96	19,612
Deposits by customers	24,600	5,616	1,519	286	185	32,206
Derivative financial instruments	-	51	225	196	55	527
Financial liabilities designated at fair value	-	2,376	1,788	39	77	4,280
Debt securities in issue	-	4,560	4,145	10,490	14,365	33,560
Subordinated liabilities	-	12	102	128	932	1,174
Total financial liabilities	25,239	20,419	12,583	17,408	15,710	91,359

Company

At 31 December 2007	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	1,013	10,010	4,804	6,269	99	22,195
Deposits by customers	24,890	5,244	1,015	269	185	31,603
Derivative financial instruments	-	55	222	202	50	529
Financial liabilities designated at fair value	-	2,376	1,788	39	77	4,280
Debt securities in issue	-	4,098	3,971	9,596	761	18,426
Subordinated liabilities	-	12	102	128	932	1,174
Funding for securitisations	-	62	174	882	13,607	14,725
Total financial liabilities	25,903	21,857	12,076	17,385	15,711	92,932

Directors

Board of Directors
As at 31 December 2008

Chairman
Lord Burns

Lord Burns (age 65) was appointed Chairman on 12 October 2008. He is also Chairman of Abbey National plc and Glas Cymru Cyfyngedig (Welsh Water) and a Non-Executive Director of Pearson plc and Banco Santander, S.A..His current professional roles include President of the Society of Business Economists, Fellow of the London Business School, Companion of the Institute of Management, President of the National Institute of Economic and Social Research and Vice President of the Royal Economic Society. He was formerly Permanent Secretary to the Treasury and chaired the Parliamentary Financial Services and Markets Bill Joint Committee. He was a Non-Executive Director of British Land plc (2000-2005) and Legal & General Group plc (1991-2001). He was also Chairman of the National Lottery Commission (2000-2001) and Marks and Spencer Group plc (2006-2008).

Executive Directors

António Horta-Osório
Chief Executive

António Horta-Osório (age 45) was appointed Chief Executive on 12 October 2008. He was a Non-Executive Director of Abbey National plc from 1 December 2004 until his appointment as Chief Executive in August 2006. He joined Abbey National plc from Banco Santander Totta in Portugal where he was Chief Executive Officer. He is also Executive Vice President of Banco Santander, S.A. and a member of its management committee as well as Non-Executive Chairman of Banco Santander Totta. He was previously Chief Executive Officer of Banco Santander Brasil. António started his career at Citibank Portugal, where he was head of Capital Markets and at the same time was an assistant professor at the Universidade Católica Portuguesa. He then worked for Goldman Sachs in New York and London, focusing on corporate finance activities in Portugal and, in 1993, joined the Santander group as Chief Executive Officer of Banco Santander de Negócios Portugal. He is a graduate in Management and Business Administration at Universidade Católica Portuguesa, has an MBA from INSEAD, where he was awarded the Henry Ford II Prize, and an AMP from Harvard Business School.

David Bennett
Executive Director, Integration Advisor and Intermediaries

David Bennett (age 46) was appointed as Finance Director in January 2000 and Chief Executive on 27 July 2007. Following the acquisition of Alliance & Leicester plc by Banco Santander, S.A., David became Executive Director, Integration Advisor and Intermediaries on 12 October 2008. He is also an Executive Director of Abbey National plc and a Non-Executive Director of EasyJet plc. He has many years experience in the financial sector as Finance Director of Cheltenham & Gloucester plc and Executive Director of the National Bank of New Zealand Ltd.

Nathan Bostock
Chief Financial Officer and Executive Director, Retail Products & Marketing, Human Resources, Credit Cards and Insurance

Nathan Bostock (age 48) was appointed as an Executive Director on 12 October 2008. He is currently Chief Financial Officer and his responsibilities include Group Infrastructure (comprising Asset & Liability Management, Group Capital and Funding), Retail Products and Marketing, Human Resources, Credit Cards and Insurance. Nathan joined Abbey National plc in November 2001 as Chief Operating Officer, Abbey National Treasury Services plc, with responsibility for finance, market risk and operations. Prior to joining Abbey National plc, Nathan spent nine years (1992-2001) with The Royal Bank of Scotland plc where his roles included Director, Group Risk Management and Chief Operating Officer, Treasury and Capital Markets. Prior to joining The Royal Bank of Scotland plc, Nathan was Head of Risk Analysis and Finance, Treasury and Interest Rate Derivatives (Europe) for Chase Manhattan Bank (1988-1992). He joined Chase Manhattan Bank in 1986 having previously worked for Coopers and Lybrand. He is also an Executive Director of Abbey National plc.

Alison Brittain
Executive Director, Retail Distribution

Alison Brittain (age 44) was appointed as an Executive Director on 12 October 2008 and became responsible for Branch Distribution, Telephone Distribution, e-commerce, Premium Banking and Commercial Mortgages on 16 January 2009. She is also an Executive Director of Abbey National plc and was previously Managing Director of the Barclays and Woolwich Retail Network divisions and the Small Business Banking division of Barclays Bank plc.

Non-Executive Directors

Juan Rodríguez Inciarte
Deputy Chairman

Juan Inciarte (age 56) was appointed Non-Executive Director on 12 October 2008. He joined Banco Santander, S.A. in 1985. After holding various positions, he was appointed to the Board of Directors in 1991, holding this office until 1999. He is currently Chief Executive of Santander Consumer Finance, S.A., Executive Vice President of Banco Santander, S.A. and a Non-Executive Director of Abbey National plc. In addition, he is a director of Compañia Española de Petróleos, NIBC Bank N.V., Banco Banif S.A., Vista Capital de Expansion S.A. and director and member of the Executive Committee of Sovereign Bancorp in the US. For several years he served on the Board of Directors of First Union Corporation (presently Wachovia) in the US, the Board of Directors and Executive Committee of San Paolo-IMI in Italy and the Boards of The Royal Bank of Scotland plc and National Westminster Bank plc (from 1998–2004). He is a member of the US-Spain Council and Fellow of The Chartered Institute of Bankers in Scotland.

Jane Barker

Jane Barker (age 59) was appointed Non-Executive Director in 2004. She is Chief Executive Officer of Equitas Limited, the company set up to re-insure and run-off the 1992 and prior years' non-life liabilities of Lloyd's of London syndicates and a Non-Executive Director of Abbey National plc. She is Deputy Chairman of the Royal College of Music and was previously a member of the council and chair of the Audit Committee of the Open University. Her previous roles have included being Finance Director of the London Stock Exchange.

Roy Brown

Roy Brown (age 62) was appointed Non-Executive Deputy Chairman and Senior Independent Director in May 2007. Following the acquisition of the Company by Banco Santander, S.A. he became a Non-Executive Director on 12 October 2008. He is a Chartered Engineer and is Chairman of GKN plc, Senior Independent Director of HMV Group plc and a Non-Executive Director of Abbey National plc. Formerly, he was an Executive Director of Unilever plc and NV, a Non-Executive Director of Brambles Industries plc, the British United Provident Association Ltd (BUPA) and the Franchise Board of Lloyd's of London.

José María Carballo

José María Carballo (age 64) was appointed Non-Executive Director on 12 October 2008. He is a Non-Executive Director of Abbey National plc, Chairman of La Unión Resinera Española, Chairman of Vista Desarrollo, Director of Vista Capital Expansion S.A. S.G.E.C.R., and Director of Teleférico Pico del Teide S.A. He is also Vice President and Honorary Treasurer of the Iberoamerican Benevolent Society (UK). He was Executive Vice President of Banco Santander, S.A. from 1989-2001 and Chief Executive Officer of Banco Santander de Negocios from 1989 to 1993. Until 1989 he was Executive Vice President responsible for Europe at Banco Bilbao Vizcaya. He was also Executive Vice President of Banco de Bilbao in New York until 1983.

José María Fuster

José María Fuster (age 50) was appointed Non-Executive Director on 12 October 2008. He is Executive Vice President of Operations and Technology and Chief Information Officer of Banco Santander, S.A., Non-Executive Director of Banesto and a Non-Executive Director of Abbey National plc. He joined Banesto in 1998 and was appointed as Chief Information Officer of Banco Santander, S.A. in 2003. He started his professional career with International Business Machines, S.A. and Arthur Andersen as a consultant. He has also worked for Citibank España S.A. and National Westminster Bank plc.

Rosemary Thorne

Rosemary Thorne (age 57) was appointed Non-Executive Director on 12 October 2008. She is also a Non-Executive Director on the board of Smurfitt Kappa Group plc and a Non-Executive Director of Abbey National plc. She was Group Finance Director of Ladbrokes plc until April 2007, Non-Executive Director of Cadbury Schweppes plc until September 2007 and Senior Independent Director on the board of Virgin Radio Holdings Limited until June 2008. Previously, she was Group Financial Controller of Grand Metropolitan Public Limited Company (prior to its merger with Guinness plc to become Diageo plc) and spent almost eight years as the Group Finance Director of J Sainsbury plc. She joined the board of Bradford & Bingley plc in 1999 as Group Finance Director, initially working on its demutualisation and flotation, resulting in a place in the FTSE 100 in December 2000. She remained in this role for a further five years. She was a member of the Financial Reporting Council and Financial Reporting Review Panel for nine years and a member of The Hundred Group of Finance Directors Main Committee for 15 years. She also sits on the Council of the Royal College of Art.

Keith Woodley

Keith Woodley (age 69) was appointed Non-Executive Director on 12 October 2008. He is also Non-Executive Director of Abbey National plc. He is a former Non-Executive Director of National and Provincial Building Society and a former partner of Deloitte Haskins & Sells. A past President of the Institute of Chartered Accountants in England and Wales, he is Complaints Commissioner for the London Stock Exchange and a Council Member and Pro-Chancellor of the University of Bath.

Directors' Report

Corporate Structure

On 10 October 2008, a Scheme of Arrangement, which was approved by the High Court of England & Wales and by the Shareholders of Alliance & Leicester plc (the 'Company') and Banco Santander, S.A., became effective. On that date, the Company became a wholly owned subsidiary of Banco Santander, S.A. and the ordinary shares of the Company ceased to be traded on the London Stock Exchange. Shareholders in the UK were awarded one new Santander share for every three shares which they held in the Company.

On 17 December 2008, Abbey National plc injected £950m of capital into the Company through a subscription of (i) 234,113,712 Alliance & Leicester plc ordinary shares for cash at £2.99 per share; (ii) US$220m undated subordinated notes issued by Alliance & Leicester plc; and (iii) Euro 115m undated subordinated notes issued by Alliance & Leicester plc. As a result of the subscription of ordinary shares, Abbey National plc held 35.6% of the issued share capital of the Company at 31 December 2008.

The Company is subject to the Listing Rules and the Disclosure & Transparency Rules of the UK Financial Services Authority, because it has preference shares listed on the London Stock Exchange. As it does not have listed ordinary shares, the Company is exempt from the requirement to make certain disclosures that are normally part of the continuing obligations of listed companies in the UK. This exemption applies, among other things, to corporate governance and certain Directors' remuneration disclosures.

Principal Activities and Business Review

The principal activity of the Company and its subsidiaries (together 'Alliance & Leicester' or the 'Group') continues to be the provision of an extensive range of personal financial services. In addition, Alliance & Leicester provides a wide range of banking and financial services to business and public sector customers. The Company is authorised and regulated by the UK Financial Services Authority.

The Company is required to set out in this report a fair view of the development and performance of the business of the Group during the year ended 31 December 2008 and of the position of the Group at the end of the year. The information that fulfils this requirement can be found in the Chief Executive's Review on pages 2 to 3. The Chief Executive's Review also contains a description of the likely future developments of the Group. When reading the Chief Executive's Review, reference should be made to the forward-looking statements section on page 4.

Further information on the development and performance of the business of the Group, both at a consolidated level and analysed by division can be found in the following sections:

An analysis of the Group's development and performance during the year is contained in the Business Review -Summary on pages 8 to 10.

A further detailed analysis of the business segments is contained in the Business Review – Personal Financial Services on pages 11 to 14.

Further information on the position of the Group at the end of the year can be found in the following sections:

An analysis of the business flows is contained in the Business Review on page 12.

The Group's key performance indicators are described in the Business Review - Summary on page 10.

The Company is also required to describe the principal risks and uncertainties facing the Group. Financial risks are described in the Risk Management Report for each segment of the business by type of risk on pages 18 to 33, and material risk factors are described in the Risk Factors section on pages 102 to 105.

Results and Dividends

The results of the Group are discussed in the Principal Activities and Business Review above. The Directors do not recommend the payment of a final dividend (2007: 36.5 pence per ordinary share). An interim dividend of 18.0 pence per ordinary share was paid on 6 October 2008 (2007: 18.8 pence per ordinary share).

Post Balance Sheet Events

On 9 January 2009, in order to optimise the capital, liquidity funding and overall financial efficiency of the enlarged group, Banco Santander, S.A. transferred all of its shares in the Company to Abbey National plc in exchange for newly issued Abbey National plc ordinary shares of £0.10 per share. Accordingly, Abbey National plc is now the immediate parent company of the Company.

Going Concern

The Company's business activities, together with the factors likely to affect its future development, performance and position are set out above. The financial position of the Company, its cash flows, liquidity position and borrowing facilities are set out in the financial statements. The Company's objectives, policies and processes for managing its capital are described in Note 45 to the financial statements.

Details of the Company's financial risk management objectives, its financial instruments and hedging activities; and its exposures to credit risk, interest rate risk, liquidity risk, operational risk and other risks are set out in the Risk Management Report on pages 16 to 33 and material risk factors are described on pages 102 to 105.

The Company is now part of the Abbey National plc group. The Company is reliant on Abbey National plc and other companies in the Abbey National plc group for a significant proportion of its funding. The Board of Abbey National plc has confirmed that Abbey National plc and the Abbey National plc group are going concerns, and that it will provide funding to the

Company for the foreseeable future. In giving this commitment to provide funding to Alliance & Leicester plc, the Board of Abbey National plc has considered the uncertainties within Alliance & Leicester plc when preparing the forecasts and budgets of the combined business of the Abbey National Group.

The Company has given a full and unconditional guarantee in respect of the unsubordinated liabilities of Abbey National plc incurred prior to 31 July 2012 under a deed poll guarantee entered into by the Company on 19 March 2009. Abbey National plc has given a reciprocal guarantee in respect of the unsubordinated liabilities of the Company incurred prior to 31 July 2012.

After making enquiries, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the Annual Report and Accounts.

Directors

The members of the Company's Board (the 'Board') at 31 December 2008 are named on pages 34 to 35. For each Director, the date of appointment is shown. As at 31 December 2008, the Board comprised a Chairman, four Executive Directors including the Chief Executive, and seven Non-Executive Directors. At the date of publication of this report, the Board comprises a Chairman, four Executive Directors, including the Chief Executive, and seven Non-Executive Directors. 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. During 2008 the following Directors resigned:

Director	Title	Date of Resignation
Sir Derek Higgs	Chairman	28 April 2008 (deceased)
Richard Banks	Group Risk Director	13 October 2008
Chris Rhodes	Group Finance Director	13 October 2008
Ian Buchanan (appointed 7 July 2008)	Group Manufacturing Director	13 October 2008
Malcolm Aish	Non-Executive Director	13 October 2008
Rob Duke	Non-Executive Director	13 October 2008
Mary Francis	Non-Executive Director	13 October 2008
Mike McTighe	Non-Executive Director	13 October 2008
Angus Porter (appointed 14 May 2008)	Non-Executive Director	13 October 2008
Margaret Salmon	Non-Executive Director	13 October 2008
Jonathan Watts	Non-Executive Director	13 October 2008

In addition, on 25 February 2009 the Company announced that Executive Director, Nathan Bostock, would be leaving the Company on 1 June 2009.

Non-Executive Directors have been appointed for an indefinite term (other than Keith Woodley and Rosemary Thorne, who have been appointed for a three year term after which their appointments may be extended upon mutual agreement). In accordance with the Company's Articles of Association, all of the Directors shall retire from office and face re-election at every Annual General Meeting.

When they were appointed, the appointments of Terence Burns, António Horta-Osório, Juan Rodriguez Inciarte, José María Fuster, José María Carballo, Nathan Bostock, Alison Brittain, Rosemary Thorne and Keith Woodley were all proposed by Banco Santander, S.A. The Company may pay an Executive Director instead of allowing them to work during their notice period.

Karen M Fortunato was appointed as Company Secretary in place of Simon Lloyd with effect from 12 October 2008.

Committees of the Board

The Board maintains one Standing Committee, which operates within written terms of reference.

Audit and Risk Committee

Membership of the Audit and Risk Committee is restricted to Non-Executive Directors. The Audit and Risk Committee's primary tasks are to review the scope of external and internal audit, to receive reports from the external auditors (currently Deloitte LLP) and the Chief Internal Auditor, and to review the preliminary results, interim information, annual financial statements and any other significant financial reports before they are presented to the Board, focusing in particular on accounting policies, compliance and areas of management judgement and estimates. The Audit and Risk Committee's scope also includes risk management and oversight and the review of the procedures in place for employees to raise concerns about possible wrongdoing in financial reporting and other matters. For a further discussion of the risk-control responsibilities of the Audit and Risk Committee, see the Risk Management section on page 18.

The Audit and Risk Committee more generally acts as a forum for discussion of internal control issues and contributes to the Board's review of the effectiveness of the Group's internal control and risk management systems and processes. The Audit and Risk Committee also conducts a review of the remit and reports of the Alliance & Leicester and Banco Santander, S.A. internal audit functions, as well as their effectiveness, authority, resources and standing within Alliance & Leicester and management's response to their findings and recommendations. Alliance & Leicester's relationship with the external auditors and the experience and qualifications of the external auditors are monitored by the Audit and Risk Committee and external auditor's audit plans and audit findings are reviewed by the Audit and Risk Committee. A framework for ensuring auditor independence

Directors' Report continued

has been adopted which defines unacceptable non-audit assignments, pre-approval of acceptable non-audit assignments and procedures for approval of other non-audit assignments.

The Audit and Risk Committee may make any recommendations to the Board as it sees fit and the Chairperson of the Audit and Risk Committee reports formally to the Board after each meeting. The members of the Audit and Risk Committee are Rosemary Thorne (Chairperson), Juan Rodriguez Inciarte, José Maria Carballo, Keith Woodley, Roy Brown and Jane Barker.

Remuneration Committee

The Remuneration Committee was formally dissolved on 12 October 2008 following the acquisition of the Company by Banco Santander, S.A. Prior to this date, the Remuneration Committee was responsible for determining the pay and benefits and contractual arrangements of the Directors and Senior Managers of Alliance & Leicester. These responsibilities are now discharged by the Banco Santander, S.A. Appointments & Remuneration Committee.

Directors' Remuneration (audited)

The aggregate remuneration received by the Directors of the Company in 2008 was:

	£
Salaries and fees	1,929,979
Performance-related payments	50,500
Other taxable benefits	38,674
Total remuneration excluding pension contributions	2,019,153
Pension contributions	186,170
Compensation for loss of office	931,037

These totals exclude emoluments received by Directors in respect of their primary duties as Directors or Officers of Abbey National plc or Banco Santander, S.A., in respect of which no apportionment has been made.

Long Term Incentive Plans (audited)

During 2008, prior to the acquisition of the Company by Banco Santander, S.A., three Directors and six other Key Management Personnel received conditional awards of shares and options under the Alliance & Leicester Long Term Incentive Plan and the Company Share Option Plan respectively for a total fair value of £678,257. These awards and options were in respect of the Company's ordinary shares. All Long Term Incentive Plan awards lapsed on 7 October 2008; all Company Share Option Plan options granted in 2008 remain unexercised as at 31 December 2008 and will lapse on 7 April 2009. On 7 October 2008, three Directors and four other Key Management Personnel exercised options under the Alliance & Leicester Deferred Bonus Plan. Alliance & Leicester Deferred Bonus Plan options outstanding as at 31 December 2008 will lapse on 7 April 2009. No further options were granted over the Company's ordinary shares.

Remuneration of Highest Paid Director (audited)

In 2008, the remuneration, excluding pension contributions, of the highest paid Director was £663,936 (2007: £860,000) of which £25,000 (2007: £249,000) was performance related. The accrued pension benefit for the highest paid Director as at 31 December 2008 was £109,647 (2007: £108,155). A conditional award of shares was made to the highest paid Director under the Long-Term Incentive Plan during the year.

Retirement Benefits (audited)

Defined benefit pension plans are provided to certain of Alliance & Leicester's employees. See Note 33 to the Consolidated Financial Statements for a description of the plans and related costs and obligations. Retirement benefits are accruing for one Director under the Alliance & Leicester Defined Benefit Scheme (2007: three) in respect of his qualifying service to Alliance & Leicester.

Non-Executive Directors (audited)

Fees were paid to Non-Executive Directors in 2008 totalling £748,784 (2007: £906,000); this amount is included above in the table of Directors' remuneration and excludes emoluments received by Terence Burns, Juan Rodriguez Inciarte, José Maria Carballo, José Maria Fuster, Rosemary Thorne and Keith Woodley, which are shown aggregated in the Report and Accounts of Abbey National plc.

Directors' Interests and Related Party Transactions (audited)

In 2008, loans were made to four members of Alliance & Leicester's Key Management Personnel, with the principal amount of £217,000 outstanding at 31 December 2008. No Directors had loans outstanding at 31 December 2008. See Notes 41 and 42 to the Consolidated Financial Statements on pages 96 to 98 for disclosures of deposits and investments made and insurance policies entered into by the Directors, Key Management Personnel and their connected persons with Alliance & Leicester at 31 December 2008. Note 42 to the Consolidated Financial Statements also includes details of other related party transactions.

In 2008 there were no other transactions, arrangements or agreements with the Group in which Directors or Key Management Personnel or persons connected with them had a material interest, other than options to subscribe for ordinary shares under the Alliance & Leicester Share Option Plans. 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. During 2008, no Directors exercised share options over shares in Banco Santander, S.A., the ultimate parent company of the Company (2007: none).

Third Party Indemnities

Since 26 November 2008, the Company has issued enhanced indemnities to its Directors against liabilities and associated costs which they incur in the course of their duties for Alliance & Leicester. All of the indemnities remain in force as at the date of this Annual Report and Accounts. A copy of each of the indemnities is kept at the address shown on page 107.

Financial Risk Management Objectives

The financial risk management objectives and policies of the Group; the policy for hedging each major type of forecasted transaction for which hedge accounting is used; and the exposure of the Group to price risk, credit risk, liquidity risk and cash-flow risk are outlined in the Risk Management Report on pages 16 to 33.

Pension Funds

The assets of the Alliance & Leicester Pension Scheme are held separately from those of Alliance & Leicester and are under the control of the trustees. As at 31 December 2008 the Alliance & Leicester Pension Scheme had nine trustees, of whom five are selected by Alliance & Leicester (one of whom is an independent trustee) and four are elected by eligible members. Asset management of the schemes is delegated to a number of fund managers and the trustees receive independent professional advice on the performance of the managers. Legal advice to the trustees is provided by an external firm of solicitors. The audits of the pension scheme are separate from that of Alliance & Leicester and are all undertaken by KPMG LLP. Further information is provided in Note 33 to the Consolidated Financial Statements.

Market Value of Land and Buildings

On the basis of a periodic review process, the estimated aggregate market value of the Group's land and buildings was not significantly different from the fixed asset net book value of £173m, as disclosed in Note 22 to the Consolidated Financial Statements. It is considered that, except where specific provisions have been made, the land and buildings have a value in use to the Group that exceeds the estimated market value, and the net book value is not impaired.

Disability

Alliance & Leicester is committed to equality of access and quality of service for disabled people and embraces the spirit of the UK Disability Discrimination Act 1995 and 2005 throughout its business operations. Alliance & Leicester has processes in place to help recruit, train, develop, retain and promote employees with disabilities and is committed to giving full and fair consideration to applications for employment made by disabled persons, and for continuing the employment of, and arranging appropriate training for, existing employees who have become disabled.

Employee Involvement

Employee Share Ownership

During 2008, eligible employees were able to participate in a ShareSave plan, or a Share Incentive Plan to acquire partnership shares which gave employees the opportunity to save money from their pre-tax salary. Through these share plans, a number of employees owned shares in the Company. At the time of the acquisition by Banco Santander, S.A., shares held in the Alliance & Leicester Share Incentive Plan were converted into Banco Santander, S.A. shares on the same basis as all other shareholders. Options granted under the Alliance & Leicester ShareSave Plan became exercisable from 7 October 2008 and will lapse on 7 April 2009.

In recognition of the Banco Santander, S.A. acquisition of the Company all employees were given 100 free shares in Banco Santander, S.A. on 1 December 2008. These shares were granted using an HM Revenue & Customs approved Share Incentive Plan. The free shares will be held in trust on the employee's behalf for a minimum of three years. At present no new all employee share plans are expected to be launched.

Communication

Alliance & Leicester wants to involve and inform employees on matters that affect them. Almost all employees have access to the Company intranet. Alliance & Leicester also uses more traditional methods of communication such as team meetings. All these channels are designed to keep employees fully informed of news and developments which may have an impact on them and also to keep them up-to-date on financial, economic and other factors which affect the Group's performance. Alliance & Leicester considers employees' opinions and asks for their views on a range of issues through regular company-wide opinion surveys.

Consultation

Alliance & Leicester has for many years worked closely with the Communication Workers Union ('CWU') and the Public and Commercial Services Union ('PCS'), who are the independent trade unions that it recognises to act as the voice of Alliance & Leicester employees. CWU and PCS are affiliated to the Trade Union Congress and operate from their own offices. CWU and PCS are involved in major Alliance & Leicester initiatives and the Company consults them on significant proposals within the

Directors' Report continued

business. Consultation takes place at both national and local levels. Alliance & Leicester holds regular consultation and negotiation meetings to enable collaborative working and ensure that communication is open and two-way.

Donations

Alliance & Leicester made total cash donations of £710,000 (2007: £810,000) to a wide range of charities. For 2008 Alliance & Leicester's employees chose Zoe's Place, the UK's only baby hospice, based in Liverpool, and LOROS, the Leicestershire and Rutland Hospice to be Alliance & Leicester's two charities of the year. Each charity benefited from an initial £10,000 donation from the Group in January with further support during the year.

Political Contributions

No contributions were made for political purposes and no political expenditure was incurred.

Suppliers

Alliance & Leicester has cost management and procurement policies that explicitly promote competitive tendering and dealing with suppliers in a fair and open manner. Alliance & Leicester has a policy of paying suppliers within 30 days of receipt of invoice; payment terms will only differ from this policy where there is a commercial benefit to the Group. Further details on Alliance & Leicester's policy on payment of creditors are set out below.

Policy & Practice on Payment of Creditors

Alliance & Leicester continues to be a signatory of the Better Payment Practice Code, more details on which can be found at www.payontime.co.uk. Alliance & Leicester's policy is to agree the terms of payment at the start of business with a supplier, to ensure suppliers are aware of the payment terms and to pay in accordance with the terms and conditions agreed, except where the supplier fails to comply with those terms and conditions. Based on the ratio of the aggregate amounts owed to trade creditors at the end of the year to the aggregate amounts invoiced by suppliers during the year to 31 December 2008, trade creditor days for Alliance & Leicester were 7 days (2007: 12 days).

Business Principles

Alliance & Leicester's Statement of Business Principles were formally adopted in 2005 and are reviewed annually by the Board. The principles have been communicated to all employees.

The principles require staff to act at all times with the highest standards of business conduct in order to protect Alliance & Leicester's reputation and ensure a company culture which is free from any risk of corruption, compromise or conflicts of interest. The Statement of Business Principles sets out the conduct of the business and requires staff to:

- Treat Customers Fairly
- Enhance shareholder value through sound corporate governance
- Take responsibility for the Company's success and reputation
- Maintain high standards of integrity in business relationships
- Support local communities through volunteering, charitable giving and sponsorship
- Act responsibly to minimise the impact of business on the environment.

The Company's parent company, Abbey National plc, is committed to maintaining high ethical standards and has developed policies in this regard. A review during 2008 of such policies by Abbey National plc has resulted in the creation of a dedicated Code of Conduct for employees, consistent with Banco Santander, S.A.'s General Code of Conduct. Abbey National plc anticipates that the new policy will be launched during 2009, as part of the harmonisation of Human Resources policies across Abbey National plc's businesses. As part of the integration process it is intended that Alliance & Leicester will align its Business Principles to Abbey National plc's Code of Conduct. Further details on Abbey National plc's proposed Code of Conduct can be obtained in the Annual Report and Accounts of Abbey National plc.

Management's Report on Internal Control of the Financial Reporting

Internal control over financial reporting is a component of an overall system of internal control. The Group's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting, the preparation and fair presentation of financial statements for external purposes in accordance with International Financial Reporting Standards ('IFRS') as issued by the International Accounting Standards Board, and as endorsed by the European Union. The Group's internal control over financial reporting includes:

- Policies and procedures that relate to the maintenance of records that fairly and accurately reflect the transactions and disposition of assets;
- Controls providing reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with IFRS, and that receipts and expenditures are being made only as authorised by management;
- Controls providing reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or because the degree of compliance with policies or procedures may deteriorate.

Directors' Report continued

Management is responsible for establishing and maintaining adequate internal control over the financial reporting of the Group. Management assessed the effectiveness of the Group's internal control over financial reporting as of 31 December 2008. Based on this assessment, management believes that, as of 31 December 2008, the Group's internal control over financial reporting is effective.

Relevant Audit Information

Each of the Directors as at the date of approval of this report confirms that:

> so far as the Director is aware, there is no relevant audit information of which Alliance & Leicester's auditors are unaware; and

> the Director has taken all steps that he/she ought to have taken as a Director to make himself/herself aware of any relevant audit information and to establish that Alliance & Leicester's auditors are aware of that information.

> This confirmation is given and should be interpreted in accordance with the provisions of Section 234ZA of the Companies Act 1985.

Statement of Directors' Responsibilities

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

Company law requires the Directors to prepare financial statements for each financial year. The Directors are required by the International Accounting Standards ('IAS') Regulation to prepare the Group financial statements under IFRS, as adopted by the European Union and have also elected to prepare the parent Company financial statements in accordance with IFRS, as adopted by the European Union. The financial statements are also required by law to be properly prepared in accordance with the UK Companies Act 1985 and Article 4 of the IAS Regulation. In addition, in order to meet certain US requirements, the Directors are required to prepare the Group financial statements in accordance with IFRS, as issued by the International Accounting Standards Board.

The Directors acknowledge their responsibility to ensure the financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss presented and that the management report, which is incorporated into this report, includes a fair review of the development and performance of the business and the position presented in these financial statements, together with a description of the principal risks and uncertainties they face.

International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the preparation and presentation of financial statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS. However, the Directors are also required to:

> properly select and apply accounting policies;

> present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;

> provide additional disclosures when compliance with the specific requirements in IFRS are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and

> make an assessment of the Company's ability to continue as a going concern.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the UK Companies Act 1985. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

Auditors

Deloitte LLP have expressed their willingness to continue in office as auditors and a resolution to reappoint them will be proposed at the Company's forthcoming Annual General Meeting.

By order of the Board

KFortunato

Karen M. Fortunato
Company Secretary and Head of Legal
19 March 2009
Alliance & Leicester plc, Carlton Park, Narborough, Leicester LE19 0AL

Supervision and Regulation

As a firm authorised by the UK Financial Services Authority, the Company is subject to UK financial services laws and regulations, which are discussed below. Recent significant regulatory developments which will affect Alliance & Leicester are also highlighted below.

UK

In the UK, the Financial Services Authority is the single independent regulator for the regulation of deposit taking, investment business, mortgages and insurance. The UK Financial Services Authority was set up by the Government and exercises statutory powers under the UK Financial Services and Markets Act 2000 ('FSMA'). The Company, together with several of its subsidiaries, is authorised by the UK Financial Services Authority to carry on a range of regulated activities in the UK, which include mortgages, banking, insurance and investment business. The UK Financial Services Authority must adhere to four regulatory objectives, as prescribed in FSMA, which set out the parameters of regulation: market confidence; public awareness; the protection of consumers; and the reduction of financial crime. Based on these regulatory objectives, the UK Financial Services Authority has formulated an extensive handbook of rules and guidance to which authorised firms are subject.

Banks, insurance companies and other financial institutions in the UK are subject to the UK Financial Services Compensation Scheme (the 'FSCS'). The FSCS covers claims made against authorised firms (or any participating EEA firms) where they are unable, or likely to be unable, to pay claims against them. In relation to deposits, the FSCS provides cover for 100% of the first £50,000 of a claim, with £50,000 being the maximum amount payable per customer. In relation to investments, 100% of the first £30,000 can be claimed plus 90% of the next £20,000, with £48,000 being the maximum amount payable per customer. In relation to mortgage advice and arranging, the FSCS will pay 100% of the first £30,000 and 90% of the next £20,000, with £48,000 being the maximum amount payable per customer. The FSCS also extends (up to various amounts) to certain long term and general insurance contracts, including general insurance advice and arranging.

In October 2008 Alliance & Leicester agreed a settlement with the UK Financial Services Authority in relation to the sale of payment protection insurance with unsecured personal loans between 14 January 2005 and 31 December 2007. Under the agreement Alliance & Leicester paid a financial penalty of £7m. The Company is writing to all customers concerned and will put right any disadvantage identified. With effect from December 2007, Alliance & Leicester has improved its systems and processes for telephone contact and also made changes to its training and monitoring.

European Union

Alliance & Leicester is directly affected by laws emanating from the European Union, primarily through directives that must be implemented by the UK as a Member State of the European Union.

Basel II

The new Basel II Accord replaces the 1988 Basel Capital Accord. The supervisory objective of the Basel II Accord is to promote safety and soundness in the financial system and require banks to maintain appropriate levels of capital to cover the risks inherent in their business model. Basel II is a supervisory framework for the risk and capital management of banks and is structured around three pillars. Pillar 1 specifies minimum capital requirements for banks and new methodologies for calculating risk weighted assets. Pillar 2 describes the supervisory review process and outlines the internal capital adequacy assessment process ('ICAAP') required by banks applying Pillar 1 methodologies. Pillar 3 requires disclosure of risk and capital information to the market. These can be found on the Alliance & Leicester group website.

In the European Union, Basel II was implemented by the Capital Requirements Directive ('CRD') with effect from 1 January 2007. In the UK, the Financial Services Authority implemented the CRD by including it in UK Financial Services Authority rules. These new UK Financial Services Authority rules took effect from 1 January 2007. In addition, as part of the Group's implementation of Basel II, Alliance & Leicester was successful in its application to the UK Financial Services Authority to adopt the Retail IRB and FIRB with effect from 1 January 2007. Since 1 January 2007 Alliance & Leicester has operated under the Basel II regime.

Other Changes to Capital Adequacy and Liquidity Arrangements

On 8 October 2008, the UK Government announced a UK banking support scheme that addressed both capital and liquidity requirements of the UK banking industry. To fulfil its agreed commitment to this scheme, Banco Santander, S.A. subscribed for £1bn of Abbey National plc's Core Tier 1 capital issued on 12 October 2008. This capital was, in turn, transferred to the Company in December as planned. As a part of the UK Government's banking support scheme, Alliance & Leicester plc has participated in the UK Special Liquidity Scheme.

Other Regulatory Developments

There are a number of other regulatory developments going through a regulatory consultation and implementation process which may have some effect on Alliance & Leicester's business. These include the FSCS arrangements, consumer credit regulations, financial stability, capital adequacy and liquidity arrangements, and conduct of business arrangements such as those resulting from the Payment Services Directive, Retail Distribution review and UK Financial Services Authority review of deposit taking regulation and Treating Customers Fairly.

Following the recent turmoil in the money markets and the credit markets, regulatory capital and liquidity supervisory arrangements and requirements are being reviewed by financial services supervisors and policy makers at a number of international and national forums. These reviews are expected to result in changes to the regulation of capital adequacy, the measurement of regulatory capital requirements and liquidity risk management and reporting. These changes may have some direct or indirect effect on Alliance & Leicester's business.

Contents to Financial Statements

Financial Statements

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

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

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

Respective responsibilities of Directors and Auditors

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

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

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

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

Basis of audit opinion

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

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

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its loss for the year then ended;
- the parent Company's financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent Company's affairs as at 31 December 2008;
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the financial statements.

Separate opinion in relation to IFRSs

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

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

Deloitte LLP

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

Consolidated Income Statement

For the years ended 31 December 2008 and 2007

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

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

Consolidated Balance Sheet

As at 31 December 2008 and 2007

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

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

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

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

N. Bostock

Nathan Bostock
Chief Financial Officer

Consolidated Statement of Recognised Income and Expense

For the years ended 31 December 2008 and 2007

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

Consolidated Cash Flow Statement

For the years ended 31 December 2008 and 2007

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

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

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

Company Balance Sheet

As at 31 December 2008 and 2007

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

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

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

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

Nathan Bostock
Chief Financial Officer

Company Statement of Recognised Income and Expense

For the years ended 31 December 2008 and 2007

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

Company Cash Flow Statement

For the years ended 31 December 2008 and 2007

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

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

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

Accounting Policies

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

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

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

a) IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'. On 13 October 2008, the IASB issued amendments to IAS 39 and IFRS 7 regarding the reclassification of financial instruments. The changes to IAS 39 permit an entity to reclassify, in limited circumstances, certain non-derivative financial assets out of the 'fair value through profit and loss' and 'available-for-sale' categories into 'loans and receivable securities', 'available-for-sale' and 'held-to-maturity'. In addition, the amendments to IFRS 7 require expanded disclosures about these assets. The amendments became effective on 1 July 2008. The impact of the adoption of the amendments to IAS 39 and IFRS can be found in Note 18 on page 78.
b) 'Amendment to IFRS2: Share based payments - vesting conditions and cancellations'. The amendment requires share option awards lapsing due to a failure to meet the service condition to be treated as cancellations rather than forfeitures. The impact on the Group's results has been immaterial.

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

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

a) IAS 23 'Borrowing Costs' – On 29 March 2007, the IASB issued an amendment to IAS 23 'Borrowing costs' which removes the option to expense borrowing costs incurred during the acquisition, construction or production of a qualifying asset. The Group does not expect the adoption of the amendment to IAS 23 to have a material impact on the Group's profit or loss or financial position. The amendment to IAS 23 is effective for periods beginning on or after 1 January 2009.
b) IAS 1 'Presentation of Financial Statements' – On 6 September 2007, the IASB issued an amendment to IAS 1 'Presentation of Financial Statements' which changes the way in which non-owner changes in equity are required to be presented. It also changes the titles of primary financial statements as they will be referred to in IFRS but does not require that these be renamed in an entity's financial statements. The Group does not expect the adoption of the amendment to IAS 1 to have an impact on the financial statements. The amendment to IAS 1 is effective for periods beginning on or after 1 January 2009.
c) IFRS 3 'Business Combinations' – On 10 January 2008, the IASB issued an amendment to IFRS 3 'Business Combinations' which clarifies and changes certain elements of accounting for a business combination, including measurement of contingent consideration, step acquisition and intangible assets and also widens the scope of this standard. There are also associated amendments to IAS 27, IAS 28 and IAS 31. The amendment to IFRS 3 is effective for periods beginning on or after 1 July 2009.

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

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

a) Amounts previously shown as 'Net investment in finance leases and hire purchase contracts' are now included within 'Loans and advances to customers'.
b) Amounts previously shown as 'Prepayments and accrued income' are now included within 'Other assets'.
c) Amounts previously shown as 'Accruals and deferred income' are now included within 'Other liabilities'.
d) 'Financial liabilities designated at fair value' are now shown as a separate balance sheet heading. Previously, these amounts were included within 'Deposits by banks', 'Deposits by customers' and 'Debt securities in issue'.

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

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

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

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

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

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

Consolidation

a) Subsidiaries

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

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

b) Jointly controlled entities

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

Foreign currency translation

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

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

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

Revenue recognition

(a) Interest income and expense

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

Accounting Policies continued

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

Pensions and other post retirement benefits

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

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

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

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

Share-based payments

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

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

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

Goodwill and other intangible assets

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

Negative goodwill is recognised immediately in the income statement.

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

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

Property, plant and equipment

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

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

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

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

Financial assets

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

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

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

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

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

(b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments, that are not quoted in an active market, and which are not classified as available-for-sale or fair value through profit or loss. They arise when the Group provides money or services directly to a customer with no intention of trading the loan. Loans and receivables are initially recognised at fair value including direct and incremental transaction costs. They are subsequently valued at amortised cost, using the effective interest method. They are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all of the risks and rewards of ownership. Loans and receivables includes Loans and advances to banks, Loans and advances to customers and Loan and receivable securities.

(c) Available-for-sale

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

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

(d) Held-to-maturity

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

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

Offsetting financial assets and liabilities

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

Sale and repurchase agreements (including stock borrowing and lending)

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

Derivative financial instruments

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

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

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

Hedge accounting

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

At the time a financial instrument is designated as a hedge, the Group formally documents the relationship between the hedging instrument(s) and hedged item(s). Documentation includes risk management objectives and the strategy in undertaking the hedge transaction, together with the methods that will be used to assess the effectiveness of the hedging relationship. Accordingly, the Group formally assesses, both at the inception of the hedge and on an ongoing basis, whether the hedging derivatives have been and will be highly effective in offsetting changes in the fair value of the hedged items. A hedge is normally regarded as highly effective if, at inception and throughout its life, the Group can expect, and actual results indicate, that changes in the fair value of the hedged items are effectively offset by changes in the fair value of the hedging instrument, and actual results are within a range of 80% to 125%.

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

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

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

Securitisation transactions

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

Impairment of financial assets

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

(a) Retail assets carried at amortised cost

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

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

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

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

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

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

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

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

Accounting Policies continued

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

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

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

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

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

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

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

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

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

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

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

Impairment of non-financial assets

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

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

Leases

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

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

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

Income taxes, including deferred taxes

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

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

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

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

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

Cash and cash equivalents

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

Financial liabilities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(b) Valuation of financial instruments

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

Initial measurement

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

Subsequent measurement

Fair value hierarchy

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

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

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

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

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

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

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

Financial instruments valued using observable market prices

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

Financial instruments valued using a valuation technique

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

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

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

At 31 December 2008

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

At 31 December 2007

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

Valuation techniques

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

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

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

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

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

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

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

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

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

(c) Provisions for misselling

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

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

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

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

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

(d) Pensions

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

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

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

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

(e) Deferred tax

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

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

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

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

Notes to the Financial Statements

1. Segments

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

> Retail Banking
> Corporate Banking
> Treasury & Group Items

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

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

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

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

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

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

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

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

a) Segmental information

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

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

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

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

Notes to the Financial Statements continued

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

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

2. Net interest income

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

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

3. Net fee and commission income

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

4. Net trading and other income

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

5. Administration expenses

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

Other personnel costs include restructuring costs.

6. Depreciation and amortisation

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

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

7. Audit and other services

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

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

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

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

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

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

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

Notes to the Financial Statements continued

8. Impairment losses

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

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

9. Taxation expense

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

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

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

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

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

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

11. Cash and balances at central banks

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

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

12. Trading assets

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

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

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

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

Debt securities can be analysed by listing status as follows:

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

13. Derivative financial instruments

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

Derivatives held for trading purposes

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

> Marketing derivatives to end users and hedging the resulting exposures efficiently; and

> The management of trading exposure reflected on the Group's balance sheet.

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

Derivatives held for risk management purposes

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

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

Derivative products which are combinations of more basic derivatives (such as swaps with embedded option features), or which have leverage features, may be used in circumstances where the underlying position being hedged contains the same risk features. In such cases, the derivative used will be structured to match the risks of the underlying asset or liability. Exposure to market risk on such contracts is therefore hedged. The fair values of derivative instruments held both for trading and hedging purposes are set out in the following tables. The tables below show the contract or underlying principal amounts, positive and negative fair values of derivatives analysed by contract. Contract or notional amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts of risk. The fair values represent the amount at which a contract could be exchanged in an arm's length transaction, calculated at market rates at the balance sheet date.

Notes to the Financial Statements continued

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

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

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

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

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

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

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

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

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

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

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

Notes to the Financial Statements continued

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

14. Financial assets designated at fair value

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

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

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

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

Debt securities can be analysed by listing status as follows:

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

15. Loans and advances to banks

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

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

16. Loans and advances to customers

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

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

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

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

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

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

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

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

Movement in loan loss allowances:

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

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

Notes to the Financial Statements continued

17. Securitisation of assets

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

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

Master Trust Structures

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

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

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

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

Bracken Securities plc

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

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

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

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

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

Income statement for the year ended 31 December

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

Balance sheet as at 31 December

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

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

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

Available-for-sale securities:

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

Maturities of debt securities:

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

Notes to the Financial Statements continued

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

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

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

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

Loan & receivable securities

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

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

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

19. Investment in subsidiary undertakings

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

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

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

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

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

* Held indirectly through subsidiary companies.

All the above companies are included in the Consolidated Financial Statements. The Company holds directly or indirectly 100% of the issued ordinary share capital of its principal subsidiaries. All companies operate principally in their country of incorporation or registration. The ability of Alliance & Leicester International Limited to pay dividends to the Company is restricted by regulatory capital requirements.

20. Investment in joint ventures

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

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

21. Intangible assets

a) Goodwill

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

Impairment of goodwill

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

Notes to the Financial Statements continued

b) Other intangibles

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

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

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

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

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

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

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

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

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

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

Notes to the Financial Statements continued

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

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

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

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

23. Operating lease assets

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

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

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

The Company has no operating lease assets.

24. Deferred tax

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

The movement on the deferred tax account is as follows:

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

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

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

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

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

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

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

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

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

25. Other assets

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

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

Notes to the Financial Statements continued

26. Deposits by banks

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

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

27. Deposits by customers

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

28. Financial liabilities designated at fair value

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

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

29. Debt securities in issue

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

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

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

30. Subordinated liabilities

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

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

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

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

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

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

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

Notes to the Financial Statements continued

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

Subordinated liabilities in issue are repayable:

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

31. Other liabilities

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

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

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

Future minimum lease payments are:

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

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

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

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

32. Provisions

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

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

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

The misselling provision comprises various claims with respect to product misselling. In calculating the misselling provision, management's best estimate of the provision was calculated based on conclusions regarding the number of claims that will be received, of those, the number that will be upheld, and the estimated average settlement per case. Further information on misselling provisions can be found in 'Critical Accounting Policies' within the Accounting Policies on page 63.

The provision in 2007 was nil for Group and Company.

33. Retirement benefit obligations

The amounts recognised in the balance sheet were as follows:

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

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

Defined Contribution Pension schemes

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

Defined Benefit Pension schemes

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

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

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

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

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

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

Notes to the Financial Statements continued

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

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Balance at 1 January	**(1,336)**	(1,337)	**(1,336)**	(1,337)
Current service cost	**(19)**	(20)	**(19)**	(20)
Interest cost	**(75)**	(70)	**(75)**	(70)
Employee contributions	**(2)**	(2)	**(2)**	(2)
Past service cost	**–**	–	**–**	–
Actuarial gain	**170**	57	**170**	57
Actual benefit payments	**41**	37	**41**	37
Balance at 31 December	**(1,220)**	(1,335)	**(1,220)**	(1,335)

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

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

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

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

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

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

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

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

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

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

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

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

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

- To maintain a portfolio of suitable assets of appropriate quality, suitability and liquidity which will generate income and capital growth to meet, together with new contributions from members and the employers, the cost of current and future benefits which the pension fund provides, as set out in the trust deed and rules;
- To limit the risk of the assets failing to meet the liabilities, over the long-term and on a shorter-term basis as required by prevailing legislation;
- To minimise the long term costs of the pension fund by maximising the return on the assets while having regard to the objectives shown above.

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

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

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

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

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

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

34. Contingent liabilities and commitments

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

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

Notes to the Financial Statements continued

Unauthorised overdraft fees

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

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

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

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

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

Financial Services Compensation Scheme

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

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

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

Regulatory

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

Obligations under stock borrowing and lending agreements

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

Other off-balance sheet commitments

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

Operating lease commitments

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

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

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

Group rental expense comprises:

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

35. Innovative tier 1

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

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

Notes to the Financial Statements continued

36. Share capital and preference shares

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

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

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

Preference shares

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

37. Retained earnings and other reserves

Movements in retained earnings were as follows:

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

Movements in minority interest were as follows:

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

Analysis of dividends paid is as follows:

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

Movements in capital redemption reserve were as follows:

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

Movements in share based payment reserve were as follows:

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

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

	Group & Company	
	2008 £m	2007 £m
At 1 January	**(143)**	4
Net losses from changes in fair value	**(241)**	(220)
Net losses/(gains) transferred to profit on disposal	**14**	(1)
Impairment loss transferred to Income Statement	**18**	11
Deferred tax	**69**	63
At 31 December	**(293)**	(143)

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

Movements in cash flow hedging reserve were as follows:

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

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

Notes to the Financial Statements continued

38. Cash flow statement

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

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

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

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

39. Collateral pledged and received

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

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

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

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

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

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

40. Share-based compensation

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

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

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

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

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

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

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

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

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

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

Notes to the Financial Statements continued

41. Directors' emoluments and interests

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

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

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

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

42. Related party disclosures

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

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

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

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

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

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

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

Remuneration of Key Management Personnel

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

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

Company Share Option Plan

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

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

Deferred Bonus Scheme

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

Long Term Incentive Plan

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

Parent undertaking and controlling party

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

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

Transactions with related parties

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

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

Notes to the Financial Statements continued

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

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

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

43. Events after the reporting date

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

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

44. Financial instruments

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

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

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

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

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

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

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

Fair value measurement

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

Fair value management

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

Assets:

Cash and balances at central banks/Loans and advances to banks

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

Loans and advances to customers

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

a) Variable rate

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

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

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

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

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

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

Net gains and losses on financial instruments

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

45. Capital Management and Resources

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

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

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

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

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

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

Group Capital

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

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

Risk factors

An investment in Alliance & Leicester plc (the 'Company') and its subsidiaries (together, 'Alliance & Leicester) involves a number of risks, the material ones of which are set forth below.

Alliance & Leicester's risk management measures may not be successful

The management of risk is an integral part of all Alliance & Leicester's activities. Risk constitutes Alliance & Leicester's exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse impacts on profitability arising from different sources of uncertainty including Credit Risk (Retail), Credit Risk (Wholesale), Market Risk, Operational Risk, Securitisation Risk, Concentration Risk, Liquidity Risk, Reputational Risk, Strategic Risk, Pension Obligation Risk and Regulatory Risk. Alliance & Leicester seeks to monitor and manage its risk exposure through a variety of separate but complementary financial, credit, market, operational, compliance and legal reporting systems. While Alliance & Leicester employs a broad and diversified set of risk monitoring and risk mitigation techniques, those techniques, and the judgements that accompany their application, cannot anticipate every unfavourable event or the specifics and timing of every outcome. Accordingly, Alliance & Leicester's ability to successfully identify and balance risks and rewards, and to manage all significant risks, is an important factor that can significantly affect results of operations.

Risks concerning borrower credit quality and general economic conditions are inherent in Alliance & Leicester's business

Risks arising from changes in credit quality and the recoverability of loans and amounts due from borrowers and counterparties are inherent in a wide range of Alliance & Leicester's businesses. Adverse changes in the credit quality of Alliance & Leicester's borrowers and counterparties or a general deterioration in UK or global economic conditions, or arising from systemic risks in the financial system, could reduce the recoverability and value of Alliance & Leicester's assets and require an increase in Alliance & Leicester's level of provisions for bad and doubtful debts. Likewise, a significant reduction in the demand for Alliance & Leicester's products and services could negatively impact Alliance & Leicester's business and financial condition. Since August 2007, the global financial system has experienced difficult credit and liquidity conditions and disruptions leading to less liquidity, greater volatility, an increase in general fraud and money laundering activity (first and third party), and general widening of spreads.

In September 2008, global financial markets deteriorated sharply following the bankruptcy filing by Lehman Brothers Holdings Inc. Since then a number of other major financial institutions, including some of the largest global commercial banks, investment banks, mortgage lenders, mortgage guarantors and insurance companies, have experienced significant difficulties.

This market turmoil and reduction of available credit have decreasing consumer confidence, increased market volatility, reduced business activity and, consequently, increasing commercial and consumer loan delinquencies. These market developments may further affect consumer confidence levels and may cause adverse changes in payment patterns, causing further increases in delinquencies. and default rates, which may impact on Alliance & Leicester's charge-offs and provision for credit losses. These market conditions could materially and adversely affect Alliance & Leicester's financial condition and results of operation.

The soundness of other financial institutions could materially and adversely affect Alliance & Leicester's business

Alliance & Leicester's ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. Alliance & Leicester has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, investment banks, mutual funds, and other institutional clients. As a result, defaults by, or even rumours or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by Alliance & Leicester or by other institutions. Many of these transactions expose Alliance & Leicester to credit risk in the event of default of Alliance & Leicester's counterparty or client. In addition, Alliance & Leicester's credit risk may be exacerbated when the collateral held by us cannot be realised upon or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due to Alliance & Leicester. There is no assurance that any such losses would not materially and adversely affect Alliance & Leicester's results of operations.

Risks associated with liquidity and funding are inherent in Alliance & Leicester's business

Alliance & Leicester receives a large proportion of its funding and liquidity from its parent company Abbey National plc. However, liquidity risks are inherent in any retail and commercial bank. While Abbey National plc and Alliance & Leicester have implemented liquidity management processes to mitigate and control these risks, unforeseen systemic market factors in particular make it difficult to eliminate these risks completely. Adverse and continued constraints in the supply of liquidity, including inter-bank lending, may materially and adversely affect the cost of funding the business and extreme liquidity constraints may impact Alliance & Leicester's current operations as well as limit growth possibilities. These events may also have a material adverse effect on the market value and liquidity of bonds issued by Alliance & Leicester in the secondary markets. From 2007 to date, the prime residential mortgage securitisation and covered bond markets experienced severe disruption as a result of a material reduction in investor demand for these securities. These severe disruptions have resulted in extraordinary Government intervention into the financial services sector as a whole. These markets, which are important sources of funding for Abbey National plc and Alliance & Leicester, were effectively closed to new external issuances of securities. Global investor confidence also remains low and credit remains relatively scarce.

Continued or worsening disruption and volatility in the global financial markets could have a material adverse effect on Abbey National plc and Alliance & Leicester's ability to access capital and liquidity on financial terms acceptable to them, if at all. If capital markets financing ceases to become available, or becomes excessively expensive, Alliance & Leicester may be forced to raise the rates it pays on deposits to attract more customers. While central banks around the world have taken co-ordinated efforts to increase liquidity in the financial markets by taking measures such as increasing the amounts they lend directly to financial institutions, lowering interest rates and significantly increasing temporary reciprocal currency arrangements (or 'swap lines'), it is not known how long these market conditions will continue or whether they will worsen. The persistence of these adverse market conditions could have a material adverse effect on Abbey National plc and Alliance & Leicester's liquidity and funding.

Any reduction in Alliance & Leicester's credit rating could increase its cost of funding and adversely affect its interest margins

Credit ratings affect the cost and other terms upon which Alliance & Leicester is able to obtain funding. Rating agencies regularly evaluate Alliance & Leicester and their ratings of Alliance & Leicester's long-term debt are based on a number of factors, including Alliance & Leicester's financial strength as well as conditions affecting the financial services industry generally. In light of the difficulties in the financial services industry and the financial markets, there can be no assurance that the rating agencies will maintain Alliance & Leicester's current ratings or outlooks. Any reduction in those ratings and outlooks could increase the cost of Alliance & Leicester's funding, adversely affect Alliance & Leicester's interest margins and/or impact its liquidity position.

Market risks associated with fluctuations in interest rates, bond prices and other market factors are inherent in Alliance & Leicester's business

The most significant market risks Alliance & Leicester faces are interest rates and bond and equity price risks. Changes in the general level of interest rates, as well as changes in the shape of yield curves and basis spreads may adversely affect the interest rate margin realised between lending rates and borrowing costs in Alliance & Leicester's banking operation. Dramatic declines in housing markets over the past two years have negatively impacted the credit performance of real estate-related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions.

As a result of these market forces, volatility in interest rates and basis spreads has increased, which has increased Alliance & Leicester's borrowing costs. Any such increase in capital markets funding costs or deposit rates could entail a re-pricing of loans, which would result in a reduction of volumes, and may also have an adverse effect on Alliance & Leicester's interest margins. Alliance & Leicester also sponsors a number of defined benefit staff pension schemes, and its obligations to those schemes may increase depending on the performance of financial markets. Although Alliance & Leicester is undertaking measures to mitigate and control the effects of these conditions, there can be no assurances that such controls will insulate Alliance & Leicester from deteriorating market conditions.

Risks associated with strategic decisions regarding organic growth, and potential acquisitions and disposals

Alliance & Leicester devotes substantial management and planning resources developing strategic plans for organic growth and identifying possible acquisitions and disposals and the restructuring of Alliance & Leicester's businesses. If the outcomes of these plans do not match expectations, Alliance & Leicester's earnings may not develop as forecast.

Abbey National plc and Alliance & Leicester may fail to realise the anticipated benefits of integrating the businesses

The success of the recent acquisition of Alliance & Leicester by Abbey National plc and subsequent integration will depend, in part, on Abbey National plc's ability to realise the anticipated benefits from combining Abbey National plc's business with the business of Alliance & Leicester. It is possible that the integration process could take longer or be more costly than anticipated or could result in the loss of key employees, the disruption of each company's ongoing businesses or inconsistencies in standards, controls, procedures and policies that adversely affect the ability of each company to maintain relationships with clients, customers or employees. In addition, Alliance & Leicester is currently run by management and employees who have not previously been exposed to Abbey National plc's business culture or philosophy. The efforts to integrate these companies are also likely to divert management attention and resources. If the integration of Alliance & Leicester with Abbey National plc takes longer than anticipated or Abbey National plc is not able to integrate the aforementioned businesses, the anticipated benefits of integrating the businesses may not be realised fully or at all, or may take longer to realise than expected.

Risk factors continued

Alliance & Leicester's business is concentrated in the UK and on the offering of mortgage-related products and services

Alliance & Leicester's business is principally concentrated in the UK and on the offering of mortgage-related products and services. As a consequence, Alliance & Leicester's financial condition and results of operations are highly dependent on economic conditions in the UK generally, and the UK property market in particular. Beginning in the second half of 2008, UK and global economic conditions deteriorated significantly and global financial markets experienced acute turbulence. Recently, the UK recorded negative GDP growth and it is currently expected that the UK will also record negative GDP growth in 2009. During this period, the UK property market began a significant correction as a consequence of housing demand being constrained by a combination of subdued earnings growth, greater pressure on housing finances, higher interest rates, a decline in the availability of mortgage finance and the continued effect of global market volatility. UK and global economic conditions and uncertainties may have an adverse effect on the quality of Alliance & Leicester's loan portfolio and may result in a rise in delinquency and default rates and charge-offs. There can be no assurance that Alliance & Leicester will not have to increase its provisions for loan losses in the future as a result of future increases in non-performing loans or for other reasons beyond its control. Any increases in Alliance & Leicester's provisions for loan losses could materially and adversely affect Alliance & Leicester's financial condition and results of operations.

Alliance & Leicester's business is conducted in a highly competitive environment

The market for UK financial services is highly competitive, and management expects such competition to intensify in response to competitor behaviour, consumer demand, technological changes, the impact of consolidation, regulatory actions and other factors. If financial markets remain unstable, financial institution consolidation may accelerate. Moreover, the UK government has effectively nationalised some of the country's largest banks, has announced a preferred equity programme open to all financial institutions and has announced a programme to guarantee short-term and certain medium-term debt of financial institutions, among other measures. These measures could lead to increased government ownership and control over financial institutions in the UK and further consolidation in the financial industry, all of which could adversely affect Alliance & Leicester's business, financial condition and results of operations. Alliance & Leicester's financial condition and results of operations may be materially and adversely affected by competition, including declining lending margins or competition for savings driving up funding costs that cannot be recovered from borrowers. If Alliance & Leicester is not successful in retaining and strengthening customer relationships, it may lose market share, incur losses on some or all of its activities or fail to attract new and retain existing deposits, which could materially and adversely affect its financial position and results of operations.

Operational risks are inherent in Alliance & Leicester's business

Operational losses can result from fraud, criminal acts, errors by employees, failure to document transactions properly or to obtain proper authorisation, failure to comply with regulatory requirements and conduct of business rules, failure or breakdown of accounting, data processing and other record keeping systems, natural disasters, or failure or breakdown of external systems, including those of the Alliance & Leicester's suppliers or counterparties.

Reputational risk could cause harm to Alliance & Leicester and its business prospects

Alliance & Leicester's ability to attract and retain customers and conduct business transactions with its counterparties could be adversely affected to the extent that its reputation, or the reputation of affiliates operating under the Alliance & Leicester brand, is damaged. Failure to address, or appearing to fail to address, various issues that could give rise to reputational risk could cause harm to Alliance & Leicester and its business prospects. Reputational issues include, but are not limited to: appropriately addressing potential conflicts of interest; legal and regulatory requirements; ethical issues; adequacy of anti-money laundering processes; privacy issues; record-keeping; sales and trading practices; proper identification of the legal, reputational, credit, liquidity and market risks inherent in products offered; and general company performance. The failure to address these issues appropriately could make customers unwilling to do business with Alliance & Leicester, which could adversely affect its results of operations.

Alliance & Leicester's businesses are subject to substantial legislation, regulatory and governmental oversight

Alliance & Leicester is subject to financial services laws, regulations, administrative actions and policies in each location in which Alliance & Leicester operates and, indirectly, in Spain, as a result of being part of Banco Santander, S.A. Changes in supervision and regulation, in particular in the UK, which are beyond Alliance & Leicester's control, could materially affect Alliance & Leicester's business, the products and services offered and the value of assets as well as Alliance & Leicester's operations. Although Alliance & Leicester works closely with its regulators and continually monitors the situation, future changes in regulation, fiscal or other policies can be unpredictable and are beyond the control of Alliance & Leicester. No assurance can be given generally that laws or regulations will be adopted, enforced or interpreted in a manner that will not have an adverse effect on Alliance & Leicester's business. The resolution of a number of issues, including regulatory investigations and reviews and court cases, affecting the UK financial services industry, including Alliance & Leicester, could have a negative impact on Alliance & Leicester's results on operations or on its relations with some of its customers and potential customers.

The UK Banking Act 2009 may adversely affect the Group's business

The Banking Act 2009 (the 'Act') came into force on 21 February 2009. The Act creates a special resolution regime ('SRR') which provides the UK HM Treasury, the Bank of England and the UK Financial Services Authority (the 'Authorities') with a variety of tools for dealing with UK institutions which are authorised deposit takers (such as the Company). These tools also allow the Authorities to deal with such institutions, which are failing, and in certain circumstances, their holding companies. The Act is intended to replace the emergency powers contained in the Banking (Special Provisions) Act 2008 (which powers ceased to be exercisable on 21 February 2009, when the Act came into force).

The Act enables the Authorities, in specified circumstances, to: (i) take a bank or a bank holding company into temporary public ownership ('TPO'); (ii) transfer all or part of the business of a bank to a private sector purchaser ('PSP'); or (iii) transfer all or part of the business of a bank to a bridge bank owned by the Bank of England ('Bridge Bank'). The SRR also comprises a new insolvency procedure and a new administration procedure, each of specific application to banks.

TPO and PSP transfers may be effected via a compulsory transfer of securities in the affected entity (which includes bonds). PSP and Bridge Bank transfers may be effected via a compulsory transfer of the affected entity's assets and liabilities.

SRR transfers are subject to the satisfaction of two general conditions. In summary, the UK Financial Services Authority must determine that (i) the bank is failing or likely to fail to meet its regulatory threshold conditions (within the meaning of section 41(1) of the UK Financial Services and Markets Act 2000); and (ii) having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers under the Act), action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions (ignoring for this purpose, UK HM Treasury or Bank of England financial assistance). There are additional trigger conditions which must be satisfied, the nature of which depends on the nature of the transfer and certain statutory objectives to which the Authorities must have regard in operating the SRR.

SRR transfers under the Act may impact the rights of transferors and third parties in relation to the affected institution. Legal or contractual rights which would operate to inhibit the transfer or which would otherwise be triggered by the transfer are disregarded and SRR transfers can take effect free from trusts, liabilities or other encumbrances. A PSP or Bridge Bank transfer may involve a partial transfer of the affected institution's property which could lead to the rights and obligations of counterparties of the affected institution being split between the transferor and transferee entity (although the Act and the Banking Act 2009 (Restrictions of Partial Property Transfers) Order 2009 do restrict partial property transfers to some extent).

The Act confers wide-ranging ancillary powers on the Authorities to enable SRR transfers and to ensure the continuity of the transferred business. In particular, the UK HM Treasury is given the power to change the law, either generally or specifically and with immediate or with retrospective effect, if the UK HM Treasury feels it is necessary or desirable in order to make an SRR power more effective. The Act includes provisions to effect the payment of compensation to transferors under an SRR transfer and third parties.

If an SRR transfer of the securities or property of Alliance & Leicester were made, the transfer order may (amongst other things) (i) result in a compulsory transfer of securities or property of Alliance & Leicester and/or (ii) impact on the rights of holders of securities and/or result in the nullification or modification of the terms and conditions of such securities and/or (iii) result in the de-listing of the securities.

At present, no SRR transfer orders have been made under the Act in respect of Alliance & Leicester and there has been no indication that any such order will be made, but there can be no assurance that this will not change and/or that holders of securities will not be adversely affected by any such order if made in the future.

Share Information

Sterling-denominated preference shares

At 31 December 2008, Alliance & Leicester plc had outstanding 300,000 sterling denominated preference shares, nominal value of £1.00 each. The sterling denominated preference shares were issued on 24 May 2006. Currently, the only trading market for these sterling denominated preference shares is the London Stock Exchange.

Major shareholders

As at 31 December 2008, Alliance & Leicester plc was a wholly owned subsidiary of Banco Santander, S.A. The acquisition was effected by means of a scheme of arrangement under Section 425 Companies Act 1985 on 13 October 2008. The ordinary shares in Alliance & Leicester plc were cancelled and holders of Alliance & Leicester plc shares who were on the register at 4.30pm on 10 October 2008 received one Banco Santander, S.A. share for every three Alliance & Leicester plc shares.

On 9 January 2009 Banco Santander, S.A. transferred all of its shares in Alliance & Leicester to Abbey National plc in exchange for ordinary shares in Abbey National plc. Accordingly, Abbey National plc is now the immediate parent company of Alliance & Leicester.

Exchange controls

There are no UK laws, decrees or regulations that restrict Alliance & Leicester's export or import of capital, including the availability of cash and cash equivalents for use by Alliance & Leicester, or that affect the remittance of dividends or other shareholder payments to non-UK holders of the Company's shares, save for the potential tax implications on the receipt of dividends, capital gains and inheritance tax in respect of which investors should take independent financial advice.

Contact information

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Cross Guarantee

GUARANTEE

THIS INSTRUMENT by way of deed poll is executed on 19 March 2009 by **ALLIANCE & LEICESTER PLC** (registered in England No. 03263713) whose registered office is at Carlton Park, Narborough, Leicester LE19 0AL (the "Guarantor").

WHEREAS ABBEY NATIONAL PLC, a company incorporated in England (number 2294747) whose registered office is at Abbey National House, 2 Triton Square, Regent's Place London NW1 3AN (the "**Company**"), has requested the Guarantor and the Guarantor has agreed to guarantee payment of all Obligations (as hereinafter defined) in accordance with, and as limited by, the terms and conditions of this Deed (this "**Guarantee**").

NOW IN WITNESS THEREOF the Guarantor hereby covenants and agrees as follows:

1. In this Guarantee, unless the context otherwise requires:

"Creditor" means any person (other than the Company or any subsidiary of the Company (as defined in section 736 of the Companies Act 1985) or any individual who is a connected person of the Company within the meaning of section 252 of the Companies Act 2006) to whom an Obligation is from time to time owed.

"Obligation" means any obligation or liability, either primary or contingent, lawfully incurred by the Company to any person on or before 31 July 2012 (whether before or after the execution of this Guarantee) under or in respect of any dealing, transaction or engagement whatsoever, including without prejudice to the generality of the foregoing, for:

(i) any moneys lent, advanced or otherwise made available to the Company (including, without limitation to the generality of the foregoing, the liability of the Company for drawing or issuing bills of exchange, promissory notes, bonds, debentures, certificates of deposit, commercial paper or other negotiable instruments or securities);

(ii) any moneys lent, advanced or otherwise made available to any person, the repayment or payments in respect of which has or have been guaranteed by the Company or in respect of which the Company has given an indemnity (including, without limitation to the generality of the foregoing, guarantees and letters of credit issued by the Company and bills of exchange or other negotiable instruments accepted or endorsed by the Company);

(iii) any moneys which any person shall pay or become liable to pay, for or on account of the Company, by reason of entering into or being party to any bond, indemnity, bill of exchange, guarantee, letter of credit or other engagement for the benefit or at the request of the Company;

(iv) deposits made with the Company (including, without limitation of the generality of the foregoing, certificates of deposit issued by the Company);

(v) any rate swap transaction, swap option, basis swap, forward rate transaction, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, interest rate option, foreign exchange transaction, cap transaction, collar transaction, floor transaction, currency swap transaction, cross-currency rate swap transaction, currency option, credit protection transaction, credit swap, credit default swap, credit default option, total return swap, credit spread transaction, repurchase transaction, reverse repurchase transaction, buy/sell back transaction, securities lending transaction or forward purchase or sale of a security, commodity or other financial instrument or interest (including any option with respect to any such transactions) or any other derivative transaction on one or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, indices, or measures of economic risk or value, in each case, to which the Company is party (including, for the avoidance of doubt, any obligation or liability under any master agreement that governs any such transactions);

(vi) any such obligation or liability assumed under or incurred pursuant to any novation, transfer, assignment or other similar agreement between the Company and any other person; and

(vii) any payments of interest due from the Company with respect to any of the foregoing transactions (whether or not the liability to pay such interest arises on or before 31 July 2012) together with all reasonable costs, commissions and other expenses incurred by any person in connection with the enforcement of this Guarantee, but excluding:

(a) any such obligations or liabilities of the Company (including under any guarantee given by the Company) which by their terms are expressed (in whatever manner) to be conditional upon the solvency of the Company or subordinated to, or payable only after full satisfaction of, all or any obligations of the Company to all or any of its unsubordinated creditors; and

(b) any such obligations or liabilities of the Company transferred to, or assumed by, any other person whether pursuant to any novation or transfer or other similar agreement, any statutory transfer (pursuant to Part VII of The Financial Services and Markets Act 2000 or otherwise), any scheme of arrangement or otherwise.

"person" means any person, firm, trust estate, corporation, association, cooperative, government or government agency or other entity.

2. (a) The Guarantor hereby unconditionally and irrevocably guarantees, for the benefit of each Creditor, in accordance with the terms and conditions of this Guarantee, the full payment by the Company when due

(whether at stated maturity, upon acceleration or otherwise) of each and every Obligation and in the event that the Company shall default in the due and punctual payment of any Obligation, undertakes to pay, or procure the payment of, such Obligations in the currency in which the particular Obligation is denominated in the case of a payment upon written demand being made under this Guarantee by the relevant Creditor,

(b) The Guarantor waives any right it may have of first requiring any Creditor to make demand, proceed or enforce any rights or security against the Company or any other person before making a claim against the Guarantor under this Guarantee.

3. A Creditor shall only be entitled to take or obtain the benefit of this Guarantee upon the condition that, after receipt by the Guarantor of a written demand from the Creditor, the Guarantor shall be entitled to deal with the Creditor, and the Creditor shall be obliged to deal with the Guarantor with respect to the Obligation due to the Creditor and this Guarantee without the necessity or duty to rely on, act through or otherwise involve or deal with the Company to the intent that the Guarantor and the Creditor shall deal with one another as principals in relation to the same provided that the rights, powers, privileges and remedies of the Creditor under this Guarantee shall not thereby be in any way limited or otherwise affected.

4. No delay or omission on the part of the Creditor in exercising any right, power, privilege or remedy (hereinafter together called "**Rights**") in respect of this Guarantee shall impair any such Rights or be construed as a waiver of any thereof nor shall any single or partial exercise of any such Rights preclude any further exercise of any other Rights. The Rights herein provided are cumulative and not exclusive of any rights, powers, privileges or remedies provided by law. Nothing in this Guarantee shall be construed as voiding, negating or restricting any right of set-off or any other right whatsoever existing in favour of a Creditor or arising at common law, by statute or otherwise howsoever.

5. This Guarantee is a continuing guarantee and shall not be satisfied, discharged or affected by any intermediate payment or settlement of account.

6. The Guarantor will not exercise any rights of subrogation or any other rights or remedy (including, without limiting the generality of the foregoing, the benefit of any security or right of set-off) which it may acquire due to its payment of any Obligation pursuant to the terms of this Guarantee and will not prove in the liquidation of the Company in competition with any Creditor unless and until all Obligations in respect of the relevant Creditor hereby guaranteed have been satisfied in full by the Guarantor or the Company. In the event that the Guarantor shall receive any payment on account of such rights while any Obligation remains outstanding, the Guarantor shall pay all amounts so received to the relevant Creditor.

7. Payments hereunder shall be made free and clear of any deduction or withholdings other than those required by law and in that event the Guarantor shall pay such additional amount to the relevant Creditor as may be necessary in order that the actual amount received after all such deductions and withholdings shall equal the amount that would have been received if no such deduction or withholding were required provided that the Guarantor shall not be obliged to pay any such additional amount which would not have been payable if the payment which is the subject of the withholding or deduction had been made by the Company. A Creditor shall be entitled to receive payment of any additional amount which would otherwise be due under this paragraph only upon the condition that, if the Guarantor makes a payment of an additional amount in compliance with its obligations under this paragraph and the relevant Creditor determines that it has received or been granted a credit against or relief or payment of any tax paid or payable by it in respect thereof the relevant Creditor shall to the extent that it can do so without prejudice to the retention of the amount of such credit, relief or repayment pay to the Guarantor such amount as shall be attributable to such deduction or withholding provided that nothing contained in this paragraph shall interfere with the right of any Creditor to arrange its tax affairs in whatsoever manner it thinks fit and, in particular, no Creditor shall be under any obligation to claim relief in respect of any such deduction or withholding in priority to any other claims for relief available to it.

8. Any demand shall be given in writing addressed to the Guarantor at the registered or principal office of the Guarantor and served by hand or sent by post, marked for the attention of the Company Secretary. A demand so made shall be deemed to have been duly made if left at such address on the day it was so left or, if sent by post, two weekdays after the time when the same was put in the post and in proving delivery it shall be sufficient to prove that the same was properly addressed and put in the post.

9. The liability of the Guarantor under this Guarantee shall not be affected by the liquidation, winding-up or other incapacity of the Company. In the event that any payment to a Creditor from the Company in respect of an Obligation is avoided or reduced by virtue of any enactments for the time being in force relating to liquidation or insolvency the Creditor shall be entitled to recover the value or amount thereof from the Guarantor as if such payment by the Company had not been made.

Cross Guarantee

10. This Guarantee shall remain in full force and effect irrespective of the validity, regularity, legality or enforceability against the Company of, or of any defence or counter-claim whatsoever, available in relation to, any Obligations whether or not any action has been taken to enforce the same or any judgement obtained against the Company or any other person, whether or not any time or indulgence has been granted to the Company or any other person by or on behalf of any Creditor, whether or not there have been any dealings or transactions between the Company or any other person and any of the Creditors, whether or not the Company or any other person has been dissolved, liquidated, merged, consolidated, become bankrupt or has changed its status, functions, control or ownership, whether or not the Company or any other person has been prevented from making payment by foreign exchange provisions applicable at its place of registration or incorporation and whether or not any circumstances have occurred which might otherwise constitute a legal or equitable discharge of or defence to a guarantor.
11. In the event that any of the terms or provisions of this Guarantee are or shall become invalid, illegal or unenforceable, the remaining terms and provisions hereof shall survive unaffected.
12. The Guarantor shall be permitted from time to time and at any time to amend or vary the terms of this Guarantee PROVIDED THAT the liability of the Guarantor to a Creditor in respect of any Obligation incurred before, or arising out of an Obligation entered into before, the date of such variation or amendment, shall not be in any way reduced or limited by such variation or amendment. Any person shall be entitled to rely on a certificate given by a director or other duly authorised officer of the Guarantor as to the existence and extent of this Guarantee and any such variation and/or amendment of this Guarantee on entering into any dealing, transaction or arrangement with the Company under or in respect of which an Obligation would or might be incurred by the Company to that person.
13. This Guarantee shall be governed by and construed in accordance with English law.

IN WITNESS WHEREOF this Guarantee has been executed as of the day and year first written above.

THE COMMON SEAL of
ALLIANCE & LEICESTER PLC
was hereunto affixed
in the presence of:

Shaun Patrick Coles

Deputy Company Secretary

Directors' Responsibility Statement

We confirm to the best of our knowledge:

1. The financial statements, prepared in accordance with International Financial Reporting Standards, as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and
2. The management report, which is incorporated into the Directors' Report, includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties they face.

By order of the Board

António Horta-Osório
Chief Executive
19 March 2009

Nathan Bostock
Chief Financial Officer
19 March 2009

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We confirm to the best of our knowledge:

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By order of the Board

Antós Horta-Osório

António Horta-Osório
Chief Executive
19 March 2009

Nathan Bostock
Chief Financial Officer
19 March 2009