

**THIS DOCUMENT AND THE ACCOMPANYING DOCUMENTS ARE IMPORTANT AND REQUIRE YOUR IMMEDIATE ATTENTION. If you are in any doubt as to the action you should take, you are recommended to seek your own personal financial advice immediately from your stockbroker, bank, solicitor, accountant, fund manager or other appropriate independent financial adviser, who is authorised under the Financial Services and Markets Act 2000 if you are in the United Kingdom, or, if not, from another appropriately authorised independent financial adviser.**

If you sell or have sold or otherwise transferred all of your Lloyds TSB Shares you should send this document and the accompanying documents as soon as possible to the purchaser or transferee or to the stockbroker, bank or other agent through whom the sale or transfer is/was effected for delivery to the purchaser or the transferee. However, the distribution of this document and any accompanying documents into certain jurisdictions (including but not limited to the United States) other than the United Kingdom is or may be restricted by law and therefore persons into whose possession this document and any accompanying documents come should inform themselves about and observe any such restrictions. Failure to comply with any such restrictions may constitute a violation of the securities laws of any such jurisdiction. See paragraph 11 of Part III ("Principal Terms of the Acquisition") of this document. If you sell or have sold or otherwise transferred only part of your holding of Lloyds TSB Shares, you should retain this document and the accompanying documents.

**This document does not constitute or form part of any offer or invitation to purchase, otherwise acquire, subscribe for, sell, otherwise dispose of or issue, or any solicitation of any offer to sell, otherwise dispose of, issue, purchase, otherwise acquire or subscribe for, any security.**

**This document does not constitute a prospectus or prospectus equivalent document. Nothing in this document should be interpreted as a term or condition of the Placing and Open Offer. Any decision to acquire Lloyds TSB Shares under the Placing and Open Offer must be made only on the basis of the information contained in and incorporated by reference into the Prospectus expected to be published in mid-November 2008. Copies of the Prospectus will be available following publication from Lloyds TSB's registered office and as described in paragraph 16 of Part XII ("Additional Information") of this document.**

Application will be made to the FSA for the Consideration Shares proposed to be issued in connection with the Acquisition and the Open Offer Shares to be issued in connection with the Placing and Open Offer to be admitted to the Official List, and will be made to the London Stock Exchange for the Consideration Shares and the Open Offer Shares to be admitted to trading on the London Stock Exchange's main market for listed securities. It is expected that, subject to the satisfaction of certain conditions, Admission of the Open Offer Shares to the Official List and the London Stock Exchange will become effective, and that dealings in the Open Offer Shares will commence, in mid-January 2009. It is expected that Admission of the Consideration Shares to the Official List and the London Stock Exchange will become effective, and that dealings in the Consideration Shares will commence, on the Effective Date which, subject to the satisfaction of certain conditions, including the sanction of the Scheme by the Court, is also expected to occur in mid-January 2009.



**Lloyds TSB**

**Lloyds TSB Group plc**

*(incorporated under the Companies Act 1985 and registered in Scotland with Registered No. 95000)*

**Proposed Acquisition of HBOS plc by means of a scheme of arrangement  
under sections 895 to 899 of the Companies Act 2006  
Proposed Placing and Open Offer of 2,596,653,203 Open Offer Shares at 173.3 pence  
per Open Offer Share  
Proposed Capitalisation Issue  
Circular to Shareholders and  
Notice of General Meeting of the Company**

**Your attention is drawn to the letter from the Chairman of the Company which is set out on pages 8 to 28 of this document and which recommends you to vote in favour of the Resolutions to be proposed at the General Meeting referred to below. The Acquisition, the Placing and Open Offer and the New Preference Share Issue are conditional, amongst other things, upon the passing of certain of the Resolutions at the General Meeting. Please read the whole of this document and, in particular, the risks relating to Lloyds TSB Group and the Enlarged Group and the other risk factors set out in the section headed "Risk Factors" on pages 29 to 46. You should not rely solely on summarised information in this document.**

Notice of a General Meeting of the Company to be held at the Scottish Exhibition and Conference Centre, Glasgow G3 8YW at 11.00 a.m. on 19 November 2008 is set out at the end of this document. A Form of Proxy for the General Meeting (the "Form of Proxy") is enclosed. To be valid, Forms of Proxy should be completed, signed and returned in accordance with the instructions printed on them so as to be received by the Company's Registrars as soon as possible and in any event no later than 11.00 a.m. on 17 November 2008 (or, in the case of an adjournment, no later than 48 hours before the time fixed for the holding of the adjourned meeting). If you are a member of CREST you may be able to use the CREST electronic proxy appointment service in accordance with the procedures set out in the notice convening the General Meeting at the end of this document. Proxies sent electronically must be sent as soon as possible and, in any event, so as to be received by not later than 11.00 a.m. on 17 November 2008 (or, in the case of an adjournment, not later than 48 hours before the time fixed for the holding of the adjourned meeting). Lloyds TSB Shareholders are requested to complete, sign and return the Form of Proxy, or use the CREST electronic proxy appointment service, whether or not they intend to be present at the General Meeting. Completion and return of a Form of Proxy, or use of the CREST electronic proxy appointment service, will not preclude Lloyds TSB Shareholders from attending and voting in person at the General Meeting, should they so wish.

Citi, which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting exclusively for Lloyds TSB and for no-one else as joint sponsor, joint bookrunner and joint placing agent (and also in providing financial advice in relation to the Acquisition) in relation to the Placing and Open Offer and the listing of the securities to be issued pursuant to the Placing and Open Offer and the Acquisition on the Official List and their admission to trading on the London Stock Exchange's main market for listed securities, and will not be responsible to any other person for providing the protections afforded to clients of Citi nor for providing advice in connection with the proposed Placing and Open Offer or the Acquisition, proposed listing or admission to trading or contents of this document or any other matters referred to in this document.

Lazard is acting exclusively for Lloyds TSB and for no-one else in providing financial advice in relation to the Acquisition and will not be responsible to any other person for providing the protections afforded to clients of Lazard nor for providing advice in connection with the Acquisition, proposed listing or admission to trading or contents of this document or any other matters referred to in this document.

Merrill Lynch, which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting exclusively for Lloyds TSB and for no-one else as joint sponsor, joint financial adviser, joint bookrunner and joint placing agent in relation to the Acquisition, the Placing and Open Offer and the listing of the securities to be issued pursuant to the Placing and Open Offer and the Acquisition on the Official List and their admission to trading on the London Stock Exchange's main market for listed securities, and will not be responsible to any other person for providing the protections afforded to clients of Merrill Lynch nor for providing advice in connection with the proposed Placing and Open Offer or the Acquisition, proposed listing or admission to trading or contents of this document or any other matters referred to in this document.

UBS is acting exclusively for Lloyds TSB and for no-one else as joint sponsor, joint financial adviser, joint bookrunner and joint placing agent in relation to the Acquisition, the Placing and Open Offer and the listing of the securities to be issued pursuant to the Placing and Open Offer and the Acquisition on the Official List and their admission to trading on the London Stock Exchange's main market for listed securities, and will not be responsible to any other person for providing the protections afforded to clients of UBS nor for providing advice in connection with the proposed Placing and Open Offer or the Acquisition, proposed listing or admission to trading or contents of this document or any other matters referred to in this document.

Dated: 3 November 2008

## **PRESENTATION OF INFORMATION**

### ***Presentation of Financial Information***

Unless otherwise indicated, financial information for Lloyds TSB and the Lloyds TSB Group in this document has been extracted without material adjustment from the Lloyds TSB Interim Results for the six months ended 30 June 2008 published on 30 July 2008 prepared in accordance with the Disclosure and Transparency Rules and with IAS 34, "Interim Financial Reporting", as adopted by the European Union, is presented in pounds sterling, and is unaudited. For further information, see "Accounting policies, presentation and estimates" on page 36 of the Lloyds TSB Interim Results, such page being incorporated into this document by reference.

See also note 2 "Segmental analysis" on pages 37-38 of the Lloyds TSB Interim Results (such pages being incorporated into this document by reference) and paragraph 5 of Part VII ("Information on the Lloyds TSB Group") of this document.

Unless otherwise indicated, financial information for HBOS and the HBOS Group in this document has been extracted without material amendment from the condensed consolidated half year financial statements of HBOS prepared in accordance with the Disclosure and Transparency Rules and with IAS 34 "Interim Financial Reporting" as adopted by the European Union, and is unaudited. For further information, see "Condensed Financial Statements" on pages 74 and 75 of the HBOS Interim Results.

### ***Information on Risk Factors***

The risk factors set out in Part II of this document have not been extracted from public documents filed or published by Lloyds TSB or HBOS and, instead, are the risks that the Lloyds TSB Group believes apply to Lloyds TSB's business and will apply to the Enlarged Group's business.

### ***Enlarged Group***

Unless the context otherwise requires, references in this document to the "Enlarged Group" are to Lloyds TSB and its subsidiaries and subsidiary undertakings and, where the context requires, its associated undertakings as constituted immediately following completion of the Acquisition and therefore such references include the Lloyds TSB Group as enlarged by the HBOS Group. Completion of the Acquisition is subject to a number of conditions which are described in detail in Part I ("Letter from Sir Victor Blank, Chairman of Lloyds TSB Group Plc") and Part III ("Principal Terms of the Acquisition").

### ***No Profit Forecast***

No statement in this document or incorporated by reference into this document is intended to constitute a profit forecast or profit estimate for any period, nor should any statement be interpreted to mean that earnings or earnings per share will necessarily be greater or lesser than those for the relevant preceding financial periods for either Lloyds TSB or HBOS as appropriate.

### ***Rounding***

Certain figures included in this document and in the information incorporated by reference into this document have been subject to rounding adjustments. Accordingly, discrepancies in tables between the totals and the sums of the relevant amounts are due to rounding.

### ***Websites***

Neither the content of the Company's website (or any other website) nor the content of any website accessible from hyperlinks on the Company's website (or any other website) is incorporated into, or forms part of, this document.

### ***Time***

All references in this document to times are to UK time unless otherwise stated.

### ***Definitions***

Capitalised terms have the meanings ascribed to them in the section of this document headed "Definitions".

## **NOTICE TO US INVESTORS**

The Consideration Shares and the Consideration ADRs will not be, and are not required to be, registered under the Securities Act in reliance upon the exemption from registration requirements of the Securities Act provided by section 3(a)(10) thereof. The Open Offer Shares have not been and will not be registered under the Securities Act or under any securities laws of any state or other jurisdiction of the United States and may not be offered, sold, resold, transferred or delivered, directly or indirectly, within the United States except pursuant to an applicable exemption from the registration requirements of the Securities Act and in compliance with any applicable securities laws of any state or other jurisdiction of the United States. The Open Offer Shares will be offered and sold in the United States in a transaction not involving a public offering within the meaning of Section 4(2) of the Securities Act to persons reasonably believed to be “qualified institutional buyers” within the meaning of Rule 144A under the Securities Act. There will be no public offer of the Consideration Shares, the Consideration ADRs or the Open Offer Shares in the United States. Neither the SEC nor any other US federal or state securities commission or regulatory authority has approved or disapproved the Consideration Shares, the Consideration ADRs or the Open Offer Shares or passed an opinion on the adequacy of this document. Any representation to the contrary is a criminal offence in the United States. Shareholders who are or become affiliates (within the meaning of the Securities Act) of Lloyds TSB will be subject to timing, manner of sale and volume restrictions on the sale of the Consideration Shares or Consideration ADRs received in connection with the Scheme under Rule 145(d) of the Securities Act. The Open Offer Shares offered and sold in the United States will constitute “restricted securities” under Rule 144(a)(3) of the Securities Act.

The securities mentioned herein may not be offered or sold in any Restricted Jurisdiction absent registration or an applicable exemption from the registration requirements of the relevant laws of any Restricted Jurisdiction. There will be no public offer of such securities in any Restricted Jurisdiction.

## **FORWARD-LOOKING STATEMENTS**

This document and the information incorporated by reference to this document includes certain “forward-looking statements”. Statements that are not historical facts, including statements about the Lloyds TSB Group’s or the HBOS Group’s or their respective directors’ and or management’s beliefs and expectations are forward-looking statements. Words such as “believes”, “anticipates”, “estimates”, “expects”, “intends”, “aims”, “potential”, “will”, “would”, “could”, “considered”, “likely”, “estimate” and variations of these words and similar future or conditional expressions, are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend upon future circumstances that may or may not occur, many of which are beyond the Company’s control and all of which are based on the Lloyds TSB Directors’ current beliefs and expectations about future events. Such forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements of Lloyds TSB, HBOS or the Enlarged Group, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such forward-looking statements are based on numerous assumptions regarding Lloyds TSB’s, HBOS’s and the Enlarged Group’s present and future business strategies and the environment in which the Enlarged Group will operate in the future. These forward-looking statements speak only as at the date of this document.

Examples of such forward-looking statements include, but are not limited to, statements about expected benefits and risks associated with the Acquisition and the Placing and Open Offer, projections or expectations of profit attributable to shareholders, anticipated provisions or write-downs, economic profit, dividends, capital structure or any other financial items or ratios; statements of plans, objectives or goals of Lloyds TSB, HBOS or the Enlarged Group following completion of the Acquisition, including in relation to the achievement of anticipated cost synergies, other operating efficiencies, business growth opportunities, revenue and other benefits; statements about the future trends in interest rates, liquidity, foreign exchange rates, stock market levels and demographic trends and any impact that those matters may have on Lloyds TSB, HBOS or the Enlarged Group following completion of the Acquisition; statements concerning any future UK, US

or other economic environment or performance; statements about strategic goals, competition, regulation, regulatory approvals, dispositions and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Lloyds TSB Shareholders and potential investors should specifically consider all of the information set out in, and incorporated by reference into this document before making any investment decision or any decision whether or not to vote in favour of the Resolutions. In particular, Lloyds TSB Shareholders and potential investors should consider the risks, uncertainties and other factors are set out in Part II (“Risk Factors”) of this document, which include general risks relating to the Lloyds TSB Group and, if the Acquisition becomes Effective, the Enlarged Group, risks relating to the Acquisition, and risks relating to the Placing and Open Offer and to investment in Lloyds TSB Shares and Lloyds TSB ADRs.

Except as required by the FSA, the London Stock Exchange, the Takeover Panel, the Listing Rules, the Prospectus Rules, the Disclosure and Transparency Rules, the City Code or any other applicable law or regulation, the Company expressly disclaims any obligations or undertaking to release publicly any updates or revisions to any forward-looking statements contained in this document or incorporated by reference into this document to reflect any change in the Company’s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

## DEALING DISCLOSURE REQUIREMENTS

Under the provisions of Rule 8.3 of the City Code, if any person is, or becomes, “interested” (directly or indirectly) in one per cent. or more of any class of “relevant securities” of Lloyds TSB or HBOS, all “dealings” in any “relevant securities” of that company (including by means of an option in respect of, or a derivative referenced to, any such “relevant securities”) must be publicly disclosed by no later than 3.30 p.m. on the London business day following the date of the relevant transaction. This requirement will continue until the Effective Date, or on which the “offer period” for the purposes of the City Code otherwise ends. If two or more persons act together pursuant to an agreement or understanding, whether formal or informal, to acquire an “interest” in “relevant securities” of Lloyds TSB or HBOS, they will be deemed to be a single person for the purpose of Rule 8.3.

Under the provisions of Rule 8.1 of the City Code, all “dealings” in “relevant securities” of Lloyds TSB or HBOS by Lloyds TSB or HBOS, or by any of their respective “associates”, must be disclosed by no later than 12.00 noon on the London business day following the date of the relevant transaction.

A disclosure table, giving details of the companies in whose “relevant securities” “dealings” should be disclosed, and the number of such securities in issue, can be found on the Panel’s website at [www.thetakeoverpanel.org.uk](http://www.thetakeoverpanel.org.uk).

“Interests in securities” arise, in summary, when a person has long economic exposure, whether conditional or absolute, to changes in the price of securities. In particular, a person will be treated as having an “interest” by virtue of the ownership or control of securities, or by virtue of any option in respect of, or derivative referenced to, securities.

Terms in quotation marks are defined in the Code, which can also be found on the Panel’s website. If you are in any doubt as to whether or not you are required to disclose a “dealing” under Rule 8, you should consult the Panel.

## TABLE OF CONTENTS

	<i>Page</i>
EXPECTED TIMETABLE OF PRINCIPAL EVENTS	7
PART I LETTER FROM SIR VICTOR BLANK, CHAIRMAN OF LLOYDS TSB GROUP PLC	8
PART II RISK FACTORS	29
PART III PRINCIPAL TERMS OF THE ACQUISITION	47
PART IV PRINCIPAL TERMS OF THE PLACING AND OPEN OFFER	53
PART V CONDITIONS RELATING TO THE PROPOSED GOVERNMENT FUNDING	57
PART VI PRINCIPAL TERMS OF THE CAPITALISATION ISSUE	59
PART VII INFORMATION ON THE LLOYDS TSB GROUP	61
PART VIII INFORMATION ON THE HBOS GROUP	72
PART IX HISTORICAL FINANCIAL INFORMATION RELATING TO HBOS PLC Part A – Audited Financial Information	75
PART IX HISTORICAL FINANCIAL INFORMATION RELATING TO HBOS PLC Part B – Unaudited Interim Financial Information	213
PART X RECONCILIATION OF ACCOUNTING POLICIES	235
PART XI UNAUDITED PRO FORMA NET ASSETS STATEMENT OF THE ENLARGED GROUP AS AT 30 JUNE 2008	238
PART XII ADDITIONAL INFORMATION	246
PART XIII – HBOS INTERIM MANAGEMENT STATEMENT 3 NOVEMBER 2008	271
DEFINITIONS	274
LLOYDS TSB GROUP PLC NOTICE OF GENERAL MEETING	283

## EXPECTED TIMETABLE OF PRINCIPAL EVENTS

Latest time for lodging Forms of Proxy for Lloyds TSB General Meeting	11.00 a.m. on 17 November 2008
Expected date of publication of Prospectus	mid-November 2008
Lloyds TSB General Meeting	11.00 a.m. on 19 November 2008
HBOS Court Meeting	12 December 2008
HBOS General Meeting	12 December 2008
Record date for entitlement under the Open Offer for Qualifying CREST Shareholders and Qualifying Non-CREST Shareholders	12 December 2008
Ex-entitlement date for the Open Offer	12 December 2008
Latest time and date for receipt of completed Application Forms and payment in full under the Open Offer and settlement of relevant CREST instructions (as appropriate)	12 January 2009
Scheme Court Hearing to sanction the Scheme	13 January 2009
Admission and commencement of dealings in Open Offer Shares on the London Stock Exchange	14 January 2009 <sup>(1)</sup>
Reduction Court Hearing to confirm the Capital Reduction	16 January 2009 <sup>(1)</sup>
Effective Date of the Scheme	16 January 2009 <sup>(1)</sup>
Delisting of HBOS Shares	19 January 2009 <sup>(1)</sup>
Issue of Consideration Shares	19 January 2009 <sup>(1)</sup>
Admission and commencement of dealings in Consideration Shares on the London Stock Exchange	19 January 2009 <sup>(1)</sup>

---

Note:

(1) These dates are indicative only and will depend, among other things, on the date upon which the Court sanctions the Scheme.

**The above times and dates are indicative only and may be subject to change. If any of the above times and/or dates change, the revised times and/or dates will be notified by announcement through a Regulatory Information Service.**

Different deadlines and procedures may apply in certain cases. For example, Lloyds TSB Shareholders that hold their Lloyds TSB Shares through a CREST member or other nominee may be set earlier deadlines by the CREST member or other nominee than the times and dates noted above.

## PART I

### LETTER FROM SIR VICTOR BLANK, CHAIRMAN OF LLOYDS TSB GROUP PLC



# Lloyds TSB

**Directors:**

Sir Victor Blank (*Chairman*)  
J Eric Daniels  
Archie G Kane  
G Truett Tate  
Tim J W Tookey  
Helen A Weir CBE  
Wolfgang C G Berndt  
Ewan Brown CBE FRSE  
Jan P du Plessis  
Philip N Green  
Sir Julian Horn-Smith  
Lord Leitch  
Sir David Manning GCMG CVO  
Carolyn J McCall OBE  
Martin A Scicluna

**Registered Office:**

Henry Duncan House,  
120 George Street,  
Edinburgh EH2 4LH

3 November 2008

*Dear Shareholder*

### **PROPOSED ACQUISITION OF HBOS, PLACING AND OPEN OFFER AND NEW PREFERENCE SHARE ISSUE**

The Lloyds TSB Board of Directors has long recognised the attractions of a combination of Lloyds TSB and HBOS. The Acquisition of HBOS represents a compelling opportunity to accelerate Lloyds TSB's strategy and create the UK's leading financial services group. In retail banking, the Acquisition brings together two of the leading retailers in UK financial services with particular expertise in bancassurance, insurance and long-term savings. In wholesale banking, the combination of expertise and products across an enlarged distribution network and customer base is expected to generate significant shareholder value. Importantly, the combination will also drive significant synergy benefits; the Lloyds TSB Board believes it will deliver total annual pre-tax cost savings greater than £1.5 billion by the end of 2011.

Since August 2007, and even more so since September 2008, global financial markets have experienced a period of significant turmoil. On 18 September 2008 the boards of Lloyds TSB and HBOS announced that they had reached agreement on the terms of a recommended acquisition by Lloyds TSB of HBOS. Since that date, conditions in global financial markets have continued to deteriorate, which has negatively affected capital ratios, in part because the banking sector's capital requirements are sensitive to changes in economic conditions under the Basel II accord. In light of the current economic environment, the UK Government decided that it would be appropriate for the UK banking sector to have higher levels of capital. This led to the UK Government announcing, on 8 October 2008, specific and comprehensive measures to ensure the stability of the UK financial system.



Lloyds TSB welcomed the UK Government's proposals and confirmed its commitment to completing the Acquisition. On 13 October 2008, as part of a co-ordinated package of capital and funding measures for the UK banking sector to be implemented by HM Treasury, the boards of Lloyds TSB and HBOS announced that they intended to participate in the Proposed Government Funding with £5.5 billion of new capital to be raised by Lloyds TSB (consisting of £4.5 billion in ordinary shares and £1 billion in preference shares (before costs and expenses)) and £11.5 billion by HBOS (consisting of £8.5 billion in ordinary shares and £3 billion in preference shares (before costs and expenses)). Lloyds TSB and HBOS also announced that they had agreed to proceed with the Acquisition on revised terms, adjusted to 0.605 Lloyds TSB shares for every HBOS share from 0.833 Lloyds TSB shares for every HBOS share.

The Lloyds TSB Directors believe that Lloyds TSB's and HBOS's participation in the Proposed Government Funding provides the capital necessary to complete the Acquisition in a timely fashion, with certainty and on terms that the Lloyds TSB Directors believe are the best available to Lloyds TSB and HBOS in current market conditions.

When combined with the new capital being raised by HBOS, the Proposed Government Funding is designed to provide the Enlarged Group with the capital strength and the funding capabilities to meet the short-term challenges that current markets present and support the longer-term creation of shareholder value. Lloyds TSB believes that HM Treasury will, in accordance with its public statements, act as a value-oriented shareholder with regard to the strategic development of the Enlarged Group and will recognise the importance of delivering the significant cost synergies highlighted above. Details of the conditions attaching to the Proposed Government Funding are set out in Part V of this document. Subject to this, at the Lloyds TSB Board's request, HM Treasury has confirmed that it currently has no intentions or strategic plans concerning the Enlarged Group or its business or employees.

The Lloyds TSB Directors believe that the combination of Lloyds TSB and HBOS, including the required capital raising by both companies, is in the best interests of the Company and Lloyds TSB Shareholders as a whole. The Lloyds TSB Board believes the turbulence in current markets has presented a unique opportunity to pursue the Acquisition, and unanimously recommends that Lloyds TSB Shareholders vote in favour of the Acquisition and the Resolutions associated with the Proposed Government Funding.

In considering the merits of the Acquisition, the Lloyds TSB Directors have been mindful that the landscape of the UK banking industry has shifted materially in recent months. The Lloyds TSB Directors do not believe it is appropriate to compare the Enlarged Group, including the impact of the Proposed Government Funding, with Lloyds TSB as it currently stands but rather compare the Enlarged Group against the position Lloyds TSB would likely be in should the Acquisition not become Effective.

If the Acquisition and Placing and Open Offer do not complete, HM Treasury has stated that it would expect Lloyds TSB to take appropriate action to strengthen its capital position. The FSA has advised Lloyds TSB that if the Acquisition were not to occur, it would require Lloyds TSB to raise £7 billion of additional capital, made up of £5 billion of Core Tier 1 equity and £2 billion of Tier 1 instruments. Whilst Lloyds TSB would be able to seek to raise such additional new capital in the public markets, there can be no certainty that Lloyds TSB would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising, or as to whether any such fundraising would be on a pre-emptive basis.

The Lloyds TSB Directors believe that the Enlarged Group will be more competitive and will have significantly greater opportunities to create sustainable shareholder value than Lloyds TSB would on a standalone basis in what is now a materially more challenging market environment.

I am writing to give you further details of the Acquisition, the Placing and Open Offer and the New Preference Share Issue.

- Paragraph 1 provides further insight into the Lloyds TSB Board's views of the proposals, and a chronology of recent events to put the Acquisition and Placing and Open Offer into context.
- Paragraph 2 reminds shareholders of Lloyds TSB's strong track record of delivery of its strategy.
- Paragraphs 4 and 5 highlight the rationale for, and the financial effects of, the Acquisition.

- The Resolutions that will be put to the Lloyds TSB General Meeting are summarised in Paragraph 16.

This letter as a whole explains why the Lloyds TSB Board unanimously considers the Acquisition and Placing and Open Offer to be in the best interests of Lloyds TSB and the Lloyds TSB Shareholders as a whole and seeks your approval of the Resolutions.

## **1 Introduction and chronology of events**

Since August 2007, and even more so since September 2008, global financial markets have experienced a period of significant turmoil, which, among other things, included the UK Government placing Northern Rock into temporary public ownership on 22 February 2008 and the announcement on 15 September 2008 by Lehman Brothers that it intended to file a Chapter 11 Bankruptcy petition in the US.

On 18 September 2008, with the support of the UK Government, the boards of Lloyds TSB and HBOS announced that they had reached agreement on the terms of a recommended acquisition by Lloyds TSB of HBOS. HBOS Shareholders were to receive 0.83 Lloyds TSB Shares for every 1 HBOS Share (amended to 0.833 Lloyds TSB Shares following Lloyds TSB's successful share placing on 19 September 2008). On completion of the transaction on such terms, existing Lloyds TSB Shareholders would have owned approximately 56 per cent. of the enlarged group with the remaining 44 per cent. being held by existing HBOS Shareholders.

Following the announcement on 18 September 2008, conditions in global financial markets continued to deteriorate. Bradford & Bingley was placed into temporary public ownership in the UK on 29 September 2008. This was followed by the Icelandic Financial Services Authority putting Landsbanki into receivership on 7 October 2008, which affected UK savers through its internet brand, Icesave. On 8 October 2008, HM Treasury announced that, after consultation with the Bank of England and the Financial Services Authority, it was bringing forward specific and comprehensive measures to ensure the stability of the UK financial system and to protect ordinary savers, depositors, businesses and borrowers. On the same day, Lloyds TSB announced that it welcomed the announcement by HM Treasury to bring stability and certainty to the UK banking industry and that it continued to progress the Acquisition.

On 13 October 2008, in the context of further unprecedented turbulence in global financial markets and as part of a co-ordinated package of capital and funding measures for the UK banking sector implemented by HM Treasury, the boards of both Lloyds TSB and HBOS announced that they intended to participate in the Proposed Government Funding, thereby gaining access to the UK Government backed provision of liquidity, and that they had agreed to proceed with the Acquisition on revised terms.

A combined total of £17 billion of new capital will be raised by Lloyds TSB and HBOS, of which £5.5 billion (consisting of £4.5 billion in ordinary shares and £1 billion in preference shares (before costs and expenses)) will be raised by Lloyds TSB and £11.5 billion (consisting of £8.5 billion in ordinary shares and £3 billion in preference shares (before costs and expenses)) by HBOS:

- The Lloyds TSB Placing and Open Offer comprises a proposed placing and open offer of approximately 2.6 billion Open Offer Shares at 173.3 pence per Open Offer Share, representing an 8.5 per cent. discount to Lloyds TSB's Closing Price on 10 October 2008. Eligible Lloyds TSB Shareholders will have the opportunity to claw back their proportionate entitlement to Open Offer Shares through the Open Offer and to apply for Open Offer Shares in excess of their Open Offer Entitlement. HM Treasury has agreed that, to the extent the Open Offer Shares are not taken up by Eligible Lloyds TSB Shareholders or placed with placees, HM Treasury will acquire such Open Offer Shares at the Issue Price. The New Preference Share Issue comprises a subscription by HM Treasury of approximately 1,000,000 New Preference Shares at £1,000 per New Preference Share.
- The HBOS Placing and Open Offer comprises a proposed placing and open offer of approximately 7.5 billion new HBOS shares at 113.6 pence per share, representing a discount of 8.5 per cent. to the HBOS Closing Price on 10 October 2008. Eligible HBOS Shareholders will have the opportunity to claw back their proportionate entitlement to these new HBOS shares through the HBOS Open Offer and to apply for new HBOS Shares in excess of their entitlement under the HBOS Placing and Open Offer. HM Treasury has agreed that, to the extent the HBOS Open Offer Shares are not taken up by eligible HBOS Shareholders or placed with placees HM Treasury will acquire such HBOS Open Offer Shares at the issue

price. HBOS will seek approval from its shareholders of certain resolutions in respect of the Acquisition and the HBOS Placing and Open Offer at a general meeting expected to be held in early December 2008.

In the period between 18 September 2008 and 13 October 2008 market conditions continued to deteriorate. Reflecting the additional capital that Lloyds TSB and HBOS agreed to raise and the impact of the continuing severity of the market dislocation on the future prospects of the Enlarged Group, Lloyds TSB and HBOS further agreed to amend the merger ratio for the Acquisition such that HBOS Shareholders will receive 0.605 Lloyds TSB Shares for every 1 HBOS Share. The revised terms of the Acquisition have been unanimously recommended by the boards of Lloyds TSB and HBOS.

It is intended that the Acquisition will be effected by way of a scheme of arrangement under sections 895 to 899 of the Companies Act (although Lloyds TSB reserves the right, in its sole discretion, to implement the Acquisition by means of an Offer) and, subject to the satisfaction, or where appropriate, waiver, of the Conditions, it is expected that the Acquisition will become Effective in January 2009. Upon the Acquisition becoming Effective, if none of the Lloyds TSB Shareholders (in relation to the Lloyds TSB Placing and Open Offer) nor the HBOS Shareholders (in relation to the HBOS Placing and Open Offer) participate in the clawback, existing Lloyds TSB Shareholders will own 36.5 per cent. of the Enlarged Group with existing HBOS Shareholders owning 20.0 per cent. of the Enlarged Group. In such circumstances, the remaining 43.5 per cent. will be owned by HM Treasury. To the extent the Lloyds TSB Shareholders and the HBOS Shareholders (in relation to the HBOS Placing and Open Offer) fully participate in the clawback, existing Lloyds TSB Shareholders will own 52.4 per cent. of the Enlarged Group, existing HBOS Shareholders will own 47.6 per cent. of the Enlarged Group and HM Treasury will own 0 per cent.

An offer will also be made by Lloyds TSB to HM Treasury (by way of scheme of arrangement) to exchange the preference shares in HBOS to be issued by HBOS to HM Treasury for equivalent preference shares in Lloyds TSB. Upon completion of this offer, HM Treasury will hold £4 billion of new preference shares in the enlarged share capital of Lloyds TSB.

The Placing and Open Offer and the Acquisition are interconditional (as explained in Paragraph 7 of this letter). If the Resolutions on which the Placing and Open Offer or the Acquisition are conditional are not approved or for some other reason the Placing and Open Offer Agreement is terminated or the Acquisition does not complete, the Proposed Government Funding would not be available to Lloyds TSB.

HM Treasury has informed Lloyds TSB that it is not a permanent investor in UK banks. Its intention, over time, is to dispose of any Lloyds TSB Shares it may acquire under the Placing and Open Offer or pursuant to the Acquisition in an orderly way and would normally expect to consult the Lloyds TSB Board prior to disposal. In addition to being bound by the restriction on the payment of dividends discussed in Paragraph 9 of this letter, the Company has given certain undertakings to HM Treasury in relation to such matters as availability and active marketing of competitively priced mortgage lending and lending to SMEs and board remuneration aimed at ensuring that any state aid involved in the potential acquisition of Open Offer Shares and Lloyds TSB's potential participation in the guarantee scheme to be promoted by HM Treasury as part of its support for the UK banking industry is compatible with the common market under EU law. However, further undertakings may be required to ensure such compatibility.

The Company has also agreed to use The Mound as its Scottish headquarters and to hold its annual general meetings in Scotland. Pursuant to the conditions attaching to the Proposed Government Funding, a summary of which is set out in Part V of this document, HM Treasury will work with the Lloyds TSB Board on its appointment of two new independent directors following completion of the Acquisition. Thereafter, consistent with best practice the Company will engage constructively with HM Treasury in its role as a shareholder. Further details in relation to such conditions attaching to the Proposed Government Funding are set out in Part V of this document. Subject to this, at the Lloyds TSB Board's request HM Treasury has confirmed that it currently has no intentions or strategic plans concerning the Enlarged Group or its business or employees.

Due to the size of the Acquisition and the number of Lloyds TSB Shares, New Preference Shares and Replacement Lloyds TSB Preference Shares which will be issued to implement the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme (respectively), the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the approval of Lloyds TSB's

Shareholders in a general meeting. Such approval will be sought at the Lloyds TSB General Meeting to be held at 11:00 a.m. on 19 November 2008.

In addition to the Acquisition, it was also announced on 18 September 2008 that the Lloyds TSB Board intends to issue new shares by way of the Capitalisation Issue. This Capitalisation Issue requires Lloyds TSB Shareholders to authorise the capitalisation of non-distributable reserves to allow the Capitalisation Issue Shares to be issued to Lloyds TSB Shareholders. Please refer to Part VI for further details concerning the Capitalisation Issue, including certain general taxation considerations in respect of the Capitalisation Issue.

The Lloyds TSB Prospectus relating to Admission of the Consideration Shares and to the Placing and Open Offer is expected to be published on the Lloyds TSB website in mid-November 2008.

## **2 Background on the Lloyds TSB Group**

Lloyds TSB's strong track record of delivery is built on the successful implementation of its strategy to develop long term customer relationships and build strong customer franchises. Lloyds TSB has continued to extend the depth and reach of its customer relationships, achieving robust sales growth whilst maintaining efficiency and a prudent approach to risk. It is Lloyds TSB's belief that this relationship focused strategy has demonstrated its effectiveness in generating sustainable, high quality returns for shareholders.

### ***Strong customer relationships***

Customer relationships are critical to Lloyds TSB's strategy. The Lloyds TSB Group seeks to develop deep, long-lasting relationships with its customer base in order to deliver high quality, sustainable growth over time. The focus on both customer acquisition and on building diversified, sustainable revenue streams from existing customers allows Lloyds TSB to drive growth while minimising both its costs and risk profile.

The success of the customer strategy is demonstrated by:

- *The ability to deepen existing customer relationships and generate high quality income through diversified, sustainable revenue streams*

The retail bank has continued to make excellent progress, delivering strong product sales growth and revenue momentum. Underlying income increased by 9 per cent. in the six months to June 2008, as compared to the same period in 2007, with improvements over a broad range of products including mortgages, personal loans, bank savings and wealth management, while profit before tax increased by 11 per cent. Excellent cost control has allowed Lloyds TSB to reduce its cost income ratio while continuing to make ongoing investments in the business. Retail customer deposits increased by 10 per cent. in the same period, with particularly strong progress in growing relationship-focused bank savings and wealth management deposit balances. The retail business continues to deepen customer relationships, both at the time of customer acquisition and over time. During the first half of 2008, over 99 per cent. of new personal loans and 90 per cent. of new credit cards sold were to existing customers which allows better risk assessment. Retail asset growth was 8 per cent., primarily in the form of mortgages, in the six months to 30 June 2008, as compared to the same period in 2007, and Lloyds TSB enjoyed a 24 per cent. market share of net new lending over the same period. Lloyds TSB also continues to develop its insurance business with an increase in bancassurance sales of 8 per cent. in the six months to 30 June 2008 building on the success of the simplified product range developed for distribution through the Lloyds TSB branch network, Commercial Banking and Wealth Management channels.

In Corporate Markets further progress has been made in developing the Company's relationship banking franchise supported by strong cross selling performance. Revenues from cross sales to existing customers increased by 64 per cent. in the six months to 30 June 2008, as compared to the same period in 2007. In Commercial Banking growth in business volumes in particular, supported by 22 per cent. growth in lending to SMEs with a turnover of up to £15 million during the twelve months to 30 June 2008, has resulted in strong trading surplus growth. Lending margins have widened in the corporate business and Lloyds TSB enjoyed excellent wholesale liability growth of 18.2 per cent. in the six months to 30 June 2008 as compared to the same period in 2007.

- *The continued acquisition of new customers*

Lloyds TSB has continued to make good progress in expanding its customer franchise. The retail bank opened nearly half a million new current accounts and achieved a 24.4 per cent. market share of net new mortgage lending in the first half of the year. In Commercial Banking the Lloyds TSB Group has continued to win new high value customers in the £0.5 to £2 million and £2 to £15 million turnover range achieving a market share in these segments of 16 per cent. and 13 per cent. respectively as at 30 June 2008 as a result of attracting customers “switching” from other financial services providers. In the mid market corporate segment, market share has increased from 12 per cent to 14 per cent. over the period from 30 June 2007 to 30 June 2008.

- *Continuous productivity improvement*

Superior performance requires a continuous focus on productivity improvement, which drives both improved customer service and cost reduction. In recent years, Lloyds TSB has been building a set of strong capabilities in error reduction, operations efficiency and procurement. Alongside those capabilities, the Lloyds TSB Group applies an “income growth must exceed cost growth” discipline in setting goals for each business, requiring a wider gap between income growth and cost growth for lower growth businesses than for higher growth businesses. At the Lloyds TSB Group level, for the six months to June 2008, income increased by 9 per cent. whilst costs increased by 5 per cent. as compared to the same period in 2007.

All three divisions in Lloyds TSB have demonstrated growing levels of income per employee (pre-dislocation costs) and falling unit costs and Retail Banking and International Banking have demonstrated much reduced error rates in key processes in recent years; achieved without affecting investment in future growth. These improvements in operational effectiveness have led to a further reduction in the Lloyds TSB Group cost: income ratio to 46.6 per cent. for the six months to 30 June 2008, compared to 48.6 per cent. for the six months to 30 June 2007, and 50.6 per cent for the six months to 30 June 2006.

- *Capital and risk management*

Lloyds TSB measures economic profit growth to determine where value is created or destroyed. It has developed a framework to measure economic equity requirements across all its businesses, taking into account market, credit, insurance, business and operational risk. Using economic profit as a key performance measure enables the Lloyds TSB Group to understand which strategies, products, channels and customer segments are creating the most value and to make better capital allocation decisions as a result. Lloyds TSB Group economic profit for the six months to June 2008 was £1,013 million<sup>1</sup>, an increase of 7 per cent. over the same period in 2007.

The application of these economic profit disciplines, alongside a strategy linked to ensuring that revenue growth exceeds cost growth, has contributed towards a significant improvement in the capital efficiency of the Lloyds TSB Group’s Insurance and Investments division. This has been further improved by a shift in business mix towards sectors offering higher risk adjusted returns in wholesale banking. By the continued rigorous application of these disciplines at every level, the Lloyds TSB Group expects to further improve capital efficiency. Post-tax return on equity for the six months to 30 June 2008 was 26.8 per cent. compared with 26.1 per cent. for the six months to 30 June 2007.

The Lloyds TSB Directors believe that Lloyds TSB’s relationship based business model, the efficiency of its operations and its effective capital and risk management position the Company well for future development.

### **3 Information on the HBOS Group**

The HBOS Group is a leading and diversified financial services group engaged in a range of banking, insurance, asset management, financial services and finance-related activities throughout the United Kingdom and internationally (Ireland, Europe, North America and Australia). The HBOS Group’s products and services can be categorised into the following business divisions:

---

(1) On a continuing business basis and excluding volatility provisions in respect of US dollar payments, impact of market dislocation and settlement of overdraft claims. Sourced from Lloyds TSB 2008 Interim Results Presentation.

- Retail;
- Corporate;
- Insurance & Investment;
- International; and
- Treasury & Asset Management.

As set out in HBOS's audited accounts for the financial year ended 31 December 2007 and extracted without material adjustment therefrom, HBOS reported net operating income of £21.3 billion and generated profit before taxation of £5.5 billion. For the six months ended 30 June 2008, HBOS reported net operating income of approximately £2.4 billion and generated profit before taxation of £848 million. HBOS reported total assets of £681.4 billion and shareholders' equity of £21.1 billion as at 30 June 2008.

In the first half of 2008, customers opened 478,000 new bank accounts, of which 77 per cent. were full facilities current accounts, which reflected an estimated market share of 21 per cent. of new current accounts opened during this period. In spite of strong competition throughout the first half of 2008, HBOS remained the largest liquid savings provider in the UK with a market share of 15.4 per cent. as at 30 June 2008. In the corporate business, new lending pricing improved in the first half of 2008 as competition in the market lessened. However, slower churn of the back book impacting the timing of fee recognition and higher funding costs exerted downward pressure on margins. For further information on the business of HBOS, please see Part VIII ("Information on the HBOS Group") of this document.

Information on the current trends and prospects for HBOS are set out in Part XIII ("HBOS Interim Management Statement 3 November 2008") of this document.

#### **4 Rationale for the Acquisition**

During the recent period of intense change in the banking industry, all banks have been forced to scrutinise their business models, available capital and funding requirements and make important strategic decisions for the future. In the execution of its stated strategy, the Lloyds TSB Board has always sought innovative ways to enhance shareholder value, both organically as well as through mergers and acquisitions. In particular, the Lloyds TSB Board has long recognised the enormous value which it believes could be obtained from the potential combination of Lloyds TSB and HBOS.

The Lloyds TSB Board believes that its success in the UK has resulted in it being in a strong position relative to its peers with new and exciting opportunities to create value. Whilst HBOS has been significantly affected by recent challenging market conditions, including the deteriorating economic environment which has negatively impacted its funding model, the Lloyds TSB Directors believe that HBOS remains an excellent franchise with the potential to contribute substantial value to the Enlarged Group. HBOS has a significant retail customer base and leading savings, mortgage and bancassurance franchises. HBOS also has an international multi-brand presence in the retail and insurance and investment markets, alongside a sound corporate banking franchise. Like Lloyds TSB, HBOS has a successful focus on cost discipline.

The Lloyds TSB Directors believe Lloyds TSB and HBOS are highly complementary. In addition to the cost savings and increased competitive strength expected to be achieved through enhanced size and scale, the combination is expected to create the largest current account base with the strongest mortgage brand and largest retail savings base in the UK. The Enlarged Group is also expected to have excellent breadth and balance with good positions in Retail, Corporate Banking, SME Business Banking and Long Term Savings. The Lloyds TSB Directors believe that the Enlarged Group's substantial customer base will give it excellent access to reliable, low volatility, sources of funding for growth. On the asset side, the Enlarged Group's focus on relationship lending and on robust credit policies is expected to enable sustainable lending growth within its relationship-led customer businesses at relatively low risk.

The Lloyds TSB Directors believe that the Enlarged Group will also be more competitive and significantly better placed to create shareholder value in a rapidly evolving UK banking industry than Lloyds TSB would on a standalone basis, primarily given the Enlarged Group's greater size and market presence. The Proposed Government Funding is designed to provide the Enlarged Group with significant capital strength and funding capabilities to meet the short-term challenges current markets present and support the longer-term prospects to create shareholder value. Lloyds

TSB is establishing plans for the integration of HBOS's businesses to deliver synergies and long-term value for all stakeholders of the Enlarged Group.

Going forward, successful banks will need to have deep customer reach backed up by robust capital and liquidity positions, with liability growth coming principally from retail and commercial deposits and with asset growth founded on the strongest possible credit risk management. They will also need class leading cost and capital efficiency to be economically profitable in a world where capital requirements are likely to be higher.

Both Lloyds TSB and HBOS are acknowledged leaders in efficiency and cost management. Even before actual synergies, the Lloyds TSB Directors believe the Enlarged Group will have one of the lowest cost:income ratios for financial institutions in the UK. Furthermore, the combined skills of the Enlarged Group in areas like lean management and straight-through processing is expected to allow the cost:income ratio to be reduced further over time whilst also further improving customer service. Allied to the Enlarged Group's combined focus on economic profit disciplines, this is expected to enable growth with high levels of profitability, even in a world of higher capital requirements.

The Lloyds TSB Directors believe that the Enlarged Group will have market leading distribution and sales capabilities, best of breed products and services as well as mid and back office processes that deliver a high quality customer experience. The Lloyds TSB Directors therefore believe that the Enlarged Group will be strongly positioned for this new environment.

### ***Retail Banking***

In Retail Banking, the Acquisition brings together two of the leading retailers in UK financial services, with strengths in customer relationship management, product design, branch sales processes and telephone and internet banking. The Lloyds TSB Directors believe that significant cost savings can be made by combining the networks and back offices of Lloyds TSB and HBOS whilst creating one of the largest and most effective retail franchises in the UK, enabling better access and service for customers. Future growth is expected to be driven from increased bank deposits, savings and investments. Allied to the Enlarged Group's strengths in savings and in wealth management, the Acquisition is expected to create the market leader in what is likely to be the fastest growing area of retail financial services.

### ***Wholesale and International Banking***

In wholesale and international banking, the combination of expertise and products across an enlarged distribution network and customer base is expected to generate material increases in revenues. Both Lloyds TSB and HBOS have focused on the attractive SME, commercial and mid-corporate segments. With the increasing sophistication of smaller and mid-sized companies' financial services needs, this is also expected to be a high growth area for the combined franchise. The Enlarged Group is expected to benefit from greater scale, closer segmentation and a broader range of products to grow its business. A focus on customer relationships, allied to strong credit risk management, is expected to deliver sustainable earnings growth from this business.

### ***Insurance and Investments***

The Lloyds TSB Directors believe that the Enlarged Group will have compelling propositions in General Insurance, Asset Management and Life, Pensions and Investment and that its customers will benefit from the deployment of best of breed products and efficient processes. Both Lloyds TSB and HBOS have well developed customer offerings in all three areas which will be combined to capture scale benefits whilst also providing enhanced product development and customer choice. There are also many complementary offerings expected to result from the Acquisition which are expected to provide bancassurance, IFA and institutional clients with a more wide ranging and improved service. The enlarged franchise is expected to build on its strong position and continue to provide good earnings growth.

Across the Enlarged Group, the Lloyds TSB Directors believe that the Proposed Government Funding will provide significant capital strength and funding capabilities to meet the challenges current markets present and support the creation of shareholder value. Lloyds TSB has a clear plan to integrate HBOS's business and deliver synergies and long-term value for all stakeholders of the Enlarged Group. Lloyds TSB expects that HM Treasury will, in accordance with its public statements, act as a value-oriented shareholder with regard to the strategic development of the Enlarged Group and the realisation of the significant expected cost synergies.

## 5 Financial Effects of the Acquisition

Since the announcement on 18 September 2008, Lloyds TSB has applied considerable resources to the quantification of potential benefits that would result from the combination of Lloyds TSB and HBOS. Following this detailed review, Lloyds TSB believes that through the implementation of cost synergies and other operational efficiencies it will deliver total pre-tax annual cost savings greater than £1.5 billion, or approximately 15.7 per cent. of the combined estimated Lloyds TSB and HBOS 2008 cost base<sup>2</sup>, by the end of 2011<sup>3,4</sup>.

Whilst Lloyds TSB believes that the combination with HBOS will generally provide enhanced opportunities for employees, there will inevitably be some rationalisation of the combined workforce as a result of these initiatives and consultation will take place with, among others, the recognised trade unions in respect of how this can best be achieved.

Lloyds TSB expects one-off integration costs to achieve these savings to be around 140 per cent. of the expected synergy run rate. It is anticipated that these costs will have been incurred or provided for by 31 December 2011. It is expected that the costs of implementation will significantly exceed the estimated synergy benefits in 2009.

The proposed synergy savings and associated implementation costs are subject to change if any disposals are made by the Enlarged Group.

The table below sets out information on the anticipated cost savings:

	<i>Cost Savings Per Annum by end of 2011<sup>4</sup> (£ million)</i>	<i>Number of Cost Saving Initiatives</i>
UK Retail Banking	790	21
Insurance and Investments	235	10
Wholesale and International Banking	430	25
Central and Support Functions and Other	45	5
<b>Total</b>	<b>1,500</b>	<b>61</b>

### ***UK Retail Banking***

The Acquisition brings together two of the leading retailers in UK financial services, with strengths in customer relationship management, product design, branch sales processes and in telephone and internet banking. The Lloyds TSB Directors believe that significant cost savings can be made by combining the networks and back offices of Lloyds TSB and HBOS whilst creating the largest and most effective retail franchise in the UK, enabling better access and service for Lloyds TSB and HBOS customers.

Cost savings in UK Retail Banking are expected to originate from:

- optimising the efficiency of the combined retail distribution infrastructure including branch network, call centre operations and associated management and support functions;
- streamlining branch based functions across operations;
- integrating the processing capabilities and information technology platforms of Lloyds TSB and HBOS; and
- removing other areas of duplication across the UK Retail Banking platforms.

Total annual pre-tax cost savings from UK Retail Banking by the end of 2011 are currently estimated to be £790 million.

(2) Addressable cost base, 12 months to 30 June 2008.

(3) The expected synergies have been calculated by Lloyds TSB on the basis of the existing cost and operating structures of Lloyds TSB and HBOS. Statements of estimated synergies, and calculations of the one-off costs of achieving them, relate to future actions and circumstances which, by their nature, involve risks, uncertainties, contingencies and other factors. As a result, the synergies referred to may not be achievable, or those achieved may be materially different from those estimated.

(4) Run rate at 31 December 2011.



### ***Insurance and Investments***

The Lloyds TSB Directors believe that the combination provides the Lloyds TSB Group with compelling propositions in General Insurance, Fund Management and Life, Pensions and Investment and that the Enlarged Group's customers will benefit from the deployment of best of breed products and processes.

Cost savings in Insurance and Investments are expected to originate from:

- combining manufacturing in life and pensions;
- combining the best elements of each business's bancassurance and IFA product sets and distribution models;
- creating a single integrated sales structure, consolidating operating platforms and introducing consistent claims processing in General Insurance;
- integration of fund management activities; and
- removing duplicated roles in support functions.

Total annual pre-tax cost savings from Insurance and Investments by the end of 2011 are currently estimated to be £235 million.

### ***Wholesale and International Banking***

Both Lloyds TSB and HBOS have focused on the attractive SME, commercial and mid-corporate segments. The financial services needs of smaller and mid-sized companies are becoming increasingly sophisticated and this is also expected to be the fastest growing area of wholesale banking. The Lloyds TSB Directors believe that the Enlarged Group will benefit from better reach, closer segmentation and a broader range of products to grow its business. It is also expected to represent a significant cost-saving opportunity.

Cost savings in Wholesale and International Banking are expected to originate from:

- rationalising commercial and corporate banking approach and removing overlapping management and support functions;
- integrating the processing capabilities and information technology platforms; and
- removing other areas of duplication across Wholesale and International Banking.

Total annual pre-tax cost savings from Wholesale Banking by the end of 2011 are currently estimated to be £430 million.

### ***Central and Support Functions and Other***

The integration of HBOS with Lloyds TSB will also provide the opportunity to make further cost savings from the consolidation of central group corporate and support functions. Based on Lloyds TSB's initial assessment, potential net funding synergies are not considered to be material.

Total annual pre-tax cost savings from Central and Support Functions and Other by the end of 2011 are currently estimated to be £45 million.

### ***Revenue Opportunities***

It is expected that there will be the opportunity for significant revenue enhancements as a result of the combination. A wide range of key potential initiatives have been considered but are not incorporated in this numerical analysis.

### ***Basis of Preparation***

The evaluation of cost synergies has been jointly undertaken by a broad group of senior and operational management from both Lloyds TSB and HBOS. These estimates have been based on a detailed assessment of the pro forma cost structure of the combined Lloyds TSB and HBOS businesses and a detailed bottom up analysis of the efficiency cost savings that are available following the transaction. Lloyds TSB and HBOS management have applied their understanding of the relative productivity levels between Lloyds TSB and HBOS, experience in delivering operational efficiency improvements, as well as industry benchmarks, to determine the cost savings.

The principal areas for cost savings have been identified and each area carefully scrutinised through a detailed review process involving external advisers. Each individual saving initiative is supported by an implementation plan which is being developed by the relevant management team.

In determining the estimate of cost savings achievable through the combination of Lloyds TSB and HBOS, Lloyds TSB has not included any savings relating to operations where no overlap exists.

In assessing the financial effects of the Acquisition, the Lloyds TSB Directors have been mindful to compare the Enlarged Group, including the impact of the Acquisition and the Proposed Government Funding, with Lloyds TSB on a standalone basis (adjusted for the impact of further new capital that Lloyds TSB has been advised by the FSA it would be required to raise, if the Acquisition were not to occur). Whether or not the Acquisition completes, Lloyds TSB will be required to raise significant capital.

On this basis, it is expected that the Acquisition will lead to accretion in Lloyds TSB's cash earnings per share in excess of 20 per cent. in 2010<sup>5</sup>. Cash earnings per share excludes amortisation of intangibles and fair value adjustments and includes cost synergies.

## **6 Summary of the Terms of the Acquisition**

Under the terms of the Acquisition, and subject to the Conditions, HBOS Shareholders will be entitled to receive 0.605 Consideration Shares for every 1 HBOS Share. Holders of HBOS ADRs will be entitled to receive 0.15125 Consideration ADRs for each HBOS ADR cancelled in connection with the Acquisition.

These exchange ratios assume that neither HBOS nor Lloyds TSB has declared or paid, and will not declare or pay, any dividend in respect of ordinary shares after 13 October 2008, being the date of the announcement of revised terms of the Acquisition.

Based on the Closing Price of 179.2 pence per Lloyds TSB Share on 29 October 2008, being the last practicable Business Day prior to publication of this document, the Acquisition values each HBOS Share at 108.4 pence and the existing issued ordinary share capital of HBOS at approximately £5.9 billion.

Upon the Acquisition becoming Effective, if none of the Lloyds TSB Shareholders (in relation to the Lloyds TSB Placing and Open Offer) nor the HBOS Shareholders (in relation to the HBOS Placing and Open Offer) participate in the clawback, existing Lloyds TSB Shareholders will own 36.5 per cent. of the Enlarged Group with existing HBOS Shareholders owning 20.0 per cent. of the Enlarged Group. In such circumstances, the remaining 43.5 per cent. will be owned by HM Treasury. To the extent the Lloyds TSB Shareholders and the HBOS Shareholders (in relation to the HBOS Placing and Open Offer) fully participate in the clawback, existing Lloyds TSB Shareholders will own 52.4 per cent. of the Enlarged Group, existing HBOS Shareholders will own 47.6 per cent. of the Enlarged Group and HM Treasury will own 0 per cent.

The Consideration Shares will be issued credited as fully paid and will rank *pari passu* in all respects with the existing Lloyds TSB Shares in issue at the time the Consideration Shares are issued pursuant to the Acquisition, including the right to receive and retain dividends and other distributions declared, made or paid (if any) by reference to a record date falling after the Effective Date.

Applications will be made to the UK Listing Authority for the Consideration Shares to be admitted to the Official List and to the London Stock Exchange for the Consideration Shares to be admitted to trading on the London Stock Exchange's main market for listed securities. It is expected that Admission of the Consideration Shares will occur and that dealings in the Consideration Shares on the London Stock Exchange will commence in mid-January 2009. A supplemental listing application will be made to the NYSE for the Consideration Shares to be issued pursuant to the Acquisition to be listed on the NYSE for trading in the form of Consideration ADRs.

Any new HBOS Shares issued to Lloyds TSB or its nominee(s) pursuant to the Scheme will be issued fully paid and free from all liens, charges, equitable interests, encumbrances and rights of pre-emption and any other interests of any nature whatsoever and together with all rights attaching thereto. In the event that the Acquisition is implemented by means of an Offer, the HBOS Shares will be acquired pursuant to such Offer on the same basis.

The Acquisition is subject to antitrust review in a number of jurisdictions, including (but not limited to) the United Kingdom and the United States. Following an intervention by the Secretary of State for Business, Enterprise and Regulatory Reform (the "Secretary of State") in relation to the UK

---

(5) This statement is not intended to constitute a profit forecast for any period and should not be interpreted to mean that earnings or earnings per share will necessarily be greater than those for any preceding financial period for either Lloyds TSB or HBOS.

antitrust review on public interest grounds (i.e. stability of the UK financial system), the Secretary of State gave regulatory clearance to the Acquisition on 31 October 2008 after concluding that it is in the public interest.

Lloyds TSB and HBOS expect all remaining anti-trust clearances to have been obtained by mid-January 2009. Under the Implementation Agreement, Lloyds TSB and HBOS have agreed to co-operate to obtain all regulatory approvals as promptly as reasonably possible.

## **7 Summary of the Terms of the Placing and Open Offer**

Under the Placing and Open Offer, Lloyds TSB intends to invite Qualifying Shareholders to apply to acquire 2,596,653,203 Open Offer Shares at the Issue Price, raising approximately £4.5 billion (before costs and expenses). Citi, Merrill Lynch and UBS have agreed to use reasonable endeavours to procure placees to take up Open Offer Shares at the Issue Price subject to the passing of certain of the Resolutions and Admission and subject to clawback in respect of valid applications by Qualifying Shareholders at the Issue Price.

The Issue Price represents an 8.5 per cent. discount to the Closing Price of 189.4 pence per Lloyds TSB Share on 10 October 2008.

Qualifying Shareholders, subject to the terms and conditions of the Open Offer, will be given the opportunity under the Open Offer to apply for Open Offer Shares at the Issue Price on the basis of 0.4347 Open Offer Shares for every existing Lloyds TSB Share.

Entitlements to Open Offer Shares will be rounded down to the nearest whole number and fractional entitlements will not be offered to persons pursuant to the Placing and Open Offer but will be aggregated and sold in the market for the benefit of Lloyds TSB. Holdings of Lloyds TSB Shares in certificated and uncertificated form will be treated as separate holdings for the purpose of calculating entitlements under the Open Offer as will holdings under different designations and in different accounts.

An Excess Application Facility will enable Qualifying Shareholders to apply for Open Offer Shares in excess of their Open Offer Entitlement. Further details in relation to the Excess Application Facility will be set out in the Prospectus and the Application Form.

The Open Offer is conditional, *inter alia*, upon:

- (i) the Placing and Open Offer Agreement having become unconditional in all respects save for the condition relating to Admission;
- (ii) the HBOS Placing and Open Offer Agreement having become unconditional in all respects save for the condition relating to admission of the HBOS Shares issued pursuant to the HBOS Placing and Open Offer;
- (iii) Admission of the Open Offer Shares becoming effective by not later than 8.00 a.m. on 19 January 2009 (or such later time and date as HM Treasury may agree); and
- (iv) the passing, without amendment, of Ordinary Resolutions 1, and 3 only.

To the extent Open Offer Shares are not placed or taken up under the Open Offer, subject to the terms of the Placing and Open Offer Agreement and the Scheme having been sanctioned at the First Court Hearing, HM Treasury will itself acquire such Open Offer Shares.

The Open Offer Shares, when issued and fully paid, will rank *pari passu* in all respects with the existing Lloyds TSB Shares including the right to receive dividends or distributions made, paid or declared (if any) after the date of this document.

Applications will be made to the UK Listing Authority for the Open Offer Shares to be admitted to the Official List and to the London Stock Exchange for the Open Offer Shares to be admitted to trading on the London Stock Exchange's main market for listed securities.

It is expected that Admission of the Open Offer Shares will occur and that dealings in the Open Offer Shares on the London Stock Exchange will commence in mid-January 2009.

The Placing and Open Offer is conditional on, *inter alia*, the matters set out in (i) to (iv) above and upon the Scheme being sanctioned at the Scheme Court Hearing. Certain of the conditions may be waived by the Treasury in its discretion. The Acquisition is also conditional on the passing of Ordinary Resolutions 1 and 3 at the Lloyds TSB General Meeting; the passing of various resolutions at the HBOS General Meeting and the Court Meeting; and all regulatory conditions and consents having been obtained or waived.

Accordingly, the Placing and Open Offer and the Acquisition are interconditional. If the Resolutions on which the Placing and Open Offer or the Acquisition are conditional are not approved or for some other reason the Placing and Open Offer Agreement is terminated or the Acquisition does not complete, HM Treasury has stated that, in that event, it would expect Lloyds TSB to take appropriate action to address its capital position in the light of the policy objectives set out in HM Treasury's announcement of 8 October 2008 on Financial Support to the Banking Industry.

The FSA has advised Lloyds TSB that if the Acquisition were not to occur, it would require Lloyds TSB to raise £7 billion of additional capital, made up of £5 billion of Core Tier 1 equity and £2 billion of Tier 1 instruments. Whilst Lloyds TSB would be able to seek to raise such additional new capital in the public markets, there can be no certainty that Lloyds TSB would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising or as to whether any such fund raising would be on a pre-emptive basis.

Further information in relation to the Placing and Open Offer will be contained in the Prospectus, including some questions and answers in relation to the Placing and Open Offer, together with the terms and conditions of the Placing and Open Offer and the procedure for acceptance and payment. The Prospectus is expected to be made available to Qualifying Shareholders on the Lloyds TSB website ([www.investorrelations.lloydstsb.com](http://www.investorrelations.lloydstsb.com)) in mid-November 2008.

## **8 New Preference Share Issue**

Under the Preference Share Subscription Agreement, Lloyds TSB intends to issue to HM Treasury 1,000,000 New Preference Shares at the issue price of £1,000 per New Preference Share, raising approximately £1 billion (before costs and expenses). Lloyds TSB intends to seek a listing for the New Preference Shares. The New Preference Share Issue is conditional upon the Placing and Open Offer Agreement becoming unconditional in accordance with its terms.

The New Preference Shares rank ahead of the Lloyds TSB Shares. The New Preference Shares do not carry voting rights at general meetings of Lloyds TSB, save in limited circumstances (including if dividends on the New Preference Shares are not paid) described in paragraph 9.1.4 of Part XII ("Additional Information") of this document.

The New Preference Shares will pay a fixed non-cumulative dividend of 12 per cent. per annum, payable semi-annually in arrear, for the first five years after their issue. Thereafter, they will pay a variable dividend, equal to three month sterling LIBOR plus 7 per cent., payable quarterly in arrear. The payment of such dividends is at the sole discretion of the Lloyds TSB Board, however, if such dividends have not been paid in full, holders of the New Preference Shares will be entitled to vote in certain circumstances (see paragraph 9.1.4 of Part XII ("Additional Information") of this document for further information).

For as long as dividend payments have not been made on the New Preference Shares, Lloyds TSB may not (subject to certain exceptions) declare or pay cash dividends or other distributions upon any parity or junior securities, or redeem, repurchase or otherwise acquire any such securities.

In addition, until the Enlarged Group HMT Preference Shares are redeemed or purchased in full, Lloyds TSB may not declare or pay any cash dividend on its ordinary shares or redeem, purchase, cancel or otherwise acquire any of its ordinary shares or effect a reduction of its ordinary share capital which involves a distribution to holders of the ordinary shares.

The New Preference Shares will be issued credited as fully paid and, on any liquidation, will rank *pari passu* in all respects with the most senior preference shares then in issue and any other class of shares in issue at the time the New Preference Shares are issued pursuant to the Preference Share Subscription Agreement, or to be issued, which are expressed to rank equally with the New Preference Shares.

Subject to notifying the FSA and being in compliance with its capital adequacy requirements (to the extent they apply at the time), Lloyds TSB has the right to redeem the New Preference Shares at the liquidation preference of £1,000 plus accrued dividends, in whole or in part, with effect from the date five years and one day after their issue.

In addition to the £1 billion of new preference shares being issued by Lloyds TSB, HBOS is also issuing £3 billion of new preference shares to HM Treasury. Accordingly, upon completion of the Acquisition and the HBOS Preference Share Scheme, HM Treasury will own £4 billion Enlarged Group HMT Preference Shares. As the terms of the New HBOS Preference Shares and the New Preference Shares contain similar provisions, including the restrictions as to ordinary dividends set out above, the Enlarged Group will need to repurchase or redeem an aggregate of £4 billion of new preference shares before payment of dividends on ordinary shares can be resumed.

## **9 Dividend Policy, Capitalisation Issue and Capital Position**

### ***Dividend Policy and Capitalisation Issue***

No dividend may be paid on the Lloyds TSB Shares while any of the Enlarged Group HMT Preference Shares are outstanding, unless otherwise agreed by HM Treasury. However, the Lloyds TSB Board recognises the importance of dividends to Shareholders and its clear intention is to achieve the repurchase of the Enlarged Group HMT Preference Shares during 2009 so as to enable it to resume the payment of dividends.

However, the restriction on payment of dividends does not preclude the declaration of a capitalisation issue paid out of non-distributable reserves. Lloyds TSB intends to issue shares by way of Capitalisation Issue for the 2008 financial year at a level to be determined by the Board of Lloyds TSB at the appropriate time.

Repurchases of the Enlarged Group HMT Preference Shares would be subject to FSA approval and would take account of the Group's capital position at the time of the proposed repurchase and prevailing market conditions. The Enlarged Group HMT Preference Shares can be repurchased using replacement Tier 1 capital, retained earnings, the proceeds of disposals (to the extent that these are in excess of the book value of assets disposed), gross reductions in risk-weighted assets or as otherwise permitted by the FSA. Repurchase within five years will also require approval of the holders of the Enlarged Group HMT Preference Shares.

HM Treasury has indicated its encouragement that the Enlarged Group HMT Preference Shares be repurchased as soon as practicable, applying a repurchase price of 101 per cent. of nominal value for six months after the close of the Placing and Open Offer and, thereafter, a price reflecting prevailing market conditions (with no value to be attributed to the fact that upon repurchase by the Company it may become able to pay dividends). Any such repurchase arrangements will be subject to such constraints as are necessary to ensure the Enlarged Group HMT Preference Shares constitute Tier 1 capital. HM Treasury has agreed that if it were to dispose of any of the Enlarged Group HMT Preference Shares, it would either impose on any buyer an obligation to allow Lloyds TSB to repurchase the relevant Enlarged Group HMT Preference Shares on the repurchase terms set out above, or (at HMT's sole discretion) release the restriction on payment of dividends. This would be done in a manner consistent with maintaining the Enlarged Group HMT Preference Shares' Tier 1 treatment.

Lloyds TSB will assess the range of options available to allow the repurchase in full of the Enlarged Group HMT Preference Shares as set out above and intends, subject to prevailing market conditions and the restrictions described above, to achieve this during 2009 so that the block on the payment of cash ordinary dividends will be removed. This will allow the Lloyds TSB Board to resume the payment of cash ordinary dividends. The timing of recommencement and the level of dividend will be determined with due regard for the trading and economic environment and the Lloyds TSB Group's capital position at that time.

### ***Capital Position***

Based on a review of non-public information provided by HBOS, Lloyds TSB has made a preliminary assessment that net negative capital adjustments of no more than £10 billion after tax would need to be made to HBOS's financial position for Core Tier 1 capital purposes as a result of the Acquisition. The amount of the capital adjustments takes into account the elimination of the HBOS available for sale ("AFS") reserve at 30 September 2008 and includes the effect of the application of market based credit spreads at September 2008 to HBOS's portfolios. A

comprehensive assessment of the fair values of HBOS's assets will be undertaken following completion of the Acquisition, the provisional results of which will be published in Lloyds TSB's 2009 interim report. The actual capital adjustments will reflect the conditions that exist at the Effective Date of the Acquisition.

Based on published information at 30 June 2008, and taking into account Lloyds TSB's equity placing completed on 19 September 2008, the Placing and Open Offer, HBOS's rights issue announced on 29 April 2008 and the HBOS Placing and Open Offer as well as the net negative capital adjustments to HBOS's financial position referred to previously, Lloyds TSB estimates that the Enlarged Group would have had a Core Tier 1 ratio of 8.8 per cent. at 30 June 2008. In calculating this Core Tier 1 ratio no account has been taken of the trading performance of Lloyds TSB or HBOS or of other transactions by Lloyds TSB or HBOS since 30 June 2008, including the sale by HBOS of BankWest and St Andrews, except for the equity placing completed by Lloyds TSB on 19 September 2008. Lloyds TSB has made a preliminary assessment that net negative capital adjustments of no more than £10 billion after tax would need to be made to HBOS's financial position for core Tier 1 capital purposes as a result of the Acquisition, the effect of which would mean that the Enlarged Group would have a Core Tier 1 ratio in excess of 7 per cent.

The impact of the negative capital adjustments referred to above on the Enlarged Group's net tangible assets is reduced by the amount of the HBOS available for sale ("AFS") reserve which at 30 September 2008 amounted to approximately £4 billion.

In addition, the review of non-public information provided by HBOS has identified a positive fair value adjustment for the Enlarged Group's net tangible assets in respect of HBOS's own debt. This is of a similar magnitude to the capital adjustments affecting Core Tier 1 capital (excluding the AFS reserve adjustment) but will be affected, and could theoretically be eliminated by, *inter alia*, movements in credit spreads on HBOS's debt between the date of the review and the Effective Date.

The Enlarged Group has set a target core Tier 1 capital ratio range of 6-7 per cent.

## **10 Directors, Management and Employees**

Lloyds TSB attaches great importance to the skills and experience of the existing management and employees of HBOS. The management structure of the Enlarged Group will be assembled from the combined skills and experience of the current Lloyds TSB and HBOS teams.

The Lloyds TSB Board has also given assurances to the HBOS Directors that, following the Acquisition becoming Effective, the existing contractual employment rights of all employees of the HBOS Group will be fully safeguarded.

As announced on 18 September 2008, Sir Victor Blank will be Chairman and Eric Daniels will be Chief Executive of the Enlarged Group. On 30 October 2008, Lloyds TSB announced that the following Lloyds TSB Board, Company Secretary and other Group Executive Committee appointments will be made to the Enlarged Group following completion of the Acquisition:

- Helen Weir will be appointed as Group Executive Director of UK Retail Banking.
- Truett Tate will be appointed Group Executive Director of Wholesale.
- Archie Kane will be appointed Group Executive Director of Insurance and will represent the new board in Scotland.
- Tim Tookey will be appointed Group Finance Director.
- Harry Baines will be appointed General Counsel and Company Secretary.
- Jo Dawson will be appointed Wealth and International Director.
- Carol Sergeant will be appointed Chief Risk Officer.
- Angie Risley will be appointed Group Human Resources Director.
- Chris Wiscarson will be appointed Group Integration Director.

Pursuant to the conditions attaching to the Proposed Government Funding, a summary of which is set out in Part V of this document, HM Treasury will work with the Lloyds TSB Board on its appointment of two new independent directors following completion of the Acquisition. Thereafter, consistent with best practice, the Company will engage constructively with HM Treasury in its role as a shareholder.

## **11 Co-operation from HBOS: the Implementation Agreement and Inducement Fee Arrangements**

Lloyds TSB and HBOS have entered into an implementation agreement which governs their relationship during the period until the Acquisition becomes Effective or lapses. Among other things, the parties have agreed to co-operate with regard to the process of implementing the Acquisition. The Implementation Agreement will terminate (without prejudice to any obligations on HBOS to pay the inducement fee (see below)) in certain circumstances, including if the Scheme or the Acquisition is not approved at the Court Meeting or the HBOS General Meeting or the Lloyds TSB General Meeting (as appropriate).

Under the Implementation Agreement, HBOS has agreed to pay Lloyds TSB an inducement fee (inclusive of value added tax (if any)) of one per cent. of the offer value under the Acquisition (based on the Closing Price of a Lloyds TSB Share on the Business Day prior to the occurrence of the relevant event below) if, *inter alia*:

- the HBOS Directors do not unanimously and without qualification recommend the HBOS Shareholders to vote in favour of the Scheme; or
- at any time after approval of the Scheme by HBOS Shareholders at the Court Meeting but before the grant of the Court Orders, the HBOS Directors, in exercise of their fiduciary duties, decide not to proceed with the Scheme; or
- without the consent of Lloyds TSB, HBOS withdraws the Scheme or takes steps to defer (or adjourn) the holding of the Court Meeting or the HBOS General Meeting or the Court Hearings to approve the Scheme to a date later than 28 February 2009; or
- a Competing Proposal is announced prior to the Scheme lapsing or being withdrawn, which Competing Proposal subsequently becomes or is declared wholly unconditional or is completed.

## **12 Pensions**

Lloyds TSB and HBOS will continue to pay regular contributions to all group pension schemes in accordance with the current contribution schedules agreed from time to time with the trustees of each scheme. It is expected that the funding and investment strategy in relation to the defined benefit schemes will be reviewed and discussed with the trustees during the 15-month period following the triennial actuarial valuations of the schemes. The valuation date is expected to be 31 December 2009 for the HBOS Final Salary Pension Scheme and was 30 June 2008 for the Lloyds TSB Group Pension Scheme No. 1 and the Lloyds TSB Group Pension Scheme No. 2.

## **13 Settlement, Listing and Dealing of Open Offer Shares, Consideration Shares and Consideration ADRs**

The existing Lloyds TSB Shares are already admitted to CREST. It is expected that all of the Open Offer Shares and Consideration Shares, when issued and fully paid, will be capable of being held and transferred by means of CREST or in certificated form. It is expected that the Open Offer Shares and the Consideration Shares will trade under ISIN GB0008706128.

A supplemental listing application will be made to the NYSE for the Consideration Shares to be listed on the NYSE for trading in the form of Consideration ADRs. The Consideration ADRs will be issued subject to the terms and conditions of the Lloyds TSB Deposit Agreement.

## **14 Rule 9 Waiver**

Following the completion of the Placing and Open Offer and the Acquisition, if none of the existing Lloyds TSB Shareholders acquire any Open Offer Shares pursuant to the Placing and Open Offer and none of the existing HBOS Shareholders acquire any HBOS Shares pursuant to the HBOS Placing and Open Offer, HM Treasury would hold a maximum of 7,123,501,794 Lloyds TSB Shares (representing approximately 43.5 per cent. of the enlarged issued ordinary share capital of Lloyds TSB).

Rule 9 of the City Code is designed to prevent the acquisition or control of a company to which the City Code applies without a general cash offer being made to all shareholders of that company.

Under Rule 9, when any person acquires, whether by a series of transactions over a period of time or not, an interest in shares (as defined in the City Code) which (taken together with shares in

which persons acting in concert with him are interested) carry 30 per cent. or more of the voting rights of a company which is subject to the City Code, that person is normally obliged to make a general cash offer to all the remaining shareholders of the company to acquire their equity shares and transferable securities carrying voting rights in the company.

Furthermore, under Rule 9 when a person, together with persons acting in concert with him, is interested in shares which in the aggregate carry not less than 30 per cent. of the voting rights of a company but does not hold shares carrying more than 50 per cent. of such voting rights and such person, or any person acting in concert with him, acquires an interest in any other shares which increases the percentage of shares carrying voting rights in which he is interested, that person is normally obliged to make a general cash offer to all the remaining shareholders of the company to acquire their equity shares and transferable securities carrying voting rights in the company.

**However, where the obligation to make a mandatory offer under Rule 9 might arise following an issue of new shares, the Panel will normally consent to a waiver of that obligation provided that, among other things, this is approved by a vote of independent shareholders. In this case, the Panel has been consulted and has agreed, subject to the passing on a poll by the Lloyds TSB Shareholders, other than HM Treasury, of Ordinary Resolution 2 set out in the notice convening the Lloyds TSB General Meeting, to waive the obligation to make a general offer to Lloyds TSB Shareholders under Rule 9 that might otherwise arise on HM Treasury upon completion of the Placing and Open Offer and the Acquisition**

Following the Lloyds TSB General Meeting and depending, among other things, on the number of shares acquired by Lloyds TSB Shareholders pursuant to the Placing and Open Offer and the number of shares acquired by HBOS Shareholders pursuant to the HBOS Placing and Open Offer, HM Treasury may in aggregate hold shares carrying more than 30 per cent. but not more than 50 per cent. of the Enlarged Group's voting share capital. In such circumstances any further increase by HM Treasury in its aggregate interests in shares will be subject to the provisions of Rule 9.

## **15 Current Trading, Trends and Prospects**

Lloyds TSB issued an interim management statement on 3 November 2008 commenting on trading since the interim results of the current financial year. This is set out in full in Part VII ("Information on the Lloyds TSB Group") of this document however the highlights are summarised below:

- Lloyds TSB continues to trade well and deliver good income growth from its relationship businesses in an immensely challenging period for financial services companies. However, the impact of market dislocation, insurance related volatility and higher impairments, particularly in Lloyds TSB's corporate lending portfolios, has led to a substantial reduction in statutory profit before tax in the first nine months of the year.
- Excluding the impact of market dislocation and insurance related volatility, each division has achieved revenue growth in excess of cost growth.
- Lloyds TSB has continued to capture market share in a number of key areas, whilst improving new business product margins.
- Lloyds TSB has maintained its strong liquidity and funding position, with its wholesale funding maturity profile at a similar level to twelve months ago.
- Lloyds TSB remains on track to deliver a good trading performance in 2008, notwithstanding the continued deterioration in the UK economic environment.

Against the backdrop of current economic uncertainty, the Lloyds TSB Board has confidence in the opportunities available to the Enlarged Group. The Lloyds TSB Directors believe that the Enlarged Group will be more competitive and will be better placed to create sustainable shareholder value than Lloyds TSB would on a standalone basis in what is now a materially more challenging market environment. The Lloyds TSB Directors therefore believe that the Enlarged Group will be strongly positioned for this new environment.

HBOS also issued an interim management statement on 3 November 2008, which is set out in full in Part XIII ("HBOS Interim Management Statement 3 November 2008") of this document.



## **16 Lloyds TSB General Meeting**

The notice convening the Lloyds TSB General Meeting to be held at the Scottish Exhibition and Conference Centre, Glasgow G3 8YW at 11:00 a.m. on 19 November 2008 is set out at the end of this document. The purpose of the meeting is to approve certain resolutions, including in connection with the Acquisition and the Placing and Open Offer, a summary of which is set out below:

### **The Acquisition**

#### *Ordinary Resolution 1*

This resolution will be proposed as an ordinary resolution requiring a simple majority of votes in favour.

This resolution proposes to approve the Acquisition and to authorise the Lloyds TSB Board to make such waivers, extensions, amendments or variations to any of the terms and conditions of the Acquisition and to take all such steps as may be necessary in connection with the Acquisition.

The Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution.

### **Rule 9 Waiver**

#### *Ordinary Resolution 2*

This resolution will be proposed as an ordinary resolution requiring a simple majority of votes in favour and will be taken on a poll. In accordance with the City Code, HM Treasury shall not be entitled to vote on this resolution.

Ordinary Resolution 2 proposes to approve the waiver granted by the Panel of the obligation that might otherwise arise on HM Treasury to make a general offer to Lloyds TSB Shareholders as a result of the issue of new Lloyds TSB Shares to HM Treasury pursuant to the Placing and Open Offer and the Acquisition.

The Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution (unless waived by HM Treasury).

### **The Consideration and Open Offer Shares, New Preference Shares and Replacement Lloyds TSB Preference Shares**

#### *Ordinary Resolution 3*

This resolution will be proposed as an ordinary resolution requiring a simple majority of votes in favour.

Ordinary Resolution 3 proposes:

- to increase the Company's authorised share capital by £3,884,227,055 by the creation of 14,911,908,221 Lloyds TSB Shares and 625,000,000 Lloyds TSB Preference Shares. This represents an increase of approximately 213 per cent. in the authorised ordinary share capital of the Company and 357 per cent. in the authorised sterling preference share capital as at 29 October 2008, the last practicable date before the publication of this document. This will enable the Company to issue sufficient Consideration Shares, Open Offer Shares and Replacement Lloyds TSB Preference Shares for the purposes of the Acquisition, Placing and Open Offer, HBOS Preference Share Scheme (respectively) and also for general headroom purposes (including in connection with the Capitalisation Issue); and
- to authorise the Lloyds TSB Board to allot the new shares being issued pursuant to Ordinary Resolution 3. The Lloyds TSB Directors at present intend to use this authority to allot some of these Lloyds TSB Shares pursuant to the Acquisition and the Placing and Open Offer, to allot some of these Lloyds TSB Preference Shares pursuant to the HBOS Preference Share Scheme and to allot some of these Lloyds TSB Shares pursuant to any capitalisation effected under the authority covered by Ordinary Resolution 4. This authority will expire on the day of the annual general meeting in 2009 or on 7 August 2009, whichever is the earlier. This authority would relate to Lloyds TSB Shares representing approximately 274 per cent. of the current ordinary issued share capital.

The Acquisition, the Placing and Open Offer, the New Preference Share Issue, the HBOS Preference Share Scheme and the Capitalisation Issue are conditional on the passing of this resolution.

### **Capitalisation Issue**

#### *Ordinary Resolution 4*

This resolution will be proposed as an ordinary resolution requiring a simple majority of votes in favour. This resolution is conditional upon Ordinary Resolution 3 being passed.

Ordinary Resolution 4 proposes to authorise the Lloyds TSB Board to capitalise an amount out of the sums standing to the credit of any of the Company's share premium account, capital redemption reserve or other undistributable reserve of up to the maximum amount standing to the credit of such reserves and to authorise the Board to apply such amount in paying up the new Lloyds TSB Shares and to take all such other steps as it may deem necessary, expedient or appropriate to implement such capitalisation.

None of the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution.

### **Directors' Remuneration**

#### *Ordinary Resolution 5*

This resolution will be proposed as an ordinary resolution requiring a simple majority of votes in favour.

Ordinary Resolution 5 proposes to increase the ordinary remuneration of the Lloyds TSB Directors, to be divisible among them, to a sum not exceeding £1,000,000 in any year. This resolution would increase the total amount of fees that can be paid to the directors from £750,000 to £1,000,000 in any year. The current amount of £750,000 was approved by Lloyds TSB Shareholders in 2006. This proposed increase is in anticipation of an enlarged Lloyds TSB Board following completion of the Acquisition.

None of the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution.

### **Share Buy-back**

#### *Ordinary Resolution 6*

This resolution will be proposed as an ordinary resolution requiring a simple majority of votes in favour.

Ordinary Resolution 6 proposes to grant the Lloyds TSB Board a general authority to repurchase the Enlarged Group HMT Preference Shares on such terms as the Lloyds TSB Board may from time to time determine but subject to certain parameters as set out in the resolution itself.

None of the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution.

### **Section 89 disapplication**

#### *Special Resolution 7*

This resolution will be proposed as a special resolution requiring a 75 per cent. majority of votes in favour.

Special Resolution 7 proposes to renew the power conferred on the Lloyds TSB Directors by article 9.3 of the Company's articles of association for the period from the date of the Lloyds TSB General Meeting to the day of the annual general meeting in 2009 or on 7 August 2009, whichever is the earlier, and for that period the section 89 amount shall be £205,577,100 if Ordinary Resolution 3 is passed (equivalent to 822,308,400 ordinary shares of 25 pence each in the capital of the Company) or £75,647,511 if Ordinary Resolution 3 is rejected (equivalent to 302,590,044 ordinary shares of 25 pence each in the capital of the Company). This resolution would, following the cash placing undertaken and announced by the Company, on 19 September 2008, renew the Lloyds TSB Board's power to issue shares for cash to persons other than existing Lloyds TSB Shareholders provided that any such issue of Lloyds TSB Shares to these persons would represent no more than 5 per cent. of the issued ordinary share capital of the Company. In

addition, if the Company were to purchase its own shares and hold them in treasury, this resolution would give the Lloyds TSB Board power to sell these shares for cash to persons other than existing Lloyds TSB Shareholders, subject to the same limit that would apply to issues of shares for cash to these persons.

None of the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution.

### **Change of name**

#### *Special Resolution 8*

This resolution will be proposed as a special resolution requiring a 75 per cent. majority of votes in favour.

Special Resolution 8 proposes that, subject to the Acquisition being authorised pursuant to Ordinary Resolution 1 above and becoming unconditional, to change the Company's name to Lloyds Banking Group plc.

This resolution is conditional on the Acquisition being completed. None of the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme are conditional on the passing of this resolution.

In accordance with article 62.1 of the Company's articles of association, the Lloyds TSB Board has determined that holders of limited voting shares shall be entitled to vote in respect of such shares on Ordinary Resolution 1 only.

The full text of the Resolutions is set out in the notice convening the Lloyds TSB General Meeting at the end of this document.

**In the event that either or both Ordinary Resolution 1 and Ordinary Resolution 3 are not passed, none of the Acquisition, the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme will proceed.**

### **17 Action to be taken**

You will find enclosed with this document a Form of Proxy for use at the Lloyds TSB General Meeting or at any adjournment thereof. You are requested to complete and sign the Form of Proxy whether or not you propose to attend the Lloyds TSB General Meeting in person in accordance with the instructions printed on it and return it as soon as possible, but in any event so as to be received no later than 11.00 a.m. on 17 November 2008, by the Company's Registrar, Equiniti. CREST members may also choose to utilise the CREST electronic proxy appointment service in accordance with the procedures set out in the notice convening the Lloyds TSB General Meeting at the end of this document. The lodging of the Form of Proxy (or the electronic appointment of a proxy) will not preclude you from attending and voting at the meeting in person if you so wish.

### **18 Further Information**

Your attention is drawn to the further information set out in Parts II ("Risk Factors") to XII ("Additional Information") of this document. You should read the whole of this document and should not rely solely on the information set out in this letter. **In particular, you should read the risk factors set out in the section headed "Risk Factors" on pages 29 to 46 of this document.**

### **19 Recommendation**

The Lloyds TSB Board considers that the Acquisition and the Resolutions are in the best interests of Lloyds TSB and the Lloyds TSB Shareholders as a whole.

The Lloyds TSB Board has received financial advice in respect of the Acquisition from Citi, Lazard, Merrill Lynch and UBS, who, in providing such advice, relied upon the Lloyds TSB Board's commercial assessments of the Acquisition.

The Lloyds TSB Board, which has been so advised by Citi, Merrill Lynch and UBS, further considers that the Placing and Open Offer and the Rule 9 Waiver are fair and reasonable and in the best interests of the Lloyds TSB Shareholders as a whole. In providing such advice, Citi, Merrill Lynch and UBS have taken into account the Lloyds TSB Board's commercial assessments.

The Lloyds TSB Board unanimously recommends that Lloyds TSB Shareholders vote in favour of the Resolutions to be put to the Lloyds TSB General Meeting as they intend to do in relation to their own individual holdings which amount in total to 1,316,034 Lloyds TSB Shares, representing approximately 0.02 per cent. of the existing issued ordinary share capital of Lloyds TSB.

Yours faithfully,

A handwritten signature in black ink, appearing to read "Victor Blank". The signature is written in a cursive style with a large, sweeping initial 'V'.

Victor Blank  
Chairman

## PART II

### RISK FACTORS

*The Lloyds TSB Group's and/or, following the Acquisition, the Enlarged Group's operating results, financial condition and prospects could be materially and adversely affected by any of the risks described below. In that event, the value of the Lloyds TSB Shares could decline, and investors could lose all or part of their investment in the Lloyds TSB Shares.*

*This section describes the risk factors which are considered by the Lloyds TSB Directors to be material in relation to the Lloyds TSB Group and/or which will, following the Acquisition, apply to the Enlarged Group. Where risks are described in terms of a risk to an investment in Lloyds TSB Shares these apply and are equally relevant to the Open Offer Shares and to the Consideration Shares as well as to the Lloyds TSB ADRs and Consideration ADRs which represent the underlying Lloyds TSB Shares and Consideration Shares respectively.*

*These risks should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. Additional risks and uncertainties that are not presently known to the Lloyds TSB Directors, or which they currently deem immaterial, may also have an adverse effect on the Lloyds TSB Group's and/or, if the Acquisition becomes Effective, the Enlarged Group's operating results, financial condition and prospects. The information given is as of the date of this document and, except as required by the FSA, the London Stock Exchange, the Takeover Panel, the Listing Rules, the Prospectus Rules, the Disclosure and Transparency Rules, the City Code or any other applicable law or regulation, will not be updated. Any forward-looking statements are made subject to the reservations specified under "Forward-Looking Statements" on page 3 of this document.*

*You should consider carefully the risks and uncertainties described below, together with all other information contained in this document and the information incorporated by reference herein, before making any investment decision or any decision whether or not to vote in favour of the Resolutions.*

#### **Risks relating to the Lloyds TSB Group and, if the Acquisition becomes Effective, the Enlarged Group**

**1.1 *The Lloyds TSB Group's businesses are, and the Enlarged Group's businesses will be, subject to inherent risks arising from general and sector specific economic conditions in the markets in which they operate, particularly the United Kingdom. Adverse developments, such as the current and ongoing crisis in the global financial markets and further deterioration of general economic conditions, particularly in the UK, have already adversely affected the Lloyds TSB Group's earnings and profits and could continue to cause its and the Enlarged Group's profitability to decline***

The Lloyds TSB Group's businesses are, and the Enlarged Group's businesses will be, subject to inherent risks arising from general and sector specific economic conditions in the markets in which they operate, particularly the United Kingdom in which the Lloyds TSB Group's earnings are, and the Enlarged Group's earnings will be, predominantly generated. Over approximately the past fifteen months, the global economy and the global financial system have been experiencing a period of significant turbulence and uncertainty, particularly the very severe dislocation of the financial markets around the world that began in August 2007 and has substantially worsened since September 2008 and related problems at many large global and UK commercial banks, investment banks, insurance companies and other financial and related institutions. This dislocation has severely impacted general levels of liquidity, the availability of credit and the terms on which credit is available. This crisis in the financial markets led the United Kingdom and other governments to inject liquidity into the financial system and require (and participate in) recapitalisation of the banking sector to reduce the risk of failure of certain large institutions and provide confidence to the market.

Despite this intervention, the volatility and market disruption in the banking sector have continued to a degree unprecedented in recent history. This market dislocation has also been accompanied by recessionary conditions and trends in many economies throughout the world, including the United Kingdom. There is increasing concern of a deep and prolonged global recession. These conditions have already adversely affected the Lloyds TSB Group's and the

HBOS Group's earnings and profits. Continued general deterioration in the UK or other major economies throughout the world, including, but not limited to, business and consumer confidence, unemployment trends, the state of the housing market, the commercial real estate sector, equity markets, bond markets, foreign exchange markets, counterparty risk, inflation, the availability and cost of credit, lower transaction volumes in key markets, the liquidity of the global financial markets and market interest rates, would reduce the level of demand for, and supply of, the Lloyds TSB Group's and the Enlarged Group's products and services, lead to lower realisations and write downs and impairments of investments and negative fair value adjustments of assets and materially and adversely impact their operating results, financial condition and prospects.

Additionally, the profitability of the Lloyds TSB Group's and the Enlarged Group's insurance businesses could be affected by increased claims from market factors such as increased unemployment. Significantly higher UK unemployment, reduced corporate profitability, increased corporate insolvency rates, increased personal insolvency rates and/or increased interest rates may reduce borrowers' ability to repay loans and may cause prices of residential or commercial real estate or other asset prices to fall further, thereby reducing the collateral value on many of the Lloyds TSB Group's and the Enlarged Group's loans and increasing write downs and, if this happens, impairment losses will occur. Poor general economic conditions and difficulty in valuation have depressed asset valuations for both the Lloyds TSB Group and the HBOS Group and are likely to continue to do so. This would be exacerbated by a further deterioration in general economic conditions.

As discussed in greater detail in the risk factor numbered 1.3 in this Part II ("Risk Factors") below, the Lloyds TSB Group has not yet been able to assess fully the level of fair value adjustments of the assets of the HBOS Group to be acquired in the Acquisition or other aspects of the HBOS business. If the fair valuation of the assets of the HBOS Group is materially less than anticipated, this could have a material and adverse impact on the financial condition and prospects of the Enlarged Group.

The exact nature of the risks faced by the Lloyds TSB Group and the Enlarged Group is difficult to predict and guard against in view of the severity of the global financial crisis and the fact that many of the related risks to the business are totally or in part outside of the control of the Lloyds TSB Group and the Enlarged Group.

**1.2 *The Lloyds TSB Group's businesses are, and the Enlarged Group's businesses will be, inherently subject to the risk of market fluctuations, which could adversely affect operating results, financial condition and prospects***

The Lloyds TSB Group's businesses are, and the Enlarged Group's businesses will be, inherently subject to the risk of financial market fluctuations, including changes in, and increased volatility of, interest rates, inflation rates, credit spreads, foreign exchange rates, commodity, equity, bond and property prices and the risk that their customers act in a manner which is inconsistent with business, pricing and hedging assumptions.

Market movements have (and will have) an impact on the Lloyds TSB Group and the Enlarged Group in a number of key areas. For example, adverse market movements would have an adverse effect, which could be material, upon the financial condition of the pension schemes of the Lloyds TSB Group and the Enlarged Group. In addition, banking and trading activities that are undertaken by the Lloyds TSB Group and will be undertaken by the Enlarged Group are subject to interest rate risk, foreign exchange risk, inflation risk and credit spread risk. For example, changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Since August 2007, there has been a period of unprecedented high and volatile interbank lending rates (to the extent banks have been willing to lend at all), which has exacerbated these risks. Competitive pressures or fixed rates in existing loan commitments or facilities may mean that the Lloyds TSB Group and the Enlarged Group will be restricted in their ability to increase interest rates charged to customers in response to changes in interest rates that affect wholesale borrowing. In addition, such increases in interest rates may result in each of the Lloyds TSB Group and the Enlarged Group having to increase the rates paid to wholesale and retail customers, which would have an adverse impact on net interest margins.

The insurance and investments businesses of the Lloyds TSB Group, and of the Enlarged Group, will face market risk arising, for example, from equity, bond and property markets in a number of ways depending upon the product and associated contract. Some of these risks

are borne directly by the customer and some are borne by the insurance and investments businesses. Some insurance contracts involve guarantees and options that increase in value in adverse investment markets. There is a risk that the insurance and investments businesses will bear some of the cost of such guarantees and options. The insurance and investments businesses also have capital invested in the markets that are exposed to market risk. The performance of the investment markets will thus have a direct impact upon the Embedded Value of insurance and investments contracts and the Lloyds TSB Group's and Enlarged Group's operating results, financial condition and prospects. Adverse investment market conditions can affect investor confidence, which in turn can result in lower sales and/or reduced persistency.

Changes in foreign exchange rates affect the value of assets and liabilities denominated in foreign currencies and may affect earnings reported by the Lloyds TSB Group and the Enlarged Group. In the Lloyds TSB Group's and the Enlarged Group's international businesses, earnings and net assets are denominated in local currency, which will fluctuate with exchange rates in pounds sterling terms. It is difficult to predict with any accuracy changes in economic or market conditions, and such changes could have a material adverse effect on the Lloyds TSB Group's and the Enlarged Group's operating results, financial condition and prospects.

**1.3 *Market conditions have and may in the future result in material negative adjustments to the estimated fair values of financial assets of the Lloyds TSB Group and the Enlarged Group. This may include material negative adjustments to the valuation of financial assets that the Lloyds TSB Group will acquire as part of the Acquisition compared to the book value of such assets as at 30 June 2008. Any such negative fair value adjustments could have a material adverse effect on operating results, financial conditions or prospects***

Financial markets have been subject to significant stress conditions resulting in steep falls in perceived or actual financial asset values. The severity of this phenomenon is exemplified by the current and ongoing crisis in the global financial markets.

The fair value of the Lloyds TSB Group's and the Enlarged Group's financial assets could fall further and therefore result in negative adjustments, particularly in view of current market dislocation and the prospect of recession. Asset valuations in future periods, reflecting then-prevailing market conditions, may result in further negative changes in the fair values of the Lloyds TSB Group's and the Enlarged Group's financial assets. In addition, the value ultimately realised by the Lloyds TSB Group and the Enlarged Group may be lower than the current fair value. Any of these factors could require the Lloyds TSB Group and the Enlarged Group to record further negative fair value adjustments, which may have a material adverse effect on their operating results, financial condition or prospects.

The Lloyds TSB Group has made, and the Enlarged Group may make in the future, asset redesignations as permitted by recent amendments to IAS 39. The effect of such redesignations has been and would be that any effect on the profit and loss account of movements in the fair value of such redesignated assets that has occurred since 1 July 2008, in the case of assets redesignated prior to 1 November 2008, or may occur in the future may not be recognised until such time as the assets become impaired or are disposed of.

In addition, to the extent that fair values are determined using financial valuation models, the data used by such models may not be available or may become unavailable due to changes in market conditions, particularly for illiquid assets, and particularly in times of substantial instability such as the current economic crisis. In such circumstances the Lloyds TSB Group's valuation methodologies require it to make assumptions, judgments and estimates in order to establish fair value. These valuation models are complex and the assumptions used are difficult to make and are inherently uncertain, particularly in light of the uncertainty resulting from the current and ongoing crisis in the global financial markets.

In addition to some exposures of the Lloyds TSB Group to similar investments, the HBOS Group has, and the Enlarged Group will have, a significant portfolio of securities and other investments including asset backed securities, structured investments and private equity investments that are recorded at fair value and are therefore exposed to further negative fair value adjustments in the event of deterioration in market conditions.

Furthermore, fair value adjustments will be required in connection with the Acquisition. The *pro forma* net assets of the HBOS Group set out in Part IX (“Historical Financial Information Relating to HBOS plc”) of this document have been extracted from the HBOS Group’s interim report for the six months ended 30 June 2008, and do not take account of any fair value adjustments that will be required as a result of the Acquisition. The Lloyds TSB Group has not yet been able to assess fully the level of fair value adjustments of the assets of the HBOS Group. These adjustments may be material. The provisional results of this valuation exercise are not expected to be available until such time as the Lloyds TSB Group publishes its interim financial statements for the six month period ended 30 June 2009. Given the material deterioration in the value of the financial assets since 30 June 2008, and the market outlook for the near future, as well as the different valuation methodologies for such assets, following the Acquisition, such fair valuations will differ from the book value of the HBOS Group’s net assets at 30 June 2008 and such difference may be material.

**1.4 *The Lloyds TSB Group’s businesses are, and the Enlarged Group’s businesses will be, subject to inherent risks concerning borrower and counterparty credit quality which could affect the recoverability and value of assets on the balance sheet. As a result of the Acquisition, the Enlarged Group will have greater exposure to certain sectors and asset classes than the Lloyds TSB Group currently has***

The Lloyds TSB Group makes, and the Enlarged Group will make, both secured and unsecured loans to retail and corporate customers. The Lloyds TSB Group’s businesses are, and the Enlarged Group’s businesses will be, subject to inherent risks regarding the credit quality of, and the recovery on loans to and amounts due from, customers and market counterparties. Changes in the credit quality of the Lloyds TSB Group’s or the Enlarged Group’s UK and/or international borrowers and counterparties, or in their behaviour, or arising from systemic risks in the UK and global financial system, could reduce the value of the Lloyds TSB Group’s and the Enlarged Group’s assets, and increase the Lloyds TSB Group’s and the Enlarged Group’s write downs and allowances for impairment losses. Factors including higher UK unemployment, reduced corporate profitability, increased corporate and personal insolvencies and/or increased interest rates may reduce borrowers’ ability to repay loans. The outlook for the UK (and the global) economy has deteriorated significantly in recent months and this deterioration is expected to continue for the foreseeable future. In addition, changes in economic conditions may result in a deterioration in the value of security held against lending exposures and increase the risk of loss in the event of borrower default.

UK house prices have declined significantly in recent months, reflecting economic downturn and uncertainty, reduced affordability and lower availability of credit. Economic or other factors are likely to lead to further contraction in the mortgage market and further decreases in housing prices. Many borrowers in the UK borrow on short-term fixed or discounted floating rates and when such rates expire the continued reduced supply and stricter terms of mortgages together with the potential for higher mortgage rates have led and will continue to lead to higher delinquency rates. The Lloyds TSB Group and, to a greater extent, the HBOS Group both provide mortgages to buy-to-let investors where an excess supply of rental property or falls in rental demand could also impact the borrowers’ income and ability to service the loans. In addition, the HBOS Group has a substantial exposure to the self certified mortgage sector where the Lloyds TSB Group has no exposure. If the current economic downturn continues, with further falls in house prices and increases in unemployment, the Enlarged Group’s mortgage portfolios are likely to generate substantial increases in impairment losses which could materially affect the operations, financial condition and prospects of the Enlarged Group.

The average rating of the HBOS Group’s corporate lending portfolio is lower than that of the Lloyds TSB Group, with substantial lending to mid-sized and private companies. The HBOS Group also has greater exposure to leveraged finance and subordinated loans, as well as significant exposure to the commercial real estate sector, including hotels and residential property developers. Commercial real estate prices have shown declines over the last year and the construction and real estate sectors are facing very challenging market conditions. If the current economic downturn continues, as expected, with weakening consumer spending and falling corporate profitability, the Enlarged Group’s corporate lending portfolios are likely to generate substantial increases in impairment losses which could materially affect the operations, financial condition and prospects of the Enlarged Group.



**1.5 *The Lloyds TSB Group's businesses are, and the Enlarged Group's businesses will be, subject to inherent risks concerning liquidity, particularly if current market conditions continue to reduce the availability of traditional sources of funding or the access to wholesale money markets becomes more limited, which could affect the Lloyds TSB Group's and the Enlarged Group's ability to meet its financial obligations as they fall due***

The Lloyds TSB Group's businesses are, and the Enlarged Group's businesses will be, subject to risks concerning liquidity, which are inherent in banking operations, and could affect the Lloyds TSB Group's and the Enlarged Group's ability to meet financial obligations as they fall due or to fulfil commitments to lend. The HBOS Group has a funding profile that involves the need to refinance a significantly higher level of loan assets than that of the Lloyds TSB Group. Accordingly, the Enlarged Group's funding profile will involve higher refinancing risk than for the Lloyds TSB Group on a stand-alone basis. It is expected that the Enlarged Group will be required to refinance a significant amount of funding due to mature during 2009. These risks can be exacerbated by many enterprise-specific factors, including an over-reliance on a particular source of funding (including, for example, securitisations, covered bonds and short-term and overnight money markets), and changes in credit ratings, or market-wide phenomena such as market dislocation and major disasters. There is also a risk that corporate and institutional counterparties may look to reduce aggregate credit exposures to the Enlarged Group or to all banks. The funding needs of the Enlarged Group will increase to the extent that customers, including conduit vehicles of the Enlarged Group, draw down under existing credit arrangements with the Enlarged Group and such increases in funding needs may be material. In order to continue to meet their funding obligations and to maintain or grow their businesses generally the Lloyds TSB Group relies, and the Enlarged Group will rely, on customer savings and transmission balances, as well as ongoing access to the wholesale lending markets and Bank of England liquidity facilities and the UK Government's guarantee scheme. The ability of the Lloyds TSB Group and the Enlarged Group to access wholesale and retail funding sources on favourable economic terms is subject to a variety of factors, including a number of factors outside of their control, such as liquidity constraints, general market conditions, loss of confidence in the UK banking system. See the risk numbered 1.18 for a discussion of the competitive nature of the banking industry and competitive pressures that could have a negative impact on the availability of customer deposits and retail funding. In the current environment of unprecedented market volatility, banks' access to traditional sources of liquidity has been and may continue to be significantly restricted which may affect Lloyds TSB Group's and the Enlarged Group's access to such sources of liquidity.

While various governments including the UK government have taken substantial measures to ease the crisis in liquidity, such as the measures announced in the UK on 8 October 2008 and 13 October 2008, there can be no assurance that these measures will succeed in materially improving the liquidity position of major UK banks, including the Lloyds TSB Group and the Enlarged Group. In addition, the availability and the terms on which any such measures will be made available to the Company (whether in the form of access to HM Treasury's recapitalisation scheme, special liquidity scheme or guarantees scheme for short and medium term debt issuance) and how and when such measures will be implemented are uncertain. Lloyds TSB has, and the Enlarged Group will have, no influence over the policy making behind such measures. Further, there can be no assurance that these conditions will not lead to an increase in the overall cost of funding of the Lloyds TSB Group or the Enlarged Group. The Lloyds TSB Group expects that the Enlarged Group will substantially rely for the foreseeable future on the continued availability of Bank of England liquidity facilities as well as HM Treasury's guarantee scheme for short and medium-term debt issuance. If the Bank of England liquidity facility, HM Treasury's guarantee scheme or other sources of short-term funding are not available after that period, the Lloyds TSB Group, or the Enlarged Group, could face serious liquidity constraints, which would have a material adverse impact on its solvency.

Access to sufficient liquidity might also determine whether or not the Lloyds TSB Group will be in a position to redeem or repurchase the Enlarged Group HMT Preference Shares to be held by HM Treasury in accordance with their terms or, if circumstances permit, to repurchase them early. See the risk numbered 3.4 for a discussion of the limitation on cash dividends and other terms of the Enlarged Group HMT Preference Shares.

**1.6 *The Lloyds TSB Group is subject, and the Enlarged Group will be subject, to the risk of insufficient capital resources to meet the minimum required by regulators***

The Lloyds TSB Group is, and the Enlarged Group will be, subject to the risk, inherent in all regulated financial businesses, of having insufficient capital resources to meet the minimum regulatory capital requirements. In addition, those minimum regulatory requirements may increase in the future.

In the Lloyds TSB Group's announcement of 13 October 2008 it stated that the *pro forma* core Tier 1 capital ratio for the Enlarged Group as at 30 June 2008 would have been in excess of 8.5 per cent.<sup>1</sup> Such *pro forma* core Tier 1 capital ratio number does not take account of net negative capital adjustments that would be required to be made since that date and is for illustrative purposes only. Lloyds TSB has made a preliminary assessment that net negative capital adjustments of no more than £10 billion after tax would need to be made to HBOS's financial position for core Tier 1 capital purposes as a result of the Acquisition, the effect of which would mean that the Enlarged Group would have a core Tier 1 ratio of 7 per cent.

The Enlarged Group's ability to maintain its targeted and regulatory capital ratios will depend on a number of factors, including post-Acquisition net synergies and implementation costs, the level of Enlarged Group's risk weighted assets, the Enlarged Group's post-tax profit and the level of net negative capital adjustments resulting from the Acquisition. More specifically, the Enlarged Group's ability to maintain its targeted and regulatory capital ratios will be significantly impacted by net negative capital adjustments resulting from the Acquisition. In addition to the impact of net negative capital adjustments, the Enlarged Group's core Tier 1 ratio will be directly impacted by any shortfall in forecasted after-tax profit (which could result, most notably, from greater than anticipated asset impairments and/or adverse volatility relating to the issuance business). Furthermore, under Basel II, capital requirements are inherently more sensitive to market movements than under previous regimes and capital requirements will increase if economic conditions or negative trends in the financial markets worsen. Any failure of the Enlarged Group to maintain its minimum regulatory capital ratios could result in administrative actions or sanctions, which in turn may have a material adverse impact on the Lloyds TSB Group's and the Enlarged Group's operating results, financial condition and prospects. A shortage of available capital would also affect the ability to continue organic growth or to pursue acquisition or other strategic opportunities. For further information see paragraph 9 of Part I ("Letter from Sir Victor Blank, Chairman of Lloyds TSB Group plc") of this document.

The Lloyds TSB Group's life assurance and general insurance businesses in the UK are, and the Enlarged Group's will be, subject to the capital requirements prescribed by the FSA, and the Lloyds TSB Group's life and general insurance companies outside the UK are, and the Enlarged Group's will be, subject to local regulatory capital requirements. In July 2007, the European Commission published a draft proposal for primary legislation to define broad "framework" principles for Solvency II, a fundamental review of the capital adequacy regime for the European insurance industry. Solvency II aims to establish a revised set of EU-wide capital requirements where the required regulatory capital will be dependent upon the risk profile of the entities, together with risk management standards, that will replace the current Solvency I requirements. At this early stage of development, it is not possible to predict the ultimate impact of this proposed regime on the Lloyds TSB Group's or the Enlarged Group's capital. However, the final regime could significantly impact the regulatory capital the Lloyds TSB Group's or the Enlarged Group's life assurance and general insurance businesses are required to hold.

**1.7 *The Lloyds TSB Group and the Enlarged Group could be negatively affected by the soundness and/or the perceived soundness of other financial institutions, which could result in significant systemic liquidity problems, losses or defaults by other financial institutions and counterparties***

Against the backdrop of the lack of liquidity and high cost of funds in the interbank lending market, which is unprecedented in recent history, the Lloyds TSB Group is, and the Enlarged Group will be, subject to the risk of deterioration of the commercial soundness and/or perceived soundness of other financial services institutions within and outside the United Kingdom. Financial services institutions that deal with each other are interrelated as a result of trading, investment, clearing, counterparty and other relationships. This risk is sometimes

referred to as “systemic risk” and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges with whom the Lloyds TSB Group interacts and the Enlarged Group will interact on a daily basis, all of which could have an adverse effect on the Lloyds TSB Group’s and the Enlarged Group’s ability to raise new funding.

The Lloyds TSB Group routinely executes, and the Enlarged Group will routinely execute, a high volume of transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds and other institutional clients, resulting in a significant credit concentration. As a result, the Lloyds TSB Group is, and the Enlarged Group will be, exposed to counterparty risk as a result of recent financial institution failures and nationalisations and will continue to be exposed to the risk of loss if counterparty financial institutions fail or are otherwise unable to meet their obligations. A default by, or even concerns about the ability of, one or more financial services institutions could lead to further significant systemic liquidity problems, or losses or defaults by other financial institutions, which could materially and adversely affect the Lloyds TSB Group’s and the Enlarged Group’s operating results, financial condition and prospects.

**1.8 *If the perceived credit-worthiness of monoline insurers and other market counterparties continues to deteriorate, the Lloyds TSB Group and the Enlarged Group may be forced to record further credit valuation adjustments on securities insured or guaranteed by such parties, which could have a material adverse effect on the Lloyds TSB Group’s and the Enlarged Group’s results of operations, financial condition and prospects***

The Lloyds TSB Group has, and the Enlarged Group will have, credit exposure to monoline insurers and other market counterparties through securities insured or guaranteed by such parties and credit protection bought from such parties with respect to certain over-the-counter derivative contracts, mainly credit default swaps (“CDSs”) which are carried at fair value. The fair value of these underlying CDSs and other securities, and the Lloyds TSB Group’s and the Enlarged Group’s exposure to the risk of default by the underlying counterparties, depend on the valuation and the perceived credit risk of the instrument insured or guaranteed or against which protection has been bought as well as on the credit-worthiness of the relevant monoline or other insurer. In 2007 and 2008, monoline and other insurers and other market counterparties have been adversely affected by their exposure to residential mortgage-linked products, and their perceived credit-worthiness has deteriorated significantly in 2008. Their credit-worthiness may further deteriorate as a consequence of the deterioration of the value of underlying assets. Although the Lloyds TSB Group tries, and the Enlarged Group will try, to limit and manage direct exposure to monoline or other insurers and other market counterparties, indirect exposure may exist through other financial arrangements and counterparties. If the financial condition of monoline or other insurers or market counterparties or their perceived credit-worthiness deteriorates further, the Lloyds TSB Group and/or the Enlarged Group may record further credit valuation adjustments on the underlying instruments insured by such parties in addition to those already recorded. In addition, to the extent that asset devaluations lower the credit-worthiness of monoline insurers, the Lloyds TSB Group and the Enlarged Group would be further exposed to diminished credit-worthiness of such insurers themselves. Any primary or indirect exposure to the financial condition or credit-worthiness of these counterparties could have a material adverse impact on the results of operations, financial condition and prospects of the Lloyds TSB Group and/or the Enlarged Group.

**1.9 *The Lloyds TSB Group's and the Enlarged Group's insurance and investments businesses and employee pension schemes are subject to risks relating to insurance claims rates, pension scheme benefit payment levels and changes in insurance customer and employee pension scheme member behaviour***

The life and pensions insurance businesses of the Lloyds TSB Group and the Enlarged Group and their employee pension schemes are exposed to short-term and longer-term impacts arising from uncertain longevity and ill-health rates. Adverse developments in any of these factors will increase the size of the liabilities and may adversely affect the Lloyds TSB Group's and the Enlarged Group's financial condition and results of operations.

Customer behaviour in the life and pensions insurance business may result in increased propensity to cease contributing to or cancel insurance policies at a rate in excess of business assumptions. The consequent reduction in policy persistency and fee income would have an adverse impact upon the profitability of the life and pensions business of the Lloyds TSB Group and the Enlarged Group. The behaviour of employee pension scheme members affects the levels of benefits payable from the schemes. For example, the rate at which members cease employment affects the aggregate amount of benefits payable by the schemes. This rate may differ from applicable business assumptions. Adverse variances may increase the size of the aggregate pension liabilities and may adversely affect the Lloyds TSB Group's and the Enlarged Group's financial condition and results of operations.

The general insurance businesses of the Lloyds TSB Group and the Enlarged Group are exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims, higher levels of theft can increase claims on property, contents and motor vehicle insurance and changes to unemployment levels can increase claims on loan protection insurance. These claims rates may differ from business assumptions and negative developments may adversely affect the Lloyds TSB Group's and the Enlarged Group's financial condition and results of operations.

UK banks recognise an asset in their balance sheets representing the value of in-force business ("VIF") in respect of long term life assurance contracts, being insurance contracts and investment contracts with discretionary participation features. This asset represents the present value of future profits expected to arise from the portfolio of in-force life assurance contracts. Adoption of this accounting treatment results in the earlier recognition of profit on new business, but subsequently a lower contribution from existing business, when compared to the recognition of profits on investment contracts under IAS 39 (Financial Instruments: Recognition and Measurement). Differences between actual and expected experience may have a significant impact on the value of the VIF asset, as changes in experience can result in significant changes to modelled future cash flows. The VIF asset is calculated based on best estimate assumptions made by management, including the value of investments under management, mortality experience and persistency. If these assumptions prove incorrect, the VIF asset could be materially reduced, which in turn could have a material adverse effect on the Lloyds TSB Group's and the Enlarged Group's financial condition and results of operations.

Also, as further described in the risk numbered 1.2, the Lloyds TSB Group's and the Enlarged Group's insurance assets are subject to the risk of market fluctuations.

**1.10 *The Lloyds TSB Group's and the HBOS Group's borrowing costs and access to the capital markets depend significantly on their credit ratings, as will those of the Enlarged Group***

As at the date of this document, the long-term credit ratings for the Lloyds TSB Group are Aaa from Moody's Investors Service, AA from Standard & Poor's rating service, AA+ from Fitch Ratings and AA(H) from DBRS. As at the date of this document, the long-term credit ratings for the HBOS Group are Aa2 from Moody's Investors Service, A+ from Standard & Poor's rating service, AA from Fitch Ratings and AA(H) from DBRS. Recently, each of these ratings services placed the long-term credit ratings of both the Lloyds TSB Group and the HBOS Group on watch with negative implications. Reduction in the long-term credit ratings of the Lloyds TSB Group, the HBOS Group and/or the Enlarged Group could significantly increase their respective borrowing costs, limit their access to the capital markets and trigger additional collateral requirements in derivative contracts and other secured funding

arrangements. Therefore, a reduction in credit ratings could materially adversely affect the Enlarged Group's access to liquidity and competitive position and, hence, have a material adverse effect on the Enlarged Group's business, financial position and results of operations.

**1.11 *Weaknesses or failures in the Lloyds TSB Group's and the Enlarged Group's internal processes and procedures and other operational risks could have a negative impact on results and could result in reputational damage***

Operational risks, through inadequate or failed internal processes (including financial reporting and risk monitoring processes) or from people-related or external events, including the risk of fraud and other criminal acts carried out against the Lloyds TSB Group, are present in the Lloyds TSB Group's businesses and will be present in the business of the Enlarged Group. The Lloyds TSB Group's businesses and the HBOS Group's businesses are, and the Enlarged Group's business will be, dependent on their ability to process and report accurately and efficiently a high volume of complex transactions across numerous and diverse products and services, in different currencies and subject to a number of different legal and regulatory regimes. Following the Acquisition, the existing internal controls and procedures of the HBOS Group must be integrated with those of the Lloyds TSB Group. This is a complex and time consuming process and there can be no assurance that delays will not occur or that systems weaknesses or inadequacies will not be uncovered. Any weakness in such internal control systems and processes could have a negative impact on their results during the affected period. Furthermore, damage to the Lloyds TSB Group's or the Enlarged Group's reputation (including to customer confidence) arising from inadequacies, weaknesses or failures in such systems could have a significant adverse impact on the Lloyds TSB Group's and Enlarged Group's businesses.

**1.12 *The Lloyds TSB Group relies, and the Enlarged Group will rely, in part on retail deposits to fund lending activities, the ongoing availability of which is sensitive to factors outside the Lloyds TSB Group's control. Loss in consumer confidence could result in high levels of withdrawals, which could have a material adverse effect on the Lloyds TSB Group's and the Enlarged Group's business, financial position and results of operations and could, in extreme circumstances, prevent the Lloyds TSB Group or the Enlarged Group from meeting its minimum liquidity requirements***

Medium-term growth in the Lloyds TSB Group's and the Enlarged Group's lending activities will depend, in part, on the availability of retail funding on appropriate terms, for which there is increasing competition. This reliance has increased in the recent past given the difficulties in accessing wholesale funding. Increases in the cost of such funding will impact on the Lloyds TSB Group's and the Enlarged Group's margins and affect profit, and a lack of availability of such retail deposit funding could impact on the Lloyds TSB Group's and the Enlarged Group's future growth.

The ongoing availability of retail deposit funding is dependent on a variety of factors outside the Lloyds TSB Group's and the Enlarged Group's control, such as general economic conditions and the confidence of retail depositors in the economy in general and the financial services industry specifically and the availability and extent of deposit guarantees. These factors could lead to a reduction in the Lloyds TSB Group's and the Enlarged Group's ability to access retail deposit funding on appropriate terms in the future. If the current difficulties in the wholesale funding markets are not resolved or central bank lending to financial institutions is withdrawn it is likely that wholesale funding will prove even more difficult to obtain.

Any loss in consumer confidence in the banking businesses of the Lloyds TSB Group or the Enlarged Group could significantly increase the amount of retail deposit withdrawals in a short space of time. Should the Lloyds TSB Group or the Enlarged Group experience an unusually high level of withdrawals, this may have an adverse effect on the Lloyds TSB Group's and the Enlarged Group's business, financial position and results of operations and could, in extreme circumstances, prevent the Lloyds TSB Group or the Enlarged Group from meeting its minimum liquidity requirements. In such extreme circumstances the Lloyds TSB Group and/or the Enlarged Group may not be in a position to continue to operate without additional funding support, which it may be unable to access.

**1.13 *Terrorist acts, other acts of war, geopolitical, pandemic or other such events could have a negative impact on the business and results of the Lloyds TSB Group and the Enlarged Group***

Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events and responses to those acts/events, may create economic and political uncertainties, which could have a negative impact on UK and international economic conditions generally, and more specifically on the business and results of the Lloyds TSB Group and the Enlarged Group in ways that cannot necessarily be predicted.

**1.14 *The Lloyds TSB Group has agreed to certain undertakings in relation to the operation of its business in the Placing and Open Offer Agreement. The implications and details of some of these undertakings remain unclear and they could have a material adverse effect on the operations of the Lloyds TSB Group and the Enlarged Group***

Under the terms of the Placing and Open Offer Agreement, the Lloyds TSB Group has provided certain undertakings aimed at ensuring that the potential acquisition by HM Treasury of Lloyds TSB Shares and the Lloyds TSB Group's potential participation in the guarantee scheme to be promoted by HM Treasury as part of its support for the banking industry is consistent with the state aid approval. State aid approval means the decision of the European Commission of 13 October 2008 and issued in connection with the state aid aspects of the HM Treasury's recapitalisation scheme, special liquidity and guarantee scheme for short and medium term debt issuance. The state aid rules aim to prevent companies from being given an artificial or unfair competitive advantage as a result of governmental assistance. The undertakings are also aimed at supporting certain objectives of HM Treasury in providing assistance to the UK banking industry. These undertakings, which are consistent with the Lloyds TSB Group's existing focus in its relevant lines of business, include (i) supporting UK government policy in relation to mortgage lending and lending to SMEs through 2011; (ii) regulating management remuneration; (iii) regulating the rate of growth of the Lloyds TSB Group's balance sheet; and (iv) requiring the presentation to HM Treasury of a restructuring plan within six months (as all banks participating in HM Treasury's recapitalisation and guarantee schemes are required to do). There is a risk that these undertakings or any further requirements introduced by HM Treasury could have a materially adverse effect on the operations of the Lloyds TSB Group and the Enlarged Group. For a description of these undertakings, see Part V ("Conditions Relating to the Proposed Government Funding") of this document. In addition, pursuant to the conditions attaching to the Proposed Government Funding, the Lloyds TSB Board is required to consult with HM Treasury in relation to the appointment of two new independent directors.

Through the influence of its shareholding, the UK Government may seek to influence Lloyds TSB or the Enlarged Group in other ways that would have a materially adverse effect on the Lloyds TSB Group's and the Enlarged Group's business.

HM Treasury has agreed to consult with Lloyds TSB with a view to applying to the Commission to have the undertakings referred to above disapplied where (i) the Lloyds TSB Group is no longer participating in the guarantee scheme and (ii) HM Treasury either does not acquire shares in the Lloyds TSB Group or HM Treasury has substantively reduced its holding of Lloyds TSB Shares and/or preference shares.

**1.15 *The Lloyds TSB Group's businesses are, and the Enlarged Group's business will be, subject to substantial regulation, and regulatory and governmental oversight. Adverse regulatory developments or changes in government policy could have a significant negative impact on the Lloyds TSB Group's and the Enlarged Group's operating results, financial condition and prospects***

The Lloyds TSB Group conducts, and the Enlarged Group will conduct, their businesses subject to ongoing regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies, voluntary codes of practice and interpretations in the UK and the other markets where it operates. This is particularly the case in the current market environment, which is witnessing increased levels of government intervention in the banking sector. Future changes in regulation, fiscal or other policies are unpredictable and beyond the control of the Lloyds TSB Group and the Enlarged Group and could materially adversely affect the Lloyds TSB Group's and the Enlarged Group's business.

Areas where changes could have an adverse impact include, but are not limited to:

- the monetary, interest rate and other policies of central banks and regulatory authorities;
- general changes in government or regulatory policy or changes in regulatory regimes that may significantly influence investor decisions in particular markets in which the Lloyds TSB Group and the Enlarged Group operate, may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;
- other general changes in regulatory requirements, such as prudential rules relating to the capital adequacy or liquidity frameworks;
- changes to, or increased levies under, the arrangements for funding depositor or investor protection schemes and providing compensation in the event of a failure of another regulated firm, including for example, under the Financial Services Compensation Scheme in the UK to which the Lloyds TSB Group is and the Enlarged Group will be subject;
- external bodies applying or interpreting standards or laws differently to those applied by the Lloyds TSB Group or the HBOS Group historically;
- changes in competition and pricing environments;
- further developments in the financial reporting environment;
- expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; and
- other unfavourable political, military or diplomatic developments producing social instability or legal uncertainty which, in turn, may affect demand for the Lloyds TSB Group's and the Enlarged Group's products and services.

In addition, in the United Kingdom and elsewhere, there is continuing political and regulatory scrutiny of the banking industry and, in particular, retail banking. In the United Kingdom, the Competition Commission, the Financial Services Authority and the Office of Fair Trading are carrying out several inquiries, which are referred to in paragraphs 11.1.1 and 11.1.2 of Part XII ("Additional Information") of this document. In recent years there have been several issues in the UK financial services industry in which the FSA has intervened directly, including the sale of personal pensions and the sale of mortgage related endowments. There may be further inquiries in the future which could lead to further regulatory intervention.

For example in clearing the Acquisition without a reference to the Competition Commission the Secretary of State noted that there were some competition concerns identified by the OFT in the markets for personal current accounts and mortgages in Great Britain and the market for SME banking in Scotland. He said that he is asking the OFT to keep relevant markets under review in order to protect the interests of UK consumers and the British economy. It is too soon to tell what form, or implications for the Enlarged Group, those reviews might have.

The UK Government, the FSA or other regulators, in the United Kingdom or overseas, may intervene further in relation to the areas of industry risk already identified, or in new areas, which could adversely affect the Lloyds TSB Group and the Enlarged Group.

**1.16 *The Lloyds TSB Group is exposed to various forms of legal and regulatory risk including the risk of misselling financial products, acting in breach of legal or regulatory principles or requirements and giving negligent advice, any of which could have a negative impact on its results or its relations with its customers. This will also be true of the Enlarged Group***

The Lloyds TSB Group is, and the Enlarged Group will be, exposed to many forms of legal and regulatory risk, which may arise in a number of ways. Primarily:

- certain aspects of the Lloyds TSB Group's and the Enlarged Group's business may be determined by the authorities, the Financial Ombudsman Service ("FOS") or the courts as not being conducted in accordance with applicable laws or regulations, or, in the case of FOS, with what is fair and reasonable in the Ombudsman's opinion. For more information on additional constraints that may be imposed as a result of the State Aid Approval, see also the risk factor numbered 1.14;
- the possibility of alleged misselling of financial products which, as a result, may require additional provisions;

- contractual obligations may either not be enforceable as intended or may be enforced against the Lloyds TSB Group and the Enlarged Group in an adverse way;
- the intellectual property of the Lloyds TSB Group and the Enlarged Group (such as trade names) may not be adequately protected; and
- the Lloyds TSB Group and the Enlarged Group may be liable for damages to third parties harmed by the conduct of its business.

In addition, the Lloyds TSB Group faces and the Enlarged Group will face risk where legal or regulatory proceedings or FOS or other complaints are brought against it in the UK High Court or elsewhere, or in jurisdictions outside the UK, including other European countries and the United States. A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with US economic sanctions. See paragraph 11.1.3 of Part XII (“Additional Information”) of this document. The outcome of any proceeding or complaint is inherently uncertain and could have a material adverse effect on the Lloyds TSB Group’s and the Enlarged Group’s operations and/or financial condition, particularly if extended more broadly.

Failure to manage these risks adequately could impact the Lloyds TSB Group and the Enlarged Group adversely, both financially and reputationally through an adverse impact on the Lloyds TSB brand.

**1.17 *The Lloyds TSB Group is, and the Enlarged Group will be, exposed to tax risk***

Tax risk is the risk associated with changes in taxation rates or law, or misinterpretation of the law. This could result in increased charges or financial loss. Failure to manage this risk adequately could impact the Lloyds TSB Group and the Enlarged Group materially and adversely.

**1.18 *The Lloyds TSB Group’s businesses are conducted in highly competitive environments. Achieving an appropriate return for shareholders depends upon management’s ability to respond effectively to competitive pressures. This will also be true for the Enlarged Group***

The markets for UK financial services and the other markets within which the Lloyds TSB Group operates, and the Enlarged Group will operate, are 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, government intervention in the banking sector may impact the competitive position of banks within a country and among international competitors which may be subject to different forms of government intervention, thus potentially putting the Lloyds TSB Group and the Enlarged Group at a competitive disadvantage to local banks in such jurisdictions. Any combination of these factors could result in a reduction in profit. The Lloyds TSB Group’s and the Enlarged Group’s ability to generate an appropriate return for its shareholders depends significantly upon the competitive environment and management’s response to it.

The Lloyds TSB Group’s and the Enlarged Group’s financial performance may be materially and adversely impacted by competition, including declining lending margins or competition for savings driving up funding costs which cannot be recovered from borrowers. Adverse persistency in the Lloyds TSB Group’s insurance and investments business, as well as the Enlarged Group’s insurance and investment operations, is a risk to current and future earnings.

A key part of the Lloyds TSB Group’s strategy involves, and the Enlarged Group’s strategy will involve, building strong customer relationships in order to win a bigger share of its customers’ financial services spend. If the Lloyds TSB Group and the Enlarged Group are not successful in retaining and strengthening customer relationships they will not be able to deliver on this strategy, and may lose market share, incur losses on some or all of their activities or fail to attract new and retain existing deposits, which could have a material adverse effect on their business, financial position and results of operations.



### **1.19 *The Lloyds TSB Group and the Enlarged Group could fail to attract or retain senior management or other key employees***

The Lloyds TSB Group's success depends, and the Enlarged Group's success will depend, on the ability and experience of its senior management. The loss of the services of certain key employees, particularly to competitors, could have a material adverse effect on the Lloyds TSB Group's and/or the Enlarged Group's revenue, profit and financial condition. In addition, as the Enlarged Group's business develops, both in the UK and in other jurisdictions, its future success will depend on its ability to attract and retain highly skilled and qualified personnel, which cannot be guaranteed, particularly in light of the increased regulatory oversight of financial institutions and management compensation arrangements coming under closer scrutiny. In addition, failure to manage trade union relationships effectively may result in disruption to the business and its operations causing potential financial loss. The failure to attract or retain a sufficient number of appropriate personnel could significantly impede the Lloyds TSB Group's and the Enlarged Group's financial plans, growth and other objectives and have a material adverse effect on their business, financial position and results of operations.

## **2 Risks relating to the Acquisition**

### **2.1 *If the Acquisition does not become Effective, the Lloyds TSB Group will not be able to proceed with the Placing and Open Offer. In that case, the Lloyds TSB Group will be required to raise additional capital in an alternative manner. There is no certainty that it would be able to do so on acceptable terms or at all***

The Placing and Open Offer is conditional on the passing of various resolutions, including those relating to the Acquisition, at the Lloyds TSB General Meeting. It is also conditional on the satisfaction of certain conditions as set out in the Placing and Open Offer Agreement, including that the Scheme has been sanctioned at the Scheme Court Hearing and that the HBOS Placing and Open Offer Agreement has not been terminated. The Acquisition is also conditional on the passing of Ordinary Resolutions 1 and 3 at the Lloyds TSB General Meeting; the passing of various resolutions at the HBOS General Meeting and the Court Meeting; and all regulatory conditions and consents having been obtained or, in certain circumstances, waived. Accordingly, the Placing and Open Offer and the Acquisition are interconditional. If the Resolutions on which the Placing and Open Offer or the Acquisition are conditional are not approved or for some other reason the Placing and Open Offer Agreement is terminated or the Acquisition does not become Effective, the Lloyds TSB Group will not be able to proceed with its desired capital raising plan via the Placing and Open Offer. In that event, HM Treasury has stated that it would expect the Lloyds TSB Group to take appropriate action to strengthen its capital position. The FSA has advised the Lloyds TSB Group that if the Acquisition were not to occur, it would require the Lloyds TSB Group to raise £7 billion of additional capital, made up of £5 billion of core Tier 1 equity and £2 billion of Tier 1 instruments. There can be no certainty that the Lloyds TSB Group would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising and whether or not such a capital raising would be on a pre-emptive basis. Thus, if the conditions to the Acquisition are not satisfied or waived and the Lloyds TSB Group is not able to proceed with its desired capital raising plan via the Placing and Open Offer, it will be required to renegotiate the terms of either the Acquisition or the Placing and Open Offer or both with HM Treasury and the HBOS Group, and may be required to seek alternate means of raising funding. There can be no assurance as to whether the Lloyds TSB Group would be successful in raising alternative capital or as to the timetable or terms of an alternative capital raising or as to whether any such capital raising would be on a pre-emptive basis. If the Lloyds TSB Group is unable to find alternative sources of capital and sufficiently raise its capital, its business, results of operations and financial condition will suffer, its credit ratings may drop, its cost of funding may increase and it may need to access HM Treasury's recapitalisation fund, if such fund is available. Any of the above may have a material adverse impact on the Lloyds TSB Group share price.

**2.2 *The Acquisition is being effected by way of the Scheme and will require the separate approval of the Scheme Shareholders, HBOS Shareholders and Lloyds TSB Shareholders. There can be no assurance that the required shareholder approvals will be obtained***

The Acquisition is being effected by means of a scheme of arrangement between HBOS and the Scheme Shareholders under sections 895 to 899 of the Companies Act which will require an application by HBOS to the Court to sanction the Scheme and confirm the reduction and cancellation of HBOS's issued and to be issued ordinary share capital. Before such Court Orders can be sought, the Acquisition will require approval (i) by the Scheme Shareholders at the Court Meeting, (ii) by the HBOS Shareholders of certain resolutions to be proposed at the HBOS General Meeting and (iii) by Lloyds TSB Shareholders of certain resolutions to be proposed at the Lloyds TSB General Meeting. There can be no assurance that the approval of the Scheme by the Scheme Shareholders at the Court Meeting will be obtained, that the HBOS Shareholders will approve the resolutions to be proposed at the HBOS General Meeting, or that the Lloyds TSB Shareholders will approve the resolutions to be proposed at the Lloyds TSB General Meeting. In addition, there can be no assurance that if the Scheme and resolutions are approved by shareholders, the Court will grant the Court Orders, or seek to impose modifications thereto.

**2.3 *The implementation of the Scheme and the consummation of the Acquisition will be conditional upon the Scheme becoming Effective by a set date and are subject to the satisfaction or, if permitted, waiver of certain conditions. There can be no assurance that the Conditions will be satisfied or waived and that the Acquisition will be consummated***

The Acquisition is conditional upon the Scheme becoming Effective by not later than 28 February 2009 (subject to extension of such date by agreement between the HBOS Group and the Lloyds TSB Group in accordance with applicable law and regulation) and Admission of the Open Offer Shares becoming effective not later than 19 January 2009 and is subject to the satisfaction or, if permitted, waiver of certain conditions prior to such date. These conditions are set out in Appendix 1 to the Announcement and are incorporated by reference into this document. There can be no assurance that the conditions will be satisfied or waived. In addition, there can be no assurance that the Scheme or the Acquisition will become Effective as currently contemplated or at all.

**2.4 *Obtaining required regulatory approvals may delay implementation of the Scheme and consummation of the Acquisition, and compliance with conditions and obligations in connection with regulatory approvals could adversely affect prospects for the Acquisition***

The Acquisition is conditional upon obtaining merger control approvals and regulatory clearances from the FSA as well as certain other regulatory bodies in other jurisdictions.

In addition, the Acquisition is conditional upon (i) Lloyds TSB being satisfied, on terms satisfactory to it, that there is no intention by the Secretary of State to refer the Acquisition, or any matters arising from or relating to the proposal, to the Competition Commission, and (ii) if clause (i) is satisfied, either the deadline for making an application for review related to that decision having expired or that, in the event such application is made, any such application having been dismissed by the Competition Appeal Tribunal.

Following the original announcement of the Acquisition of the HBOS Group by the Lloyds TSB Group on 18 September 2008, the Secretary of State issued an intervention notice in relation to the Acquisition on public interest grounds to ensure appropriate consideration would be given, in the context of decisions under the Enterprise Act 2002 (the "Enterprise Act") on whether to refer the merger to the Competition Commission, to the public interest in the stability of the UK financial system under section 42 of the Enterprise Act, following advice from the UK Tripartite Authorities (HM Treasury, Bank of England and the FSA). As a result of that notice and of a Parliamentary Order, the Secretary of State had the power to consider the public interest issues in the stability of the UK financial system alongside competition issues in making his decision on whether to refer the Acquisition to the Competition Commission for investigation.

On 31 October 2008 the Secretary of State gave his decision that, considering the competition issues identified by the OFT and the evidence before him on the public interest issues in the stability of the UK financial system, the Acquisition is in the public interest and should be cleared unconditionally.

**2.5 *The Lloyds TSB Group may fail to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or may incur unanticipated costs associated with, the Acquisition. As a consequence, the Lloyds TSB Group's and the Enlarged Group's results of operations, financial condition and the price of the Lloyds TSB Shares may suffer***

The integration of the HBOS Group into the Lloyds TSB Group will be complex, expensive and present a number of challenges for the management of the Lloyds TSB Group, its staff and potentially its customers. On the basis described in paragraph 5 of Part I ("Letter from Sir Victor Blank, Chairman of Lloyds TSB Group Plc"), Lloyds TSB believes that the Acquisition will lead to accretion in Lloyds TSB's cash earnings per share and that through the implementation of cost synergies and other operational efficiencies it will deliver total pre-tax annual cost savings greater than £1.5 billion. The Lloyds TSB Group believes that these anticipated cost synergies as well as other operating efficiencies and the business growth opportunities, revenue benefits and other benefits it expects to achieve by combining its operations with those of the HBOS Group constitute a large part of the business rationale for the Acquisition. However, these expected business growth opportunities, revenue benefits, cost synergies and other operational efficiencies and other benefits may not develop, including because the assumptions upon which the Lloyds TSB Group determined the Acquisition consideration may prove to be incorrect. For example, the expected cost synergies have been calculated by the Lloyds TSB Group on the basis of the existing and projected cost and operating structures of the Lloyds TSB Group and the Lloyds TSB Group's estimate of the existing and projected cost and operating structures of the HBOS Group. Statements of estimated synergies and other effectiveness and calculations of the costs of achieving them relate to future actions and circumstances which, by their nature, involve risks, uncertainties, contingencies and other factors. As a result, the synergies and other efficiencies referred to may not be achieved, or those achieved may be materially different from those estimated.

The Lloyds TSB Group may also face challenges with respect to: obtaining the required approvals of various regulatory agencies, any of which could refuse or impose conditions or restrictions on its approval; retaining key employees (including key employees of the HBOS Group); redeploying resources in different areas of operations to improve efficiency; unifying financial reporting and internal control procedures; minimising the diversion of management attention from ongoing business concerns; overcoming integration challenges particularly as the Lloyds TSB Group's management may be unfamiliar with some aspects of the HBOS Group's business and operations; and addressing possible differences between the Lloyds TSB Group's business culture, processes, controls, procedures, systems, accounting practices and implementation of accounting standards and those of the HBOS Group.

Under any of these circumstances, the business growth opportunities, revenue benefits, cost savings and other benefits anticipated by the Lloyds TSB Group to result from the Acquisition may not be achieved as expected, or at all, or may be delayed. To the extent that the Lloyds TSB Group incurs higher integration costs or achieves lower revenue benefits or fewer cost savings than expected, its and the Enlarged Group's operating results, financial condition and prospects and the price of the Lloyds TSB Shares may suffer.

**2.6 *Consummation of the Acquisition may result in adverse tax consequences resulting from a change of ownership***

The consummation of the Acquisition may result in adverse tax consequences related to the change of ownership of HBOS and its subsidiaries. A change of ownership of a corporation can lead to restrictions on the ability to utilise certain tax reliefs including, but not limited to, tax losses. It can also lead to certain tax charges arising as a result of parties becoming connected with each other for tax purposes, such as credits related to loan relationships between the parties. Moreover, a change of ownership may result in other tax costs not normally associated with the ordinary course of business. Such other tax costs may include, but are not limited to, stamp duties, land transfer taxes, franchise taxes and other levies.

Furthermore, similar consequences could apply in relation to the Lloyds TSB Group and its subsidiaries if over a three year period HM Treasury, alone or together with any other shareholders with a stake of 5 per cent. or more in the Lloyds TSB Group, acquires a controlling shareholding.

**2.7 *Change of control provisions or termination rights in the HBOS Group's agreements may be triggered upon the completion of the Acquisition or upon the completion of any resulting reorganisation and may lead to adverse consequences for the Enlarged Group, including the loss of significant contractual rights and benefits, the termination of joint venture and/or licensing agreements***

Members of the HBOS Group are party to joint ventures, licenses and other agreements and instruments that may contain change of control provisions or termination rights that will be triggered upon the completion of the Acquisition or upon completion of the reorganisation of HBOS within the Lloyds TSB Group. Whilst the Lloyds TSB Group does not anticipate any material issues, the operation of such change of control provisions or termination rights, if any, could result in the loss of material contractual rights and benefits, the termination of joint venture agreements and licensing agreements or the requirement to repay outstanding indebtedness.

**2.8 *The Acquisition will result in a reduction in ownership and voting interest for existing Lloyds TSB Shareholders***

The Acquisition is such that, when it becomes Effective, existing Lloyds TSB Shareholders will suffer a reduction in their proportionate ownership, and may suffer a reduction in their proportionate voting interest, in the ordinary share capital of the Lloyds TSB Group compared to their current ownership and voting interest.

**3 Risks relating to the Placing and Open Offer and to investment in Lloyds TSB Shares**

**3.1 *HM Treasury will become the largest shareholder of the Enlarged Group if existing Lloyds TSB and HBOS Shareholders do not acquire a significant number of the new Ordinary Shares offered in the Open Offer and the HBOS Open Offer, respectively***

Under the Placing and the HBOS Placing, HM Treasury will acquire the Open Offer Shares and the HBOS Open Offer Shares, respectively, subject to the right of eligible existing shareholders to claw back their proportionate entitlement to Ordinary Shares through the Open Offer and the HBOS Open Offer and to apply for new Open Offer Shares in excess of their respective entitlements. If eligible existing Lloyds TSB Shareholders do not acquire new shares in the Open Offer, eligible existing HBOS Shareholders do not acquire new HBOS Ordinary Shares in the HBOS Open Offer and (in both cases) other placees do not acquire such shares, HM Treasury would own up to 43.5 per cent. of the ordinary share capital of the Enlarged Group. This percentage will be diminished to the extent of the participation by eligible existing shareholders in the Open Offer or the HBOS Open Offer. Details of the conditions to the Proposed Government Funding are set out in Part IV of this document. Subject to this, HM Treasury has informed the Lloyds TSB Group that it currently has no intentions or strategic plans concerning the Enlarged Group or its business and employees. HM Treasury has also informed the Lloyds TSB Group that it does not currently intend to seek to exert significant influence over financial management or operational matters. It might, however, change its views on whether it will seek to exert influence over the Lloyds TSB Group or the Enlarged Group, and may disagree with the commercial decisions of the Lloyds TSB Group, including over such matters as the implementation of synergies and commercial and consumer lending policies.

Moreover, arrangements have been announced by HM Treasury in relation to its equity participation in banks accessing the recapitalisation fund which may limit the operational flexibility of the Lloyds TSB Group and the Enlarged Group with regard to matters such as mortgage and small business lending.

Should HM Treasury decide to seek to exert influence over the Lloyds TSB Group or the Enlarged Group, it may be able to exercise a significant degree of influence over, among other things, the election of directors, the appointment of senior management and, subject to the terms of the bank recapitalisation scheme, the payment of any dividends on the Lloyds TSB Shares. Furthermore, as a major shareholder, HM Treasury's interests might conflict with those of minority shareholders, and HM Treasury may have the ability to prevent or cause a change in control and could take other actions that may not be favourable to minority shareholders. However, the Lloyds TSB Group expects that HM Treasury will, in accordance with its public statements, act as a value-oriented shareholder.

Finally, HM Treasury has confirmed its intention over time, to dispose of its investment in Lloyds TSB Group Shares and the Enlarged Group. Any such sale, or the perception that such a sale might occur, could adversely affect the market price of the Lloyds TSB Shares.

Depending on the level of the shareholdings acquired by the UK government in the Lloyds TSB Group, the Enlarged Group and other financial institutions, further filings may have to be made to UK and non-UK competition and regulatory authorities. The nature and extent of those filings and the risks of conditions being sought by or imposed upon the UK Government in relation to its shareholdings cannot be reasonably estimated at this point.

### **3.2 *Possible volatility in the price of Lloyds TSB Shares***

The market price of the Lloyds TSB Shares could be volatile and subject to significant fluctuations due to a variety of factors, including changes in sentiment in the market regarding Lloyds TSB Shares (or securities similar to them), any regulatory changes affecting Lloyds TSB's or the Enlarged Group's operations, variations in Lloyds TSB's or the Enlarged Group's operating results, business developments of Lloyds TSB or the Enlarged Group or its competitors, the operating and share price performance of other companies in the industries and markets in which Lloyds TSB or the Enlarged Group operate, the sale of Lloyds TSB Shares by HBOS Shareholders who have acquired Lloyds TSB Shares as part of their consideration under the Acquisition or speculation about Lloyds TSB's or the Enlarged Group's business in the press, media or investment community. Stock markets have from time to time, including recently and particularly with respect to certain financial institution shares, experienced significant price and volume fluctuations which have affected market prices for securities which may be unrelated to Lloyds TSB's or the Enlarged Group's operating performance or prospects. Furthermore, the Lloyds TSB's Group's or the Enlarged Group's operating results and prospects from time to time may be below the expectations of market analysts and investors. Any of these events could result in a decline in the market price of Lloyds TSB Shares.

In general, prospective investors should be aware that the value of an investment in Lloyds TSB and the Enlarged Group may go down as well as up. The market value of Lloyds TSB's Shares can fluctuate and may not always reflect the underlying asset value or prospects of the Lloyds TSB Group.

### **3.3 *Shareholders who do not acquire Open Offer Shares in the Open Offer will experience dilution in their ownership of the Lloyds TSB Group***

If Shareholders do not take up the offer of Open Offer Shares under the Open Offer by the latest date for application and payment in full in respect of their entitlements that will be set out in the Prospectus, their proportionate ownership and voting interest in the Lloyds TSB Group will be reduced, and the percentage that their Existing Ordinary Shares represent of the Enlarged Group Ordinary Share Capital will be reduced accordingly. Those shareholders in Restricted Jurisdictions will, in any event, not be able to participate in the Open Offer.

### **3.4 *Lloyds TSB will not be able to pay cash dividends until it has repurchased or redeemed the Enlarged Group HMT Preference Shares***

No dividends may be paid on the Lloyds TSB Shares until the Enlarged Group HMT Preference Shares have been repurchased or redeemed in full. The Enlarged Group HMT Preference Shares will not by their terms be redeemable for a period of five years after their issue. Although it is the Lloyds TSB Group's clear intention to seek their earlier repurchase in 2009 with the consent of the holders of the Enlarged Group HMT Preference Shares, such consent might not be forthcoming and there is no guarantee that the Lloyds TSB Group will be in a position to do so at such time. Even after repayment of the Enlarged Group HMT Preference Shares, the ability of Lloyds TSB to pay dividends in cash or otherwise on Lloyds TSB Shares is a function of its profitability and the extent to which, as a matter of law, it has available to it sufficient distributable reserves out of which any proposed dividend may be paid. Lloyds TSB's ability to pay dividends is also dependent upon receipt by it of dividends and other distributions from subsidiaries. Further, the Lloyds TSB Directors may not consider it appropriate to declare dividends in the context of prolonged economic uncertainty. Lloyds TSB can give no assurances that it will be able to pay a dividend in the future.

**3.5 *Future issues of Lloyds TSB Shares will further dilute the holdings of current Lloyds TSB Shareholders and could materially affect the market price of the Lloyds TSB Shares***

Further to the proposed issues of Open Offer Shares and Consideration Shares, Lloyds TSB has no current plans for an offering of Lloyds TSB Shares. However, it is possible that Lloyds TSB may decide to offer additional Lloyds TSB Shares in the future either to raise capital or for other purposes. An additional offering, or significant sales of Lloyds TSB Shares by major shareholders, could have an adverse effect on the market price of Lloyds TSB Shares as a whole.

**3.6 *Under the UK Banking (Special Provisions) Act 2008, HM Treasury is able to effect transfers of Lloyds TSB Shares or HBOS Shares and/or any property of the Lloyds TSB Group or the HBOS Group, or effect other transactions which could impact on the rights of Lloyds TSB Shareholders and/or HBOS Shareholders, and/or result in the de-listing of the Lloyds TSB Shares and/or the HBOS Shares***

Under the Banking (Special Provisions) Act 2008 (the “**BSP Act**”), until 21 February 2009, HM Treasury has wide powers to make certain orders in respect of a UK authorised deposit-taking institution (such as Lloyds TSB Bank plc and the HBOS Group) and, in certain circumstances, certain corporate related undertakings. The orders which may be made under the BSP Act in respect of relevant deposit-taking institutions (and/or, in certain circumstances, certain related corporate undertakings) relate to (amongst other things) (i) transfers of securities issued by relevant entities (such as the Lloyds TSB Shares, the Open Offer Shares and the Consideration Shares) (and/or securing that rights of holders of securities cease to be exercisable by such holders, discontinuing the listing of securities and/or varying or nullifying the terms of securities), (ii) transfers of property, rights and liabilities of relevant entities notwithstanding any restrictions, requirements or interest (and/or modifying related interests, rights or liabilities of third parties), (iii) the disapplication or modification of laws, (iv) the imposition of a moratorium on the commencement or continuation of any legal process in relation to any body or property and/or (v) the dissolution of any relevant entity. Significantly, orders may have retrospective effect (as from not earlier than three months before 21 February 2008) and may make provision for nullifying the effect of transactions or events taking place after the time in question.

While certain orders under the BSP Act may be made by HM Treasury only in certain circumstances for the purposes of maintaining the stability of the UK financial system and/or protecting the public interest where financial assistance has been provided by HM Treasury to the deposit-taking institution, such purpose conditions may not apply in respect of all orders which may be made under the BSP Act. The BSP Act includes provisions related to compensation in respect of any transfer orders made.

If HM Treasury were to make an order in respect of Lloyds TSB Bank plc and/or certain related corporate undertakings, such order may (amongst other things) (i) result in a transfer of the Lloyds TSB Shares and/or any property of Lloyds TSB Bank plc, or the HBOS Shares and/or any property of HBOS, (ii) impact on the rights of Lloyds TSB Shareholders and/or HBOS Shareholders, and/or (iii) result in the de-listing of the Lloyds TSB Shares and/or the HBOS Shares. At present, HM Treasury has not made any orders under the BSP Act in respect of Lloyds TSB Bank plc or HBOS or any of their respective related corporate undertakings and there has been no indication that it will make any such order under the BSP Act, but there can be no assurance that this will not change and/or that Lloyds TSB Shareholders will not be adversely affected by any such order if made.

A draft Banking Bill was introduced to the United Kingdom parliament on 7 October 2008. If enacted, the Banking Bill may have significant consequences for the UK banking industry. For example, it is currently anticipated that a new “Special Resolutions Regime” will be implemented which will give wide powers in respect of UK authorised deposit-taking institutions (such as Lloyds TSB Bank plc) to HM Treasury, the Financial Services Authority and the Bank of England in circumstances where any such UK authorised deposit-taking institution has encountered, or is likely to encounter, financial difficulties. It is also anticipated that a new administration and insolvency regime will be implemented in respect of UK authorised deposit-taking institutions (such as Lloyds TSB Bank plc). However, given that the Banking Bill is at an early stage in the legislative process, currently it is not possible to predict with any certainty what form any legislation (if enacted) will take and the impact it will have on Lloyds TSB Bank plc and the impact it will have (if any) on the Lloyds TSB Shareholders.

## PART III

### PRINCIPAL TERMS OF THE ACQUISITION

#### 1 Introduction

On 18 September 2008, the boards of Lloyds TSB and HBOS announced that they had reached agreement on the terms of a recommended acquisition by Lloyds TSB of HBOS. On 13 October 2008 as a consequence of discussions with HM Treasury together with the unprecedented turbulence in global financial markets, the boards of Lloyds TSB and HBOS announced that they intended to participate in the Proposed Government Funding, thereby gaining access to the UK Government backed provision of liquidity, and that they had agreed to proceed with the Acquisition on revised terms.

It is intended that the Acquisition will be effected by way of a scheme of arrangement under sections 895 to 899 of the Companies Act (although Lloyds TSB reserves the right, in its sole discretion, to implement the Acquisition by means of an Offer) and, subject to the satisfaction, or where appropriate, waiver, of the Conditions, it is expected that the Acquisition will become Effective during January 2009.

The Acquisition has been unanimously recommended by the boards of Lloyds TSB and HBOS.

#### 2 Summary of the Terms of the Acquisition

Under the terms of the Acquisition, and subject to the Conditions, HBOS Shareholders will be entitled to receive

<b>For every 1 HBOS Share</b>	<b>0.605 of a Consideration Share</b>
-------------------------------	---------------------------------------

Holders of HBOS ADRs will be entitled to receive 0.15125 of a Consideration ADR for each HBOS ADR cancelled in connection with the Acquisition.

These exchange ratios assume that neither HBOS nor Lloyds TSB has declared or paid, and will not declare or pay, any dividend in respect of ordinary shares after 13 October 2008, being the date of the announcement of the revised terms of the Acquisition.

Based on the Closing Price of 179.2 pence per Lloyds TSB Share on 29 October 2008, being the last practicable Business Day prior to publication of this document, the Acquisition values each HBOS Share at 108.4 pence and the existing issued ordinary share capital of HBOS at approximately £5.9 billion.

Immediately following the Effective Date, assuming that the maximum number of Consideration Shares to be issued pursuant to the Acquisition had been issued by that time, that none of the Lloyds TSB Shareholders participate in the Placing and Open Offer, that none of the HBOS Shareholders participate in the HBOS Placing and Open Offer and no third party placees acquire such shares, it is expected that existing Lloyds TSB Shareholders (including Lloyds TSB ADR holders) will own approximately 36.5 per cent. of the Enlarged Group, existing HBOS Shareholders will own approximately 20.0 per cent. of the Enlarged Group and that HM Treasury will own the remaining 43.5 per cent. of the Enlarged Group.

The Consideration Shares will be issued credited as fully paid and will rank *pari passu* in all respects with the existing Lloyds TSB Shares in issue at the time the Consideration Shares are issued pursuant to the Acquisition, including the right to receive and retain dividends and other distributions declared, made or paid, if any, by reference to a record date falling after the Effective Date.

Applications will be made to the UK Listing Authority for the Consideration Shares to be admitted to the Official List and to the London Stock Exchange for the Consideration Shares to be admitted to trading on the London Stock Exchange's main market for listed securities. It is expected that Admission will occur and that dealings in the Consideration Shares on the London Stock Exchange will commence in mid-January 2009. A supplemental listing application will be made to the NYSE for the Consideration Shares to be issued pursuant to the Acquisition to be listed on the NYSE for trading in the form of Consideration ADRs.

Any new HBOS Shares issued to Lloyds TSB or its nominee(s) pursuant to the Scheme will be issued fully paid and free from all liens, charges, equitable interests, encumbrances and rights of pre-emption and any other interests of any nature whatsoever and together with all rights attaching

thereto. In the event that the Acquisition is implemented by means of an Offer, the HBOS Shares will be acquired pursuant to such Offer on the same basis.

### **3 Lloyds TSB Shareholder Approval**

The Acquisition constitutes a Class 1 transaction (as defined in the Listing Rules) for Lloyds TSB. Accordingly, Lloyds TSB is seeking the approval of its shareholders for, among other things, the Acquisition at the Lloyds TSB General Meeting. The notice convening the Lloyds TSB General Meeting to be held at the Scottish Exhibition and Conference Centre, Glasgow G3 8YW at 11.00 a.m. on 19 November 2008 is set out at the end of this document.

### **4 Conditions to Implementation of the Acquisition**

The implementation of the Acquisition is conditional upon, among other things:

- approval of the Scheme by a majority in number representing 75 per cent. or more in value of the holders of Scheme Shares, present and voting, either in person or by proxy, at the Court Meeting and at any separate class meeting which may be required by the Court or at any adjournment of any such meeting;
- the resolution(s) required in connection with the Scheme being duly passed by the requisite majority at the HBOS General Meeting or any adjournment of that meeting;
- the passing at the Lloyds TSB General Meeting (or at any adjournment of such meeting) of such resolution or resolutions as may be necessary to approve, effect and implement the Acquisition and the implementation of the Scheme, including a resolution or resolutions to (i) approve the terms of the Acquisition and, (ii) authorise and permit the creation and allotment of new Lloyds TSB Shares, the making of any offer, proposal or other arrangement to holders of options under the HBOS Share Option Schemes and any necessary authorities and permissions for the creation and allotment of Lloyds TSB Shares in relation thereto;
- the sanction (with or without modification, but subject to each such modification being acceptable to Lloyds TSB) of the Scheme and the confirmation of any reduction of capital involved therein by the Court and an office copy of the Reduction Court Order and the minute of such reduction attached thereto being delivered for registration to the Registrar of Companies in Edinburgh;
- the time for an application for a review of the Secretary of State's decision clearing the Acquisition under UK merger control rules having expired without any such application having been made or, if such an application has been made, the Competition Appeal Tribunal having dismissed such application; and
- other appropriate regulatory approvals,

it being established in terms satisfactory to Lloyds TSB that it is not the intention of the Secretary of State to refer the Acquisition to the Competition Commission.

The conditions relating to the passing of Resolution 1 by the Lloyds TSB Shareholders at the Lloyds TSB General Meeting, the approval by the HBOS Shareholders of the resolutions to be proposed at the Court Meeting and the HBOS General Meeting, the sanction of the Scheme and the confirmation of the Capital Reduction are not capable of being waived in whole or in part, provided that Lloyds TSB will retain the right to effect the Acquisition by way of an Offer.

### **5 Further Details of the Acquisition**

#### **5.1 Structure of the Acquisition**

It is intended that the Acquisition be effected by means of a scheme of arrangement between HBOS and Scheme Shareholders under sections 895 to 899 of the Companies Act (although Lloyds TSB may, in its sole discretion and if it determines to do so, effect the Acquisition by way of an Offer). The Scheme will involve an application by HBOS to the Court to sanction the Scheme and confirm the cancellation of all the Scheme Shares. In consideration for the cancellation of the Scheme Shares and the issue of new HBOS Shares to Lloyds TSB, Scheme Shareholders will receive Consideration Shares as described above. Following implementation of the Scheme, HBOS will become a wholly-owned subsidiary of Lloyds TSB.

To become Effective, the Scheme will require, amongst other things, the approval of the resolution proposed at the Court Meeting by a majority in number of Scheme Shareholders present and voting, either in person or by proxy, representing not less than 75 per cent. in value of Scheme



Shares held by such Scheme Shareholders and the passing of the resolutions necessary to implement the Scheme by the HBOS Shareholders at the HBOS General Meeting. The Scheme must also be sanctioned, and the associated Capital Reduction confirmed, by the Court, in each case at the relevant Court Hearing. Upon the Scheme becoming Effective, it will be binding on all Scheme Shareholders, irrespective of whether they attended or voted at the Court Meeting or the HBOS General Meeting.

The formal documentation setting out details of the Acquisition, including the Scheme Document setting out the procedures to be followed to approve the Scheme, will be posted to HBOS Shareholders (other than to persons with addresses in Restricted Jurisdictions) in due course.

The results of the Court Meeting and the HBOS General Meeting will be announced on or shortly after the date of such meetings.

## **5.2 Fractional Entitlements**

As fractions of Consideration Shares or Consideration ADRs will not be allotted or issued to persons pursuant to the Scheme, fractional entitlements to Consideration Shares and Consideration ADRs will be aggregated and sold in the market and the net proceeds of sale of Consideration Shares will be donated to ShareGift (registered charity no. 1052686), subject to an option available to HBOS Shareholders to elect to receive any pro rata fractional entitlement in cash in lieu of such charitable donation.

ShareGift has already donated millions of pounds to hundreds of UK charities. Further information about ShareGift and the way it supports charities can be obtained from the website [www.sharegift.org.uk](http://www.sharegift.org.uk).

## **5.3 HBOS Share Schemes**

Lloyds TSB will make appropriate proposals to participants in the HBOS Share Schemes in respect of their outstanding options and awards. Separate letters will be sent to such participants to explain how the Acquisition will affect them.

## **5.4 HBOS Shares**

Any new HBOS Shares issued to Lloyds TSB or its nominee(s) pursuant to the Scheme will be acquired fully paid and free from all liens, charges, equitable interests, encumbrances, rights of pre-emption and any other interests of any nature whatsoever and together with all rights attaching thereto. In the event that the Acquisition is implemented pursuant to an Offer, the HBOS Shares will be acquired pursuant to such Offer on the same basis.

## **6. Dividend Entitlement**

No dividend may be paid on the Lloyds TSB Shares while any of the Enlarged Group HMT Preference Shares are outstanding, unless otherwise agreed by HM Treasury. Accordingly, it is the Board's intention to repurchase the Preference Shares as soon as possible so as to enable it to resume the payment of dividends. Lloyds TSB will assess the range of options available to allow the repurchase in full of the Enlarged Group HMT Preference Shares and intends, subject to prevailing market conditions, to achieve this during 2009 so that the block on the payment of cash ordinary dividends contained in the terms of those preference shares will be removed. This will allow the Lloyds TSB Board to resume the payment of cash ordinary dividends. The timing of recommencement and the level of dividend will be determined with due regard for the trading and economic environment and the Lloyds TSB Group's capital position at that time.

## **7 Co-operation from HBOS: the Implementation Agreement and Inducement Fee Arrangements**

Lloyds TSB and HBOS have entered into an implementation agreement which governs their relationship during the period until the Acquisition becomes Effective or lapses. Among other things, the parties have agreed to co-operate with regard to the process of implementing the Acquisition. The Implementation Agreement will terminate (without prejudice to any obligations on HBOS to pay the inducement fee (see below)) in certain circumstances, including if the Scheme or the Acquisition is not approved at the Court Meeting or the HBOS General Meeting or the Lloyds TSB General Meeting (as appropriate).

Under the Implementation Agreement, HBOS has agreed to pay Lloyds TSB an inducement fee (inclusive of value added tax (if any)) of one per cent. of the offer value under the Acquisition (based on the Closing Price of a Lloyds TSB Share on the Business Day prior to the occurrence of the relevant event below) if, *inter alia*:

- the HBOS Directors do not unanimously and without qualification recommend the HBOS Shareholders to vote in favour of the Scheme; or
- at any time after approval of the Scheme by HBOS Shareholders at the Court Meeting but before the grant of the Court Orders, the HBOS Directors, in exercise of their fiduciary duties, decide not to proceed with the Scheme; or
- without the consent of Lloyds TSB, HBOS withdraws the Scheme or takes steps to defer (or adjourn) the holding of the Court Meeting or the HBOS General Meeting or the Court Hearings to approve the Scheme to a date later than 28 February 2009; or
- a Competing Proposal is announced prior to the Scheme lapsing or being withdrawn, which Competing Proposal subsequently becomes or is declared wholly unconditional or is completed.

Further details on the Implementation Agreement are set out in paragraph 9.1.1 of Part XII (“Additional Information”) of this document.

## **8 The HBOS Preference Share Scheme**

In addition to the Scheme, it is proposed that the HBOS Preference Shares existing at the Scheme Record Time be cancelled and that preference shares be issued by Lloyds TSB to the HBOS Preference Shareholders at the Scheme Record Time in exchange for their HBOS Preference Shares. It is proposed that this proposal be implemented by way of the HBOS Preference Share Scheme. The HBOS Preference Share Scheme is conditional on, amongst other things, the Scheme becoming Effective. The full terms of the HBOS Preference Share Scheme are to be set out in the HBOS Preference Share Scheme Circular. Lloyds TSB expects to undertake to the Court to be bound by the terms of the HBOS Preference Share Scheme. Under the terms of the HBOS Preference Share Scheme, and subject to the satisfaction or waiver of the conditions thereto, it is proposed that the HBOS Preference Shares are cancelled and that HBOS Preference Shareholders will be entitled to receive Replacement Lloyds TSB Preference Shares. It is proposed that under the terms of the HBOS Preference Share Scheme, if the HBOS Preference Share Scheme is not approved by all classes of HBOS Preference Shareholders, the HBOS Preference Share Scheme shall only be effective in respect of those classes of HBOS Preference Shareholders which have approved the HBOS Preference Share Scheme, but ineffective in respect of those classes of HBOS Preference Shareholders which have not approved the HBOS Preference Share Scheme, and whose HBOS Preference Shares will remain in issue. The Scheme is not conditional upon the HBOS Preference Share Scheme becoming effective.

## **9 Lloyds TSB Shares, Consideration Shares and Consideration ADRs**

The Existing Ordinary Shares are admitted to CREST and trade under ISIN GB0008706128. The Existing Ordinary Shares can also be held in certificated form.

The Consideration Shares will be issued and allotted pursuant to the Companies Act 1985. Further details of the rights attaching to the Consideration Shares will be summarised in the Prospectus. It is expected that all of the Consideration Shares will, when issued and fully paid, be capable of being held and transferred by means of CREST or in certificated form. It is expected that the Consideration Shares will trade under the same ISIN number as the Existing Ordinary Shares.

The Consideration Shares will be issued credited as fully paid and will rank *pari passu* in all respects with the Lloyds TSB Shares in issue at the time the Consideration Shares are issued pursuant to the Acquisition, including the right to receive and retain dividends and other distributions (if any) paid by reference to a record date after the Effective Date. Application will be made to the UK Listing Authority for the Consideration Shares proposed to be issued in connection with the Acquisition to be admitted to the Official List and to the London Stock Exchange for the Consideration Shares to be admitted to trading on the London Stock Exchange’s main market for listed securities. It is expected that the Consideration Shares will be issued, and that Admission will become Effective on the Effective Date (which is currently expected to be in mid-January 2009).

The Consideration ADRs will be issued subject to the terms and conditions of the Lloyds TSB Deposit Agreement. A supplemental listing application will be made to the NYSE in respect of the Consideration Shares to be issued pursuant to the Acquisition to be listed on the NYSE for trading in the form of Consideration ADRs.

## **10 De-listing of HBOS, Termination of HBOS Deposit Agreement, Re-registration and Compulsory Acquisition**

Following the Acquisition becoming Effective, it is intended that the London Stock Exchange and the UK Listing Authority will each be requested respectively to cancel trading in HBOS Shares on the London Stock Exchange's main market for listed securities and to remove the listing of the HBOS Shares from the Official List, in each case on the Effective Date. Lloyds TSB also intends to procure that the HBOS Deposit Agreement is terminated after the Effective Date.

If the Acquisition is effected by way of an Offer, it is anticipated that cancellation of listing and trading will take effect no earlier than 20 Business Days after Lloyds TSB has acquired or agreed to acquire 75 per cent. of the voting rights attaching to the HBOS Shares. De-listing would significantly reduce the liquidity and marketability of any HBOS Shares whose holders have not accepted the Offer at that time.

If the Acquisition is effected by way of an Offer and Lloyds TSB receives acceptances under the Offer in respect of, and/or otherwise acquires, 90 per cent. or more of the HBOS Shares and voting rights to which the Offer relates, Lloyds TSB intends to exercise its rights to acquire compulsorily the remaining HBOS Shares in respect of which the Offer has not been accepted.

As part of the Acquisition, it is intended that HBOS be re-registered as a private limited company following the Effective Date.

## **11 Overseas Shareholders**

### **11.1 United States**

The Consideration Shares or Consideration ADRs to be issued in connection with the Scheme will not be, and are not required to be, registered under the Securities Act, in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 3(a)(10) thereof.

For the purpose of qualifying for the exemption from the registration requirements of the Securities Act provided by Section 3(a)(10) thereof with respect to the Consideration Shares or Consideration ADRs issued in connection with the Scheme, Lloyds TSB will advise the Court that its sanctioning of the Scheme will be relied upon by Lloyds TSB as an approval of the Scheme following a Court hearing on its fairness to HBOS Shareholders at which hearing all such HBOS Shareholders are entitled to attend in person or through counsel to support or oppose the sanctioning of the Scheme and with respect to which notification has been given to all such HBOS Shareholders.

Consideration Shares or Consideration ADRs issued to an HBOS Shareholder who is not an "affiliate" (within the meaning of the Securities Act) of Lloyds TSB prior to or after the Effective Date will not be "restricted securities" under the Securities Act and such Consideration Shares or Consideration ADRs may be sold by such person in ordinary secondary market transactions without restriction under the Securities Act.

Persons who are "affiliates" of Lloyds TSB as defined in the Securities Act prior to or after the Effective Date will be subject to timing, manner of sale and volume restrictions on the sale of Consideration Shares or Consideration ADRs received in connection with the Scheme under Rule 145(d) of the Securities Act. Persons who may be deemed to be affiliates of Lloyds TSB include individuals who, or entities that, control directly or indirectly, or are controlled by or are under common control with, Lloyds TSB. HBOS Shareholders and holders of HBOS ADRs who are affiliates, in addition to reselling their Consideration Shares or Consideration ADRs in the manner permitted by Rule 145(d) of the Securities Act, may also sell their Consideration Shares or Consideration ADRs under any other available exemption under the Securities Act, including Regulation S under the Securities Act. The Securities Act would not generally restrict sales of Consideration Shares on the London Stock Exchange provided that the sale has not been pre-arranged with a buyer in the United States. HBOS Shareholders and holders of HBOS ADRs who believe they may be affiliates for the purposes of the Securities Act should consult their own legal advisers prior to any sale of Consideration Shares or Consideration ADRs received in connection with the Scheme.

Neither the SEC nor any other US federal or state securities commission or regulatory authority has approved or disapproved the Consideration Shares or Consideration ADRs or passed an opinion upon the accuracy or adequacy of this document. Any representation to the contrary is a criminal offence in the United States.

In making any investment decision HBOS Shareholders and holders of HBOS ADRs must rely on their own examination of Lloyds TSB and the terms of the Scheme or the Offer, including the merits and risks involved.

**HBOS Shareholders who are citizens or residents of the United States should consult their own legal and tax advisers with respect to the legal and tax consequences of the Scheme in their particular circumstances.**

## **11.2 Other Jurisdictions**

The Consideration Shares and the Consideration ADRs may not be offered or sold in any Restricted Jurisdiction absent registration or an applicable exemption from the registration requirements of the relevant laws of any Restricted Jurisdiction. There will be no public offer of Consideration Shares or Consideration ADRs in any Restricted Jurisdiction.

The Consideration Shares and the Consideration ADRs have not been, and will not be, registered under the applicable securities laws of any Restricted Jurisdiction. Accordingly, the Consideration Shares and the Consideration ADRs may not be offered, sold, delivered or transferred, directly or indirectly, in or into any Restricted Jurisdiction to or for the account or benefit of any national, resident or citizen of any Restricted Jurisdiction.

The implications of the Scheme for Overseas Shareholders may be affected by the laws of relevant jurisdictions. Such Overseas Shareholders should inform themselves about, and observe, any applicable legal requirements. It is the responsibility of each overseas person who is to receive Consideration Shares pursuant to the Scheme to satisfy himself as to the full observance of the laws of the relevant jurisdiction in connection therewith, including the obtaining of any governmental, exchange control or other consents which may be required or the compliance with other necessary formalities which are required to be observed and the payment of any issue, transfer or other taxes due in such jurisdiction.

This document has been prepared for the purposes of complying with English law, the Listing Rules and the City Code and the information disclosed may not be the same as that which would have been disclosed if this document had been prepared in accordance with the laws of jurisdictions outside of England and Wales.

**THIS DOCUMENT DOES NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY ANY SECURITY. NONE OF THE SECURITIES REFERRED TO IN THIS DOCUMENT SHALL BE SOLD, ISSUED OR TRANSFERRED IN ANY JURISDICTION IN CONTRAVENTION OF APPLICABLE LAW.**

## PART IV

### PRINCIPAL TERMS OF THE PLACING AND OPEN OFFER

#### 1 Introduction

As explained in the letter set out in Part I (“Letter from Sir Victor Blank, Chairman of Lloyds TSB Group plc”) of this document, the Company is proposing to issue approximately 2.6 billion new Lloyds TSB Shares to raise approximately £4.5 billion (before expenses), through the Placing and Open Offer, representing approximately 43 per cent. of the existing issued ordinary share capital of Lloyds TSB, 30 per cent. of the enlarged issued ordinary share capital of Lloyds TSB immediately following completion of the Placing and Open Offer and 16 per cent. of the Enlarged Group Ordinary Share Capital.

HM Treasury has agreed to acquire the Open Offer Shares at the Issue Price subject to Admission of the Open Offer Shares and subject to clawback in respect of valid applications by Qualifying Shareholders at the Issue Price. The terms of the arrangements between Lloyds TSB and HM Treasury are contained in the Placing and Open Offer Agreement, the principal terms of which are summarised in paragraph 9.1.3 of Part XII (“Additional Information”) of this document.

#### 2 The Open Offer

The Open Offer will be made on the terms and subject to the conditions that will be set out in the Prospectus and the Application Form, and a summary of such terms and conditions is set out in paragraph 3 of this Part IV (“Principal Terms of the Placing and Open Offer”). Subject to the fulfilment of such terms and conditions, Qualifying Shareholders will be given the opportunity to apply for Open Offer Shares at the Issue Price (payable in full on application and free of all expenses) up to a maximum of their *pro rata* entitlement (subject to the terms of the Excess Application Facility) which shall be calculated on the basis of:

##### **0.4347 Open Offer Shares for every Existing Ordinary Share**

registered in the name of each Qualifying Shareholder on the Open Offer Record Date and so in proportion for any other number of Existing Ordinary Shares then registered.

Fractions of Open Offer Shares will not be allotted to Qualifying Shareholders in the Open Offer and fractional entitlements under the Open Offer will be rounded down to the nearest whole number of Open Offer Shares, as appropriate. The resulting fractions of Open Offer Shares will be aggregated and sold in the market for the benefit of Lloyds TSB. Accordingly, Qualifying Shareholders with fewer than 3 Existing Ordinary Shares will not be entitled to apply for any Open Offer Shares.

**Holdings of Existing Ordinary Shares in certificated and uncertificated form will be treated as separate holdings for the purpose of calculating entitlements under the Open Offer, as will holdings under different designations and in different accounts.**

The Excess Application Facility will enable Qualifying Shareholders to apply for Open Offer Shares in excess of their Open Offer Entitlement. Further details in relation to the Excess Application Facility will be set out in the Prospectus and the Application Form.

Following the issue of the Open Offer Shares and the Consideration Shares allotted pursuant to the Placing and Open Offer and the Acquisition, Qualifying Shareholders who do not take up any of their entitlements in respect of the Open Offer will be diluted by approximately 63.5 per cent. of their interests in the Company.

Qualifying Shareholders should be aware that the Open Offer is not a rights issue and the Application Forms, when published, will not be negotiable documents and will not be capable of being traded. Open Offer Shares which are not applied for under the Open Offer will not be sold in the market for the benefit of those who do not apply under the Open Offer and Qualifying Shareholders who do not apply to take up Open Offer Shares will have no rights under the Open Offer. Any Open Offer Shares which are not applied for in respect of the Open Offer or pursuant to the Excess Application Facility will be issued to any placee procured by Citi, Merrill Lynch and/or UBS, failing which to HM Treasury subject to the terms and conditions of the Placing and Open Offer Agreement, with the net proceeds retained for the benefit of the Company.

The Open Offer Shares will, when issued, be credited as fully paid and will rank *pari passu* in all respects with the Existing Ordinary Shares. All Open Offer Shares will be, when issued and fully

paid, capable of being held and transferred by means of CREST. The Open Offer Shares will not be made available in whole or in part to the public except under the terms of the Open Offer.

Qualifying Shareholders who apply for Open Offer Shares under the Open Offer will, subject to Lloyds TSB's ability to pay a dividend and provided the Lloyds TSB Directors consider it appropriate to declare a dividend, receive dividends on the Open Offer Shares in the same manner as they receive their dividend on their Existing Ordinary Shares. As explained in the letter set out in Part I ("Letter from Sir Victor Blank, Chairman of Lloyds TSB Group plc"), it is the Lloyds TSB Board's intention to resume the payment of dividends to Lloyds TSB Shareholders as soon as possible. However, no dividends may be paid on Lloyds TSB Shares while the Enlarged Group HMT Preference Shares are outstanding.

If the Lloyds TSB Directors consider it appropriate in the circumstances, options and awards under the Lloyds TSB Share Plans may be adjusted to take account of the Open Offer. If this is the case, participants will be contacted separately.

### **3 Conditions and Further Terms of the Open Offer**

The Open Offer will be conditional on the Placing and Open Offer Agreement becoming unconditional in all respects. The conditions to the Placing and Open Offer Agreement are (among other things):

- (i) Admission of the Open Offer Shares and Admission of the New Preference Shares becoming effective by not later than 8.00 a.m. on 19 January 2009 (or such later time and date as HM Treasury may agree);
- (ii) the obtaining or waiver of such regulatory approvals, authorisations and consents as may be required as a consequence of the activities contemplated by the Placing and Open Offer Agreement and the Preference Share Subscription Agreement;
- (iii) there having occurred or being reasonably likely to occur, in the opinion of HM Treasury (acting in good faith), no event which has resulted or may result in a material adverse change in or affecting the condition (financial, operational, legal or otherwise), profitability, prospects, solvency, business affairs or operations of the Lloyds TSB Group taken as a whole, whether or not arising in the ordinary course of business;
- (iv) the Acquisition having been announced on terms such that, if the Acquisition becomes Effective in accordance with its terms, the HBOS Shares shall be acquired by Lloyds TSB on terms such that, in consideration of the cancellation or transfer of the HBOS Shares it has acquired pursuant to the Placing and Open Offer, HM Treasury (or its nominee) shall receive Lloyds TSB Shares;
- (v) the Acquisition being subject only to those conditions which are required for implementation, specifically the requisite shareholder approval, court approval of the Scheme, regulatory clearances without which the proposed Acquisition may not be implemented and the listing and admission of the Consideration Shares; and
- (vi) (a) the resolutions necessary to implement the Acquisition having been approved by Lloyds TSB Shareholders and HBOS Shareholders; (b) the Scheme Court Hearing (but not the Reduction Court Hearing) having been held and the Scheme Court Order having been made; and (c) the agreement pursuant to which the HBOS Placing and Open Offer will be conducted not having terminated in accordance with its terms prior to the Scheme Court Hearing having been held and the Scheme Court Order having been made.

Certain of the conditions to the Placing and Open Offer Agreement may be waived by HM Treasury at its sole discretion. The condition described in sub-paragraph (vi) above is, among others, not capable of waiver by HM Treasury.

Accordingly, if these and the other conditions to the Open Offer are not satisfied, the Placing and Open Offer and the Acquisition will not proceed and any applications made by Qualifying Shareholders will be rejected. Please see paragraph 9.1.3 of Part XII ("Additional Information") of this document for a summary of the material terms of the Placing and Open Offer Agreement.

### **4 Expected Timetable of Open Offer**

The Company expects to send Application Forms to Qualifying Shareholders in mid-December 2008, following the HBOS General Meeting, and the Record Date for entitlement under the Open

Offer for Qualifying CREST Shareholders and Qualifying Non-CREST Shareholders is expected to be on or around 12 December 2008, with Open Offer Entitlements expected to be credited to stock accounts of Qualifying CREST Shareholders in CREST on or around 13 January 2009.

The latest time and date for receipt of completed Application Forms and payment in full under the Open Offer and settlement of relevant CREST instructions (as appropriate) is expected to be 13 January 2009.

Applications will be made for the Open Offer Shares to be listed on the Official List and to be admitted to trading on the London Stock Exchange's main market for listed securities. Admission of the Open Offer Shares is expected to occur on 14 January 2009, when dealings in the Open Offer Shares are expected to begin.

## **5 United Kingdom Taxation Considerations**

The Lloyds TSB Board has sought advice as to the likely tax treatment of Qualifying Shareholders on receipt of Open Offer Shares. The following statements are intended to apply only as a general guide to current UK tax law and to the current published practice of HMRC as at the date of this document. They are intended to apply only to Qualifying Shareholders who are resident and, if individuals, ordinarily resident in the UK and domiciled in the UK for UK tax purposes, who hold their Lloyds TSB Shares as investments (other than under an individual savings account) and who are the beneficial owners of their Lloyds TSB Shares. The statements may not apply to certain classes of shareholders such as dealers in securities, insurance companies, collective investment schemes, and shareholders who have (or who are deemed to have) acquired their shares by reason of their or another's office or employment. Such persons may be subject to special rules. The statements are not intended to apply to HM Treasury (in relation to the acquisition of Open Offer Shares pursuant to the Placing) or any entity controlled by HM Treasury. Qualifying Shareholders who are in any doubt as to their tax position regarding the acquisition, ownership and disposition of the Open Offer Shares or who are subject to tax in a jurisdiction other than the UK should consult their own tax advisers.

### ***Taxation of Chargeable Gains***

#### ***The Open Offer***

As a matter of UK law, the Open Offer may not, strictly speaking, be a reorganisation of the share capital of the Company for the purposes of the UK taxation of chargeable gains. Although HMRC's published practice to date has been to treat an open offer as a reorganisation, the Company understands that HMRC may not apply this practice in circumstances where an open offer is not made to all shareholders. Consequently, as this Open Offer is made to Qualifying Shareholders and not to all Lloyds TSB Shareholders, the capital gains tax treatment is not free from doubt.

If the Open Offer is treated as a reorganisation, to the extent that a Qualifying Shareholder takes up all or part of his entitlement under the Open Offer, he would not be treated as making a disposal of all or part of his holding of Existing Ordinary Shares. Instead, his Existing Ordinary Shares and his Open Offer Shares issued pursuant to the Open Offer would generally be treated as a single asset (a "New Holding"), acquired at the time he is deemed to have acquired his Existing Ordinary Shares. In these circumstances the issue of Open Offer Shares will not result in UK taxation of chargeable gains. For the purpose of computing any capital gain or loss on a subsequent disposal by a Qualifying Shareholder of any shares comprised in his New Holding, the amount paid for the Open Offer Shares will be added to the base cost of his Existing Ordinary Shares. However, to the extent that a Qualifying Shareholder takes up Open Offer Shares in excess of their Open Offer Entitlement pursuant to the Excess Application Facility, this will not constitute a reorganisation.

If, or to the extent that, the issue of Open Offer Shares by the Company to Qualifying Shareholders under the terms of the Open Offer is not treated as a reorganisation of the Company's share capital for the purposes of UK taxation of chargeable gains, such Open Offer Shares will be treated as acquired as part of a separate acquisition. In these circumstances the issue of Open Offer Shares will not result in UK taxation of chargeable gains. Subject to specific rules for acquisitions within specified periods either side of disposal and pre-1982 holdings held by corporates, the Existing Ordinary Shares and the Open Offer Shares will be treated as the same asset, the base cost of which will be the aggregate of the amount paid for the Open Offer Shares and the base cost of the Existing Ordinary Shares.

### *The Placing*

The issue of Open Offer Shares under the Placing will not constitute a reorganisation of share capital for the purposes of the UK taxation of chargeable gains and, accordingly, any Open Offer Shares acquired pursuant to the Placing will be treated as acquired as part of a separate acquisition.

### **Stamp Duty and Stamp Duty Reserve Tax**

No stamp duty or stamp duty reserve tax ("SDRT") will be payable on the issue of the Open Offer Shares unless such Open Offer Shares are issued or transferred (i) to, or to a nominee for, a person whose business is or includes the provision of clearance services (a "Clearance Service") or (ii) to, or to a nominee or agent for, a person whose business is or includes issuing depositary receipts (a "Depositary Receipts System"). In this event, stamp duty or SDRT will generally be payable at the higher rate of 1.5 per cent. of the consideration payable or, in certain circumstances, the value of the Open Offer Shares (rounded up in the case of stamp duty to the nearest £5).

Any subsequent dealings in the Open Offer Shares will be subject to stamp duty or SDRT in the normal way. The transfer on sale of Open Offer Shares will generally be liable to stamp duty at the rate of 0.5 per cent. (rounded to the nearest multiple of £5) of the consideration paid. An unconditional agreement to transfer such shares will generally be liable to SDRT at the rate of 0.5 per cent. of the consideration paid, but such liability will be cancelled if the agreement is completed by a duly-stamped transfer within six years of the agreement having become unconditional.

Under the CREST system for paperless share transfers, no stamp duty or SDRT will arise on the issue or transfer of shares into the system provided (i) the shares are not issued or transferred into the CREST account of, or of a nominee for, a Depositary Receipts System or the CREST account of, or of a nominee for, a Clearance Service which has not made an election under section 97A of the Finance Act 1986, and (ii) in the case of SDRT, the transfer is not for money or money's worth. Transfers of Shares within CREST are liable to SDRT (at a rate of 0.5 per cent. of the amount or value of the consideration payable) rather than stamp duty, and SDRT on relevant transactions settled within the system or reported through it for regulatory purposes will be collected by CREST.

## **6 Further Information**

The Prospectus and the Application Form are expected to be published in mid-November 2008 and mid-December 2008 (respectively) and will contain the formal terms and conditions of the Open Offer. This document does not constitute or form part of any offer or invitation to purchase, otherwise acquire, subscribe for, sell or otherwise dispose of or issue, or any solicitation of any offer or invitation to purchase, otherwise acquire, subscribe for, sell or otherwise dispose of or issue Open Offer Shares to be issued in connection with the proposed Open Offer and/or to take up any entitlements. Any decision to acquire Open Offer Shares pursuant to the proposed Open Offer must be made solely pursuant to the information contained in and incorporated by reference into the Prospectus. Investors should not acquire any Open Offer Shares except on the basis of the information contained in and incorporated by reference into the Prospectus.

The Open Offer Shares offered and sold under the Open Offer have not been and will not be registered under the Securities Act and may not be offered or sold in the United States absent registration or any exemption from registration under the Securities Act.

This document has been prepared for the purposes of complying with English law, the Listing Rules and the City Code and the information disclosed may not be the same as that which would have been disclosed if this document had been prepared in accordance with the laws of jurisdictions outside of England and Wales.

**THIS DOCUMENT DOES NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY ANY SECURITY. NONE OF THE SECURITIES REFERRED TO IN THIS DOCUMENT SHALL BE SOLD, ISSUED OR TRANSFERRED IN ANY JURISDICTION IN CONTRAVENTION OF APPLICABLE LAW.**



## PART V

### CONDITIONS RELATING TO THE PROPOSED GOVERNMENT FUNDING

In addition to the restriction on the payment of dividends discussed in Part I and Part III of this Circular, the following conditions will apply to Lloyds TSB Group as a result of the Proposed Government Funding, the credit guarantee scheme announced on 11 October 2008, the extension of the short term liquidity measures provided by the Bank of England and the related state aid clearance by the European Commission dated 13 October 2008 regarding the UK support scheme for financial institutions (the “**Clearance**”).

Unless stated otherwise, the conditions below will apply until the European Commission determines (or a court of competent jurisdiction finally determines) that Lloyds TSB is no longer in receipt of the aid which is the subject of the Clearance. If Lloyds TSB does not utilise (or ceases to utilise) the wholesale funding guarantee provided pursuant to the credit guarantee scheme and either the Placing does not occur or the Placing does occur, but HM Treasury substantively reduces its holding of Lloyds TSB Shares and/or Enlarged Group HMT Preference Shares, HM Treasury will consult with Lloyds TSB with a view to making submissions to the European Commission to obtain clarity as to the duration of the conditions and/or seek their disapplication.

HM Treasury has committed to discuss paragraphs 1.1(C), 1.1(D), 1.2, 3 and the duration of the conditions with Lloyds TSB with a view to their clarification.

#### 1. Remuneration

##### 1.1 Remuneration of the Board of Directors

- (A) HBOS Directors will receive no bonuses for 2008. If such directors are entitled to bonuses as part of contractual arrangements, they will relinquish their entitlements voluntarily.
- (B) Lloyds TSB announced on 13 October 2008 that although the Lloyds TSB Directors remain entitled to take cash as an alternative to shares in respect of their 2008 bonus it would ask the executive Lloyds TSB Directors to agree to receive such entitlement in Lloyds TSB Shares (which would be subject to a restriction on sale until December 2009). The executive Lloyds TSB Directors have responded positively to this request and have each now agreed to receive Lloyds TSB Shares in lieu of their cash entitlement in respect of such bonus, with this restriction on sale.
- (C) The Enlarged Group will comply with the ABI best practice code on remuneration. Remuneration will seek to reward long-term value creation and will not encourage excessive risk-taking. Short-term indicators will be taken into account only where fully consistent with long-term value creation and not encouraging excessive risk taking. Reward for board members will also take into account internal relative compensation packages and perceived fairness in the current economic climate.
- (D) No rewards for failure: where a director loses the confidence of the Board, they should be able to be dismissed at a cost that is reasonable and perceived as fair.

##### 1.2 Lloyds TSB commits to comply with a new FSA Code on risk based remuneration.

#### 2. Corporate Governance

HM Treasury will work with the Lloyds TSB Board on its appointment of two new independent directors following completion of the Acquisition. Thereafter, consistent with best practice, the Company will engage constructively with HM Treasury in its role as a shareholder.

#### 3. Lending

##### 3.1 Mortgages

- (A) Lloyds TSB Group commits to immediately restore and maintain the availability and active marketing of competitively priced mortgage lending (other than in the non-conforming market) through to the end of 2011 at a level at least equivalent to that of 2007.

- (B) Lloyds TSB will participate in industry-wide initiatives, including the small business forum and other industry-wide initiatives of a similar nature, and will comply with Government codes of practice and guidance.
- (C) Lloyds TSB Group commits to make available, until the end of 2009, a sum to be agreed for the establishment and maintenance of shared equity/shared ownership schemes to help people struggling with mortgage payments to stay in their homes, either through individual bank schemes or paid into a central fund run by the UK banking industry.
- (D) Lloyds TSB Group commits to make available, until the end of 2009, a sum to be agreed to support ongoing expansion of financial capability initiatives.

### 3.2 SMEs

- (A) Lloyds TSB Group commits to immediately restore and maintain the availability and active marketing of competitively priced lending to SMEs through to the end of 2011 at a level at least equivalent to that of 2007.
- (B) Lloyds TSB Group will publish an annual report, for each year through to the end of 2011, on:
  - (i) the overall level of lending to SMEs;
  - (ii) overdraft facilities and loans to SMEs: volumes, amounts and interest rates and other charges;
  - (iii) the amount of foreclosures of debt finance made available to SMEs;
  - (iv) the amount of lending through the Small Firms Loan Guarantee Scheme; and
  - (v) the application and use of a European Investment Bank global loan facility to secure additional liquidity specifically for SME lending.

3.3 The activities of the Lloyds TSB Group will be limited to the higher of: (i) the annual growth rate of growth of UK nominal gross domestic product in the preceding year; and (ii) the average historical growth of the balance sheets in the UK banking sector during the period from 1987 to 2007, unless there is evidence that the thresholds are exceeded for reasons unrelated to the provision of the aid referred to in the Clearance.

3.4 Further, in conjunction with HM Treasury, Lloyds TSB Group will, within six months of the earlier of the Recognition Date (as defined in the rules of the 2008 Credit Guarantee Scheme) and Admission, prepare a restructuring plan in a form suitable for notification to the European Commission in accordance with the Clearance and, at the request of the UK Government, furnish all information reasonably necessary for complying with the terms of the Clearance.

## 4. Other

Lloyds TSB Group will use The Mound as its Scottish headquarters, will hold its annual general meeting in Scotland and will print Bank of Scotland bank notes.

## PART VI

### PRINCIPAL TERMS OF THE CAPITALISATION ISSUE

#### 1 Introduction

The Capitalisation Issue will allow the Company to retain cash for reinvestment in the business and, at the same time, will allow Lloyds TSB Shareholders to build up their shareholding in the Company without incurring dealing costs or stamp duty.

Accordingly Lloyds TSB Shareholders are being asked at the Lloyds TSB General Meeting to authorise the capitalisation of reserves which will allow the Company to issue new ordinary shares. An explanatory note concerning the resolutions shareholders are asked to approve in order to allow the Lloyds TSB Board to effect the Capitalisation Issue is set out in section 16 of Part I.

The Capitalisation Amount will be determined by the Lloyds TSB Board in due course and announced with the preliminary results of the Company for the year ending 31 December 2008. The Lloyds TSB Board reserves the right not to complete the Capitalisation Issue if it considers such action would not be in the best interests of the Company or the Lloyds TSB Shareholders.

#### 2 Entitlement to Capitalisation Issue Shares

Each Lloyds TSB Shareholder's entitlement to Capitalisation Issue Shares will be calculated by taking an amount equal to the cash dividend for the year ending 31 December 2008 which the Company would otherwise have declared and paid to that Lloyds TSB Shareholder as determined by the Lloyds TSB Board in due course (being the Capitalisation Amount per Lloyds TSB Share multiplied by the number of Lloyds TSB Shares held at the Capitalisation Issue Record Date) and dividing it by the Capitalisation Issue calculation price. The Capitalisation Issue calculation price will be the Closing Price for a Lloyds TSB Share, on the day prior to the announcement of the Capitalisation Amount. The Capitalisation Issue calculation price, once fixed, will also be notified on the Company's website at [www.lloydstsb.com](http://www.lloydstsb.com).

Entitlements to Capitalisation Issue Shares will be rounded down to the nearest whole number of shares and no fraction of a Capitalisation Issue Share will be allotted.

#### 3 The Capitalisation Issue Shares

Applications will be made to the UK Listing Authority and to the London Stock Exchange for the Capitalisation Issue Shares to be admitted to the Official List and to trading on the London Stock Exchange's main market for listed securities.

The Capitalisation Issue Shares will be issued fully paid and will rank *pari passu* in all respects with the existing Lloyds TSB Shares, including the right to receive all dividends or other distributions declared, made or paid by reference to a record date (if any) after the date of their issue.

If the Capitalisation Issue becomes effective, in respect of Lloyds TSB Shares held on the Capitalisation Issue Record Date: (a) if held in certificated form, share certificates will be issued in respect of Capitalisation Issue Shares and posted to shareholders as soon as reasonably practicable after the Capitalisation Issue becomes effective; and (b) if held in uncertificated form (i.e. CREST), then prior to the commencement of dealings in the Capitalisation Issue Shares on the London Stock Exchange, the appropriate stock account in CREST of the relevant shareholder will be credited with such person's entitlement to Capitalisation Issue Shares. The Capitalisation Issue Shares are expected to be eligible to be traded through the CREST system with effect from the date of commencement of dealings on the London Stock Exchange.

#### 4 Lloyds TSB Share Plans

If the Lloyds TSB Directors consider it appropriate in the circumstances, options and awards under the Lloyds TSB Share Plans may be adjusted to take account of the Capitalisation Issue. If this is the case, participants will be contacted separately.

#### 5 United Kingdom Taxation Considerations

The Lloyds TSB Board has sought advice as to the likely tax treatment of Lloyds TSB Shareholders on receipt of Capitalisation Issue Shares. The following statements are intended to apply only as a general guide to current UK tax law and to the current published practice of HMRC

as at the date of this document. They are intended to apply only to Lloyds TSB Shareholders who are resident and, if individuals, ordinarily resident in the UK for UK tax purposes, who hold their Lloyds TSB Shares as investments (other than under an individual savings account) and who are the beneficial owners of their Lloyds TSB Shares. The statements may not apply to certain classes of shareholders such as dealers in securities, insurance companies, collective investment schemes, and shareholders who have (or who are deemed to have) acquired their shares by reason of their or another's office or employment. Such persons may be subject to special rules. The statements are not intended to apply to HM Treasury or any entity controlled by HM Treasury. Lloyds TSB Shareholders who are in any doubt as to their tax position regarding the acquisition, ownership and disposition of the Capitalisation Issue Shares or who are subject to tax in a jurisdiction other than the UK should consult their own tax advisers.

The Capitalisation Issue should be treated as a reorganisation of the Company's share capital for the purposes of United Kingdom taxation of chargeable gains. Accordingly, a shareholder should not be subject to a charge to UK taxation of chargeable gains on the receipt of Capitalisation Issue Shares. Instead, a shareholder's existing Lloyds TSB Shares and the Capitalisation Issue Shares should, taken together, be treated for the purposes of UK taxation of chargeable gains as the same asset, acquired at the time and for the same price that the shareholder acquired their existing Lloyds TSB Shares. A subsequent sale by a shareholder of some or all of the Capitalisation Issue Shares will be treated as a disposal for the purposes of UK taxation of chargeable gains and could give rise to a liability to tax for the shareholder.

To the extent that the Capitalisation Issue is paid up out of share premium it should not be treated as a distribution for tax purposes and so should not give rise to a charge to tax on income for shareholders. Consequently there will be no tax credit arising in respect of the Capitalisation Issue. The current intention of the Lloyds TSB Board is that the Capitalisation Issue will be paid out of share premium or other non-distributable reserves which would secure equivalent UK tax treatment for shareholders.

The issue of the Capitalisation Issue Shares should not be subject to stamp duty or stamp duty reserve tax.

## **6 Overseas Shareholders**

It is the responsibility of Overseas Shareholders to ensure that all relevant laws and regulations of overseas jurisdictions applicable to them or their shareholding (for example, exchange control laws or regulations) are complied with, and that they obtain any permissions or consents required to be obtained by them, or make any filings required to be made by them, in overseas jurisdictions. Lloyds TSB Shareholders should consult their professional advisers if they are not sure whether any formalities must be observed in order to receive Capitalisation Issue Shares. It is the responsibility of any person resident outside the UK wishing to receive Capitalisation Issue Shares to be satisfied as to full observance of the laws of the relevant territory, including obtaining any government or other consents which may be required and observing other formalities in such territories.

## PART VII

### INFORMATION ON THE LLOYDS TSB GROUP

*Unless otherwise indicated the financial information in this Part VII relating to Lloyds TSB has been extracted without material adjustment from information included in Lloyds TSB's interim results for the six months ended 30 June 2008 or published by Lloyds TSB. See "Presentation of Information" on page 2 of this document.*

#### 1 Overview

The Lloyds TSB Group is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to personal and corporate customers. Its main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision. For the six months ended 30 June 2008, Lloyds TSB had revenues of £4.6 billion and net income of £0.6 billion. As at 30 June 2008, Lloyds TSB Group had total assets of £367.8 billion and shareholders' equity of £10.8 billion. As at 30 June 2008, the risk asset ratios were 11.3 per cent. for total capital, 8.6 per cent. for Tier 1 capital and 6.2 per cent. for core Tier 1 capital.

The Lloyds TSB Group was formed in 1995 following the merger of Lloyds Bank and TSB Group plc, and now comprises the Lloyds TSB brand, along with Cheltenham & Gloucester, one of the largest mortgage providers in the UK, and Scottish Widows, one of the UK's largest providers of life, pensions and investment products.

Lloyds TSB Group's activities are organised into three divisions: UK Retail Banking, Insurance and Investments and Wholesale and International Banking. Services provided by UK Retail Banking include the provision of banking and other financial services to personal customers, private banking and mortgages. Insurance and Investments offers life assurance, pensions and investment products, general insurance and fund management services. Wholesale and International Banking provides banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers, manages Lloyds TSB Group's activities in financial markets through its treasury function and provides banking and financial services overseas.

The operations of Lloyds TSB Group in the UK are conducted through over 1,980 branches of Lloyds TSB Bank, Lloyds TSB Scotland and Cheltenham & Gloucester. C&G is Lloyds TSB Group's specialist mortgage arranger. International business is conducted mainly in the US and continental Europe. Lloyds TSB Group's services in these countries are offered largely through branches of Lloyds TSB Bank. Lloyds TSB Group also offers offshore banking facilities in a number of countries.

#### 2 History and development of Lloyds TSB

The history of the Lloyds TSB Group can be traced back to the 18th century when the banking partnership of Taylors and Lloyds was established in Birmingham, England. Lloyds Bank Plc was incorporated in 1865 and during the late 19th and early 20th centuries entered into a number of acquisitions and mergers, significantly increasing the number of banking offices in the UK. In 1995, it continued to expand with the acquisition of the Cheltenham and Gloucester Building Society.

TSB Group plc became operational in 1986 when, following UK Government legislation, the operations of four Trustee Savings Banks and other related companies were transferred to TSB Group plc and its new banking subsidiaries. By 1995, the TSB Group had, either through organic growth or acquisition, developed life and general insurance operations, investment management activities, and a motor vehicle hire purchase and leasing operation to supplement its retail banking activities.

In 1995, TSB Group plc merged with Lloyds Bank Plc. Under the terms of the merger, the TSB and Lloyds Bank groups were combined under TSB Group plc, which was re-named Lloyds TSB Group plc with Lloyds Bank Plc, which was subsequently renamed Lloyds TSB Bank plc, the principal subsidiary. In 1999, the businesses, assets and liabilities of TSB Bank plc, the principal banking subsidiary of the TSB Group prior to the merger, and its subsidiary Hill Samuel Bank Limited were vested in Lloyds TSB Bank plc, and in 2000, the Lloyds TSB Group acquired Scottish Widows' Fund and Life Assurance Society. In addition to already being one of the leading

providers of banking services in the UK, this transaction also positioned the Lloyds TSB Group as one of the leading suppliers of long-term savings and protection products in the UK.

In more recent years, the Lloyds TSB Group has disposed of a number of its non-core operations, as part of the process of managing its portfolio of businesses to focus on its core markets. These disposals have resulted in a significant reduction in the size of the Lloyds TSB Group's international business.

### **3 Strategy**

In an environment of strong competition, the Lloyds TSB Group believes that shareholder value can best be achieved by:

- focusing on markets where it can build and sustain competitive advantage;
- developing business strategies which are founded on being profitably different in the way it creates customer value; and
- building a high-performance organisation focused on the right goals and the best possible execution of the Lloyds TSB Group's strategies.

Reflecting this, in 2003, the Lloyds TSB Group put in place a three-phase strategy. In phase 1, the Lloyds TSB Group focused on enhancing the quality of its earnings by exiting businesses which were not regarded as core or which added unnecessary volatility to earnings. During this phase, the Lloyds TSB Group divested businesses in New Zealand and Latin America, markets in which it did not expect to be able to build and sustain competitive advantage. In phase 2, the Lloyds TSB Group focused on accelerating growth by deepening its customer relationships, improving productivity and building competitive advantage through enhanced capabilities. The Lloyds TSB Group also remained alert for opportunities to enter into phase 3 i.e. an acquisition that complemented its existing organic strategies. The HBOS acquisition constitutes the final phase of this strategy.

Relationships were and still are critical to the Lloyds TSB Group's strategy. The Lloyds TSB Group has chosen to focus on building deep, long-lasting relationships with its customers in order to deliver high quality, sustainable results over time. By building deep relationships, the Lloyds TSB Group aims to grow revenues and achieve a lower risk profile.

#### ***Markets***

The Lloyds TSB Group focuses on building competitive advantage in its core markets by seeking opportunities to consolidate its position in businesses where it is already strong, through a combination of organic growth and acquisitions, and by divesting businesses in markets where it is not a leader and cannot aspire reasonably to being one of the market leaders. The Lloyds TSB Group believes that it has good potential within its existing franchise to grow by meeting more of its customers' needs as well as through adding new customers to the franchise.

#### ***Strategy***

The Lloyds TSB Group's strategy is based on a belief that sustained growth comes from simultaneously focusing on (i) building strong customer relationships, (ii) continuous productivity improvement and (iii) strong capital management.

##### ***Strong customer relationships***

In an increasingly competitive financial services market, and with customers able to exercise choice amongst alternative providers, shareholder value creation is closely linked to customer value creation. Shareholder value can only be created by attracting and retaining customers and winning a greater share of their financial services business. Across its main businesses, Lloyds TSB Group has strong core banking franchises, based on building strong customer relationships. The Lloyds TSB Group's strategy is focused on being differentiated in the creation of customer value to win a bigger share of its customers' total financial services spend.

##### ***Continuous productivity improvement***

Superior economic profit growth also requires a continuous focus on productivity improvement, which drives both improved customer service and cost reduction. In recent years, the Lloyds TSB Group has been building a set of capabilities in 'six sigma' (error reduction), 'lean manufacturing' (operations efficiency) and procurement. Alongside those capabilities, the Lloyds TSB Group applies an 'income growth must exceed cost growth' discipline in setting goals for each business,

requiring a wider gap between income growth and cost growth for lower growth/return businesses than for higher growth/return businesses.

The results have been evidenced across all three divisions in much reduced error rates in key processes, growing levels of income per employee and falling unit costs, without impacting investment in future growth. Further improvements in the Lloyds TSB Group's cost: income ratio are expected as these capabilities and disciplines are extended further.

#### *Capital and risk management*

Lloyds TSB Group measures value internally by economic profit growth, a measure of financial performance which signals where value is created or destroyed. It has developed a framework to measure economic equity requirements across all its businesses, taking into account market, credit, insurance, business and operational risk. Using economic profit as a key performance measure enables the Lloyds TSB Group to understand which strategies, products, channels and customer segments are destroying value and which are creating the most value and to make better capital allocation decisions as a result.

The application of these economic profit disciplines, alongside goal-setting linked to ensuring that revenue growth constantly exceeds cost growth, has already been reflected in a significant improvement in the capital efficiency of the Lloyds TSB Group's Insurance and Investments division and by a shift in business mix towards sectors offering higher risk-adjusted returns in wholesale banking. By the continued rigorous application of these disciplines at every level, the Lloyds TSB Group expects to further improve capital efficiency whilst remaining strongly capitalised.

It is the Lloyds TSB Group's belief that the relationship focused strategy has demonstrated its effectiveness in generating sustainable, high quality results. The prudent approach to risk means that the Lloyds TSB Group believes that it has relatively limited exposure to assets affected by capital market uncertainties and continues to retain a strong liquidity position.

## **4 Principal Activities**

The Lloyds TSB Group's activities are organised into three divisions: UK Retail Banking, Insurance and Investments and Wholesale and International Banking.

### ***UK Retail Banking***

UK Retail Banking provides banking, financial services, mortgages and private banking to some 16 million personal customers through the Lloyds TSB Group's multi-channel distribution capabilities.

#### *Branches*

The Lloyds TSB Group provides wide-reaching geographic branch coverage in England, Scotland and Wales, through over 1,980 branches of Lloyds TSB Bank, Lloyds TSB Scotland and C&G.

#### *Internet banking*

Internet banking provides online banking facilities for personal customers. Some 4.9 million customers have registered to use the Lloyds TSB Group's internet banking services. For the half year to 30 June 2008, these customers were conducting on average more than 75 million actions per month online, a 16 per cent. increase on the same period in 2007.

#### *Telephone banking*

As at 30 June 2008, some 5.5 million customers had registered to use the services of PhoneBank and the automated voice response service, PhoneBank Express. Lloyds TSB's telephone banking centres handled some 39 million calls during the first six months of 2008.

#### *Cash machines*

The Lloyds TSB Group has one of the largest cash machine networks of any leading banking group in the UK and, personal customers of Lloyds TSB Bank and Lloyds TSB Scotland are able to withdraw cash and check balances through over 4,100 ATMs at branches and external locations around the country. In addition, UK Retail Banking's personal customers have access to over 65,000 cash machines via LINK in the UK and to cash machines worldwide through the VISA and MasterCard networks.

### *Current accounts*

Lloyds TSB Bank and Lloyds TSB Scotland offer a wide range of current accounts, including interest-bearing current accounts and a range of added value accounts.

### *Savings accounts*

Lloyds TSB Bank, Lloyds TSB Scotland and C&G offer a wide range of savings accounts and retail investments through their branch networks and a postal investment centre.

### *Personal loans*

Lloyds TSB Bank and Lloyds TSB Scotland offer a range of personal loans through their branch networks and directly to the customer via the internet and telephone.

### *Cards*

The Lloyds TSB Group provides a range of card-based products and services, including credit and debit cards and card transaction processing services for retailers. The Lloyds TSB Group is a member of both the VISA and MasterCard payment systems and has access to the American Express payment system.

### *Mortgages*

C&G is the Lloyds TSB Group's specialist residential mortgage arranger, offering a range of mortgage products to personal customers through its own branches and those of Lloyds TSB Bank in England and Wales, as well as through the telephone, internet and postal service, Mortgage Direct. Lloyds TSB Group also provides mortgages through Lloyds TSB Scotland and Scottish Widows Bank. The Lloyds TSB Group is one of the largest residential mortgage lenders in the UK on the basis of outstanding balances, with mortgages outstanding at 30 June 2008 of £109.3 billion.

### *UK Wealth Management*

Wealth Management provides financial planning and advice for the Lloyds TSB Group's affluent customers, providing financial solutions across investments, retirement planning and income, trusts, tax and estate planning as well as share dealing. Expert advice is provided through a large population of the Lloyds TSB Group's financial advisors who can be accessed via the retail branch network and Private Banking offices throughout the United Kingdom. Customers are also provided with access to relationship banking as part of Lloyds TSB Private Banking, one of the largest private banks in the UK.

The UK Competition Commission's investigation of payment protection (also known as repayment) insurance could affect the distribution and pricing of this product across the industry. Further details as to the investigations are set out in paragraph 11.1.1 of Part XII ("Additional Information") in this document.

### ***Insurance and Investments***

Insurance and Investments offers life assurance, pensions and investment products, general insurance and fund management products and services through the Lloyds TSB, Scottish Widows and SWIP brands.

#### *Life assurance, pensions and investments*

Scottish Widows is the Lloyds TSB Group's specialist provider of life assurance, pensions and investment products, which are distributed through Lloyds TSB Bank's branch network, through independent financial advisers and directly via a direct sales force, telephone and the internet. The Scottish Widows brand is the main brand for new sales of Lloyds TSB Group's life, pensions, Open Ended Investment Companies ('OEICs') and other long-term savings products.

In common with other life assurance companies in the UK, the life and pensions business of each of the life assurance companies in the Lloyds TSB Group is written in a long-term business fund. The main long-term business fund is divided into With-Profits and Non-Profit sub-funds.

With-profits life and pensions products are written from the With-Profits sub-fund. The benefits accruing from these policies are designed to provide a smoothed return to policyholders who hold their policies to maturity through a mix of annual and final (or terminal) bonuses added to guaranteed basic benefits. The guarantees generally only apply on death or maturity. The actual bonuses declared will reflect the experience of the With-Profits sub-fund.



Other life and pensions products are generally written from the Non-Profit sub-fund. Examples include unit-linked policies, annuities, term assurances and health insurance (under which a predetermined amount of benefit is payable in the event of an insured event such as being unable to work through sickness). The benefits provided by linked policies are wholly or partly determined by reference to a specific portfolio of assets known as unit-linked funds.

During 2007, Lloyds TSB Group sold Abbey Life, the UK life operation which was closed to new business in 2000.

#### *General insurance*

Lloyds TSB Insurance provides general insurance through the retail branches of Lloyds TSB Bank, Lloyds TSB Scotland and C&G, and through a direct telephone operation and the internet. Lloyds TSB Insurance is one of the leading distributors of household insurance in the UK.

#### *Scottish Widows Investment Partnership*

Scottish Widows Investment Partnership manages funds for Lloyds TSB Group's retail life, pensions and investment products. Clients also include corporate pension schemes, local authorities and other institutions in the UK and overseas.

#### **Wholesale and International Banking**

Wholesale and International Banking provides banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers, manages Lloyds TSB's activities in financial markets through its treasury function and provides banking and financial services overseas.

During 2007, the Lloyds TSB Group completed the sale of Lloyds TSB Registrars and The Dutton-Forshaw Group, two of Wholesale and International Banking's businesses.

#### *Corporate Markets*

Combining the respective strengths of some 3,000 people in Corporate Banking and Products and Markets, Corporate Markets plays an integral role in leveraging and expanding the Lloyds TSB Group's customer franchise and building deep, long-lasting relationships with around 26,000 corporate customers.

Corporate Banking manages the core customer franchise, providing a relationship-based financial and advisory service to the corporate market place. This is delivered through dedicated regional teams throughout the UK and key strategic locations abroad, including New York. Customers have access to expert advice and a broad range of financial solutions. Relationship Managers act as a conduit to product and service partners in Corporate Markets and other parts of the Lloyds TSB Group. Lloyds Development Capital, the Lloyds TSB Group's captive private equity arm, also reports through the Corporate Bank.

Products and Markets is where the specialist product capability resides for both the corporate relationship customers and certain other customers of the Lloyds TSB Group. It offers customers a wide range of finance and capital solutions, and also provides tailored risk management solutions and structured solutions across all areas of risk. These areas include foreign exchange, interest rates, credit, inflation and commodities on behalf of the Lloyds TSB Group. Additionally, Products and Markets fulfils the treasury role for Lloyds TSB Group including the management of balance sheet liquidity.

#### *Commercial Banking*

Commercial Banking serves nearly one million customers across the UK from one-person start-ups to large, established enterprises. The expanded business focuses on providing banking facilities and solutions to customers with business turnover up to £15 million per annum, and incorporates the invoice discounting and factoring subsidiary, Lloyds TSB Commercial Finance, through which Lloyds TSB Group provides specialised working capital finance for its customers. Commercial Banking continues to build its market share of high value customers as a result of continued progress in attracting customers "switching" from other financial services providers. The main activity of The Agricultural Mortgage Corporation is to provide long-term finance to the agricultural sector.

### Asset Finance

The Lloyds TSB Group's asset finance businesses provide individuals and companies with specialist personal lending, store credit and finance, including motor finance. Black Horse Consumer Finance, including the Retail and Motor businesses, acquire largely non Lloyds TSB franchise customers through Point of Sale (POS) credit creating the opportunity to sell Black Horse personal loans subsequently. Asset Finance is also the Group's provider of contract hire vehicles through LloydsTSB Autolease. Asset Finance has approximately 3,650 staff throughout the UK, over 1.7 million individual customers and relationships with some 16,800 companies and small businesses.

### International Banking

Lloyds TSB Group has continued to shape its international network to support its UK operations. Its overseas banking operations include offices in the UK, the Channel Islands, the Isle of Man, Dubai, Hong Kong, Spain, France, Switzerland, Luxembourg, Belgium, Netherlands, Monaco, Gibraltar, Cyprus, South Africa, Japan, Singapore, Malaysia, China and the US. The business provides a wide range of private and retail banking, wealth management and expatriate services to local island residents, UK expatriates, foreign nationals and to other customers and also serves the corporate and institutional market in a number of these locations.

## 5 Summary of Total Income, Net of Insurance Claims, by Division

A summary of total income of the Lloyds TSB Group, net of insurance claims, for the six months ended 30 June 2008 and each of the years ended 31 December 2007, 2006 and 2005 is set out in the table below:

	<i>Six months ended 30 June 2008<sup>(1)</sup></i>	<i>Year ended 31 December 2007<sup>(2)</sup> 2006<sup>(3)</sup> 2005<sup>(3)</sup></i>		
		<i>(£ million)</i>		
UK Retail Banking	2,852	5,492	5,263	5,126
Insurance and Investments				
General Insurance	191	257	418	397
Life, pensions and asset management	(242)	781	1,603	1,671
Wholesale and International Banking	1,939	4,182	4,212	3,893
Central group items	(112)	(6)	(392)	(547)
<b>Total</b>	<b>4,628</b>	<b>10,706</b>	<b>11,104</b>	<b>10,540</b>

#### Notes:

- (1) Figures for the six month period ended 30 June 2008 were extracted from the unaudited Lloyds TSB statutory segmental analysis included within its unaudited 2008 interim results announcement made on 30 July 2008. As part of the Lloyds TSB Group's transition to Basel II on 1 January 2008, the Lloyds TSB Group took the opportunity to update its capital and liquidity pricing methodology. The main difference in this approach is to allocate a greater share of certain funding costs, previously allocated to the Central group items segment, to individual divisions. These adjustments have no impact on the group income statement or balance sheet.
- (2) Figures for the financial year ended 31 December 2007 were derived from the unaudited Lloyds TSB statutory segmental analysis included within its unaudited 2008 interim results announcement made on 30 July 2008. As part of the Lloyds TSB Group's transition to Basel II on 1 January 2008 the Lloyds TSB Group took the opportunity to update its capital and liquidity pricing methodology. The main difference in this approach is to allocate a greater share of certain funding costs, previously allocated to the Central group items segment, to individual divisions. These adjustments have no impact on the group income statement or balance sheet.
- (3) Figures for 2006 and 2005 have not been updated to reflect the update to the capital and liquidity pricing methodology announced on 11 July 2008.

## 6 Competitive Environment

The Lloyds TSB Group's key markets are in the UK, in both the retail and wholesale financial services sectors, where the markets are relatively mature. Retail banking markets have shown strong rates of growth in recent years, but have slowed in 2008 as a result of low consumer confidence, a squeeze on household spending power, the withdrawal of some competitors from the mortgage market and a sharply lower housing market. The markets for life, pensions and insurance products are expected to grow over time in a number of key areas although the weakness of stock

markets in 2008 will in the short term limit demand for equity-based products. The fragmented nature of the life, pensions and insurance market in the UK has resulted in some consolidation within certain product sectors, although the overall share of new business of the top ten providers fell slightly in 2007. In the general insurance sector, the long-term trend of consolidation amongst underwriters and brokers continues, while distribution remains fragmented through growth in the number of affinity partnerships. Wholesale markets showed strong growth until mid-2007, since when the ongoing dislocation of global capital markets and growing concern about economic prospects has had a severe impact. Slower growth is now evident and this trend is likely to intensify going forward, together with a return to more normal levels of bad debt from recent cyclical lows.

The Lloyds TSB Group's competitors include all the major financial services companies operating in the UK. In the retail banking market, the Lloyds TSB Group competes with banks and building societies, major retailers and internet-only providers. In the mortgage market, competitors include the traditional banks and building societies and specialist providers, although some of these have had to reduce their business activity or exit as a result of capital and funding constraints. In the wholesale banking market, the Lloyds TSB Group competes with both UK and foreign financial institutions; in asset finance the main competition comes from other banks and specialised asset finance providers; and in the insurance market, competitors include bancassurance, life assurance and general insurance companies operating in the UK.

The current dislocation in global capital markets has been the most severe examination of the banking system's capacity to absorb sudden significant changes in the funding and liquidity environment for many years and individual institutions have faced varying degrees of stress. Many competitors have reacted to short-term funding concerns by withdrawing products and/or tightening lending criteria. Lloyds TSB Group expects these conditions to continue throughout the remainder of 2008 and in 2009.

## **7 Current Trading, Trends and Prospects**

Lloyds TSB today announced an interim management statement, the text of which is set out below:

### **LLOYDS TSB RELATIONSHIP BUSINESSES CONTINUE TO TRADE WELL**

#### **Interim management statement – key highlights\***

- The Group continues to trade well and deliver good income growth from its relationship businesses in an immensely challenging period for financial services companies. However the impact of market dislocation, insurance related volatility and higher impairments, particularly in our corporate lending portfolios, led to a substantial reduction in statutory profit before tax in the first nine months of the year.
- Excluding the impact of market dislocation and insurance related volatility, each division has achieved revenue growth in excess of cost growth.
- The Group has continued to capture market share in a number of key areas, whilst improving new business product margins.
- The Group has maintained its strong liquidity and funding position, with its wholesale funding maturity profile at a similar level to twelve months ago.
- We remain on track to deliver a good trading performance in 2008, notwithstanding the continued deterioration in the UK economic environment.

Eric Daniels, Group Chief Executive, commented:

*“Despite the extremely challenging market and economic conditions, the Group remains on track to deliver a good trading performance during 2008, notwithstanding lower statutory profits as a result of the impact of market dislocation, insurance related volatility and higher impairment charges. Our strong liquidity and funding capabilities have ensured that the Group has continued to raise wholesale funding at market leading rates and, especially over the last few weeks, the Group has been securing some longer term funding without recourse to any Government guarantees. This gives the Group a competitive advantage and has enabled our corporate and retail relationship banking businesses to continue to grow in the first nine months of the year, capturing market share*

\* Unless otherwise stated, comparisons are of performance for the first nine months of 2008 against the equivalent period of 2007 for the Group's continuing businesses.

*in a number of key areas whilst improving product margins. Our strategy and focus remains on continuing to build strong customer relationships, whilst improving the efficiency and effectiveness of our operations.*

*Whilst continuing to remain cautious on the UK economic outlook, the Group is well positioned to withstand the expected economic challenges over the next few years. Our business model is robust and, by focusing on our core strengths and selective growth opportunities, we expect to deliver a good trading performance in 2008."*

The Group's core businesses have continued to trade well during the third quarter of 2008, notwithstanding the continuing difficulties in financial markets and the worsening economic environment in the UK. This serves to demonstrate both the prudence of our business model and the high quality, sustainable nature of our income. Whilst no bank has been immune from the recent market turbulence and economic downturn, the impact on the Group's core trading continues to be manageable.

### **Continued strong revenue momentum in UK Retail Banking**

The Retail Bank has continued to make strong progress, with further growth in product sales supporting slightly higher revenue growth in the third quarter than in the first half of the year. Revenue growth has exceeded cost growth in the first nine months of the year. We continue to acquire new current accounts at a similar level to last year, and have also achieved good growth in bank savings and Wealth Management cash balances.

Levels of mortgage allocations have slowed considerably over the last few months, reflecting difficult market conditions and the impact on the housing market of falling house prices throughout the UK. However, we have maintained a significant market share of net new mortgage lending, whilst continuing to focus on the higher quality prime mortgage market and ensuring prudent new business loan-to-value ratios. The Group's estimated market share of net new lending in the third quarter of 2008 was 31 per cent. New business net interest margins have improved over the last twelve months as we benefit from both a market-wide increase in interest spreads and our relative funding advantage. The Group has continued to maintain high levels of asset quality by its continued focus on the prime UK mortgage market, with an average loan-to-value of new business written during the third quarter of 2008 of 64 per cent., in line with our recent performance.

We have maintained our strong position in personal loans and credit card issuance, and have continued to build our credit card business with continued growth in new customers choosing the Lloyds TSB AirMiles Duo account. The quality of our new unsecured personal loans has remained strong, reflecting the Group's focus on lending to existing current account customers where we better understand our customers' financial position.

### **Good progress in Insurance and Investments**

In Insurance and Investments, we have continued to achieve a good level of sales growth in the bancassurance channel, reflecting a strong performance in the sale of stand-alone protection products and OEICs through the Group's Wealth Management business. In the IFA channel, sales of pensions were good, however a significant reduction in the sale of savings and investment products led to an overall reduction in new business sales. Scottish Widows continues to make improvements in operational efficiencies and this has led to another excellent cost performance, with operating expenses continuing to be lower than last year. The capital position of Scottish Widows remains strong, notwithstanding recent falls in equity markets.

In General Insurance, we have delivered improved home insurance sales through the branch network and strong sales through our increasing corporate partnering arrangements. We expect to achieve good profit growth in the business in 2008, reflecting a significant reduction in weather-related claims, following last year's unusually high level of claims, and ongoing benefits from recent investments in improving our claims processes.

### **Strong relationship banking growth in Wholesale and International Banking**

In Wholesale and International Banking, while profits were lower reflecting the continued impact of market dislocation, the division has continued to make substantial progress in its core banking businesses. Excluding this impact of market dislocation, the division achieved double-digit growth in profit before tax. In Commercial Banking, growth in business volumes, in particular supported by 22 per cent growth in lending over the last twelve months to Small and Medium-sized Enterprises

(SMEs) with a turnover up to £15 million, and good progress in improving operational efficiency have resulted in continued strong trading surplus growth, which has been partly offset by higher impairments. In Corporate Markets, further progress has been made in developing our relationship banking franchise supporting increased customer demand for corporate lending and delivering a strong cross-selling performance.

The division has relatively limited exposure to assets affected by current market uncertainties. However, in Wholesale and International Banking profit before tax was reduced by £270 million during the third quarter of 2008 as a result of the impact of market dislocation on certain legacy portfolios. This principally reflects mark-to-market adjustments on treasury assets, impairments of exposures reclassified as loans and receivables and the write-down to zero of the Group's exposure to Structured Investment Vehicle (SIV) capital notes.

Following the recent amendment to International Accounting Standard 39 (IAS 39) the Group has reviewed the classification of its trading portfolios. For certain of the Group's legacy portfolios, there is no longer an active market and consequently trading activity has ceased. The Group now intends to hold these assets for the longer term and they have therefore been reclassified to loans and receivables (see appendix). The effect of this reclassification has been to reduce the charge, in the third quarter of 2008, relating to market dislocation by £114 million, to £270 million.

At 30 September 2008, the Group's portfolio of available-for-sale assets totalled £24.7 billion. A significant proportion of these assets (£7.2 billion) related to the Asset Backed Securities (ABS) in Cancara, our hybrid Asset Backed Commercial paper conduit. The balance of the Group's available-for-sale assets includes £3.1 billion Student Loan ABS, predominantly guaranteed by the US Government, £8.4 billion Government bonds and short-dated bank commercial paper and certificates of deposit and £5.4 billion major bank senior paper and high quality ABS. These available-for-sale assets are not held for trading purposes and as a result, under IFRS, they are marked-to-market through reserves. During the third quarter of 2008, a net £792 million reserves adjustment has been made to reflect the fact that, whilst not currently impaired, there has been a reduction in the market value of these assets. This adjustment has no impact on the Group's capital ratios.

The attached appendix shows the credit market positions on certain legacy positions in Corporate Markets, at 30 September 2008, on both a gross and net basis.

### **Strong Group cost performance**

The Group's strong cost performance has continued, resulting in a further improvement in the Group's underlying cost:income ratio. The Group's programme of efficiency improvements continues to progress well and we remain on track to deliver net benefits of circa £250 million in 2008.

### **In a difficult economic environment, asset quality remains satisfactory**

Overall Group asset quality remains satisfactory, despite higher impairment losses on loans and advances, largely reflecting the impact of lower house prices on the mortgage impairment charge and higher Corporate impairments, reflecting the ongoing deterioration in the UK economic environment and global financial markets. In the Retail Bank, arrears and delinquency trends in unsecured lending portfolios have remained satisfactory. Whilst arrears in the personal loan portfolio have continued to reduce, the Group's credit card and overdraft portfolios are showing slightly higher arrears than twelve months ago, reflecting the challenging economic environment. However, as we have previously indicated, the overall retail unsecured impairment charge in 2008 is not expected to significantly exceed that in 2007.

Mortgage credit quality remains robust with arrears levels at 30 September 2008 up 14 per cent over the last twelve months, compared to an industry average increase of 34 per cent in the twelve months to 30 June 2008. Although realised losses during the period have not been significant, the fall in the house price index (HPI) in the first nine months of 2008 has led to an increase in the HPI related charge for impairments. We expect this HPI related component of the impairment charge in the second half of 2008 to be approximately £120 million, based on the Group's latest assumption of a fall in house prices of approximately 15 per cent during 2008. Excluding the impact of this HPI related charge, mortgage impairments remain at a relatively modest level. Compared to the Council of Mortgage Lenders (CML) industry averages at 30 June 2008, Cheltenham & Gloucester had approximately half the industry average for properties in possession and new repossessions as a percentage of total cases in the first half of 2008.

In Wholesale and International Banking, corporate and small business asset quality remains satisfactory, although the recent deterioration in the UK economic environment has started to generate higher impairment charges in our corporate lending portfolios. In addition, the number of high profile financial services company collapses is likely to lead to additional write-offs of approximately £300 million in the second half of 2008 (approximately £200 million impairment, £100 million reduction in income).

### **Insurance volatility**

During the third quarter of 2008, high levels of volatility in fixed income markets and lower equity markets contributed to adverse volatility of £504 million relating to the insurance business, excluding policyholder interests volatility. This reflects a reduction in the market consistent valuation of the annuity portfolio, driven by the continued widening of corporate bond spreads, and lower expected future shareholder income from contracts where the underlying policyholder investments are in equities.

### **Robust capital ratios and strong liquidity and funding position**

The Group's capital ratios remain robust and the rate of risk-weighted asset growth in 2008 is expected to be high-teens per cent, including growth of approximately 7 percentage points reflecting the impact of falling house prices, and exchange rate movements. Throughout the ongoing market turbulence, Lloyds TSB has maintained a strong liquidity position for both the Group's funding requirements, which are supported by the Group's strong and stable retail and corporate deposit base, and those of its conduit, Cancara. In addition, retail deposit inflows remain strong and the Group continues to benefit from its strong credit ratings and diversity of funding sources. The Group's wholesale funding maturity profile has remained at a similar level to twelve months ago.

Over the last few weeks, we have seen some improved signs of stabilisation in global money markets, lower LIBOR interest rates, and an easing of general liquidity and funding pressures. This has led to higher confidence levels, in particular in some capital markets which have started to re-open for higher quality issuers, and the Group has started to secure some longer term funding, including a £400 million 10 year bond, without recourse to any Government guarantees.

## Appendix to Lloyds TSB IMS

### Credit market positions in Corporate Markets

Lloyds TSB's high quality business model means that the Group has relatively limited exposure to assets affected by current financial market turbulence. The following table shows credit market positions in certain legacy portfolios within corporate markets, on both a gross and net basis.

### Credit market positions

	30 June 2008		30 September 2008		Write-down 2008Q3 £m
	Net Exposure £m	Gross Exposure £m	Net Exposure £m	Gross Exposure £m	
<b>US sub-prime ABS-direct</b>	—	—	—	—	—
<b>ABS CDOS</b>					
– unhedged	70	70	49	49	29
– monoline hedged	—	297	—	316	16
– major global bank cash collateralised	—	1,382	—	1,538	—
<b>Structured Investment Vehicles</b>					
– capital notes	35	35	—	—	41
– liquidity backup facilities	85	85	21	21	4
<b>Loans and receivables*</b>					
– ABS trading book	—	—	316	316	81
– secondary loan trading	—	—	291	291	17
– other assets	—	—	2,265	2,265	23
<b>Trading Portfolio</b>					
– ABS trading book	417	417	—	—	—
– secondary loan trading	479	836	—	—	—
– other assets	3,622	3,622	1,391	1,391	59
					270

\*IAS39 reclassifications from Trading portfolio

### Available-for-sale assets

	30 June	30 September	Reserves
	2008	2008	adjustment
	£bn	£bn	2008Q3
			£m
<b>Cancara</b>	7.7	7.2	(400)
– US sub-prime – nil			
– Alt-A – £417 million (85% AAA/Aaa)			
– CMBS – £1,176 million (100% AAA/Aaa)			
<b>Student Loan ABS</b>	3.2	3.1	(241)
– US Government guaranteed			
<b>Treasury assets</b>	8.3	8.4	(41)
– Government bond and short-dated bank commercial paper and certificates of deposit			
<b>Other assets</b>	5.2	5.4	(107)
– Major bank senior paper and high quality ABS			
<b>Total – Corporate Markets</b>	24.4	24.1	(789)
Other businesses	0.6	0.6	(3)
<b>Total – Group</b>	25.0	24.7	(792)

## PART VIII

### INFORMATION ON THE HBOS GROUP

*Unless otherwise indicated the financial information in this Part VIII relating to HBOS has been extracted without material adjustment from information included in the condensed consolidated half year financial statements of HBOS as at and for the six months ended 30 June 2008. See "Presentation of Information" on page 2 of this document.*

#### 1 Overview

The HBOS Group is a diversified financial services group engaged in a range of banking, insurance, financial services and finance-related activities throughout the United Kingdom and internationally (Ireland, Europe, North America and Australia). The HBOS Group's products and services can be categorised into the following business divisions:

- Retail;
- Corporate;
- Insurance & Investment;
- International; and
- Treasury and Asset Management.

As at 30 June 2008, the HBOS Group was the largest retail mortgage provider in the UK with a market share (in terms of gross lending) of 19 per cent. and outstanding mortgage balances of approximately £237 billion. As at 30 June 2008, the HBOS Group was the largest liquid savings provider in the UK with a market share of 15.4 per cent.

As set out in the HBOS Group audited accounts for the financial year ended 31 December 2007, and extracted without material adjustment therefrom, HBOS reported net operating income of £21.3 billion and generated profit before taxation of £5.5 billion. For the six months ended 30 June 2008, HBOS reported net operating income of approximately £2.4 billion and generated profit before taxation of £848 million. HBOS reported total assets of £681.4 billion and shareholders' equity of £21.1 billion as at 30 June 2008.

#### 2 Principal Activities

##### ***Retail***

The Retail division provides financial services in the UK through a broad distribution base (ranging from branches to direct mail, telephone, internet services and third party intermediaries). Its range of multi-branded products includes personal banking services providing mortgages, savings, bank accounts, personal loans and credit cards.

The Retail division currently provides mortgages in the UK under five mortgage brands: Halifax; Bank of Scotland; Intelligent Finance; Birmingham Midshires; and The Mortgage Business.

Savings products are offered in the UK through four brands: Halifax; Bank of Scotland; Birmingham Midshires; and Intelligent Finance, catering for all segments of the savings market, including children's accounts, tax-free, fixed rate and regular savings accounts. Bank accounts offered by the HBOS Group range from full facility current accounts to basic social banking facilities.

Personal loans and credit cards are offered in the UK through the HBOS Group's Halifax, Bank of Scotland and Intelligent Finance brands. Credit cards are also provided through a number of affinity-brands such as charity cards, where a proportion of income earned is donated to the charity. The Retail division also distributes the HBOS Group's insurance and investment products on behalf of the Insurance & Investment division and participates in a number of joint ventures, such as Sainsbury's Bank.

##### ***Corporate***

The Corporate division provides a range of banking services to the corporate business sector. Its principal market is UK and Europe-based businesses with a turnover in excess of £1 million. The division comprises a number of relationship banking and specialist lending teams. Their responsibilities include the provision of term loans, asset finance, motor finance, multi-currency loans and deposits, mezzanine funding, equity investment, fund investment, joint venture



partnerships, working capital finance, project and specialist finance, acquisition finance and syndicated lending.

The Corporate division's real estate teams have experience in commercial property finance and offer a range of funding options. The Corporate division's commercial bank is a diverse business focusing on the needs of UK businesses with a turnover in excess of £1 million. The integrated, structured and acquisition finance teams operate in the leveraged buy-out market, providing a range of financing products to their customers. The private equity business has a reputation for innovative deal making and invests in a number of private equity funds. The Asset Solutions team focuses on a number of market sectors including: consumer point of sale, contract hire, public sector and specialist leasing. The specialised Industry Finance teams cover five discrete asset classes: housing finance; infrastructure finance; energy; telecoms & media; and transport.

### ***Insurance & Investment***

The HBOS Group's Insurance & Investment division is one of the UK's largest providers of general insurance and investment products, offering multi-brand life, pensions, mutual funds and general insurance products. The division uses a multi-channel, multi-brand operating model which the HBOS Group believes allows it to maximise both distribution reach and product and pricing flexibility. While low-cost access to the large Retail division customer base is a core strength, the division also benefits from solid third-party distribution relationships with partners and intermediaries. Products offered by the Insurance & Investment division include savings, investments and pensions, life, household, repayment and motor insurance. Products are distributed through a number of different channels, including branches, independent financial advisers, a dedicated high net worth sales force, telephone and internet sales, and partnerships and joint ventures with third parties.

The Investment businesses focus on manufacturing and distributing investment funds, bond and pension products. It has chosen not to actively market annuities given the longevity risk and capital requirements of such products. The Investment businesses have three distinct distribution channels: Bancassurance, Intermediary and Wealth Management. In Bancassurance, Halifax-branded business is distributed principally through branch-based personal financial advisers with mass affluent and high net worth business sold under the Bank of Scotland Investment Service brand. Clerical Medical-branded products are distributed through the Intermediary channel and, in Wealth Management, HBOS owns a 60 per cent. stake in St. James's Place.

The General Insurance business focuses on household, repayment and motor insurance. In addition to the Retail division's branch network, sales of household insurance are also made direct to customers via e-commerce and telephone channels and through partners and intermediaries. Repayment insurance products are also distributed through the Retail division's distribution network as well as a number of third-party relationships.

The esure joint venture manufactures and distributes all motor insurance products under the esure, Sheilas' Wheels, First Alternative, Halifax and Sainsbury's Bank brands. Distribution takes place largely through esure's direct channels as well as in Sainsbury's supermarkets. HBOS owns a 70 per cent. stake in esure.

The UK Competition Commission's investigation of payment protection (also known as repayment) insurance could affect the distribution and pricing of this product across the industry. Further details as to the investigations are set out in paragraph 11.1.1 of Part XII ("Additional Information") in this document.

### ***International***

The International division consists of three distinct businesses in (i) Ireland, (ii) Europe and North America, and (iii) Australia. In Ireland, the International division has become established in the business banking and intermediary markets, operating under the Bank of Scotland (Ireland) brand. The division has almost completed the roll out of its nationwide branch network that now supports the delivery of a full range of retail banking products including current accounts.

In Europe and North America, Corporate North America focuses on sectors in which the HBOS Group has experience, including the oil and gas, gaming and real estate sectors. The retail activities of Europe and North America consist of Banco Halifax Hispania and an online and intermediary mortgage business, BOS Netherlands. The Investment business provides life insurance and pensions, predominantly to the German investment market through the Clerical Medical Europe and Heidelberger Leben brands.

As announced by HBOS on 8 October 2008, the HBOS Group has agreed the sale of part of its Australian operations, namely Bank of Western Australia Ltd and St Andrews Australia Pty Ltd, to Commonwealth Bank of Australia Limited for the equivalent of approximately A\$2.5 billion (£1.2 billion). In addition to A\$2.1 billion (£1.0 billion) of cash consideration for the sale, HBOS will receive a return of excess capital in BankWest of approximately A\$360 million, together comprising A\$2.5 billion (£1.2 billion) of proceeds. The purchaser will also redeem preferred shares issued to the HBOS Group equivalent to their par value of A\$530 million (£250 million). The businesses pending sale comprise the HBOS Group's Australian retail and business banking operations as well as its insurance and wealth management businesses. These businesses generated profits before taxation of A\$300 million (£126 million) for the year ended 31 December 2007 and A\$126 million (£59 million) for the six months ended 30 June 2008. The total asset value of these businesses as at 30 June 2008 was approximately A\$64 billion (£31 billion).<sup>1,2</sup> Completion is subject to certain regulatory approvals in Australia. A summary of the terms of the sale agreement relating to these businesses is set out in paragraph 9.2.3 Part XII ("Additional Information") in this document.

Following the sale, HBOS retains a presence in Australia through Bank of Scotland International (Australia) Limited and Capital Finance Australia Limited which are engaged in corporate banking and asset finance activities respectively, together with the Bank of Scotland Treasury branch. The corporate banking business, based in Sydney, operates under the BOS International brand and provides acquisition finance, real estate lending and infrastructure/project finance. The division's asset finance business operates under the Capital Finance brand.

### ***Treasury and Asset Management***

Bank of Scotland Treasury is the centralised treasury function for the HBOS Group and manages prudential and regulatory liquidity and wholesale multi-currency funding. It arranges the HBOS Group's debt capital issuance and asset securitisation programmes and offers a range of treasury services to HBOS Group customers from its offices in London and its branches in Glasgow, Grand Cayman, New York and Sydney. Bank of Scotland Treasury also has management responsibility for the treasury activities of Bank of Scotland (Ireland) Limited.

Asset Management, comprising Insight Investment Management Limited ("Insight") and Invista Real Estate Investment Management plc ("Invista") (55 per cent. owned) and their respective subsidiary companies, is the investment management business within the HBOS Group.

Insight operates a multi-channel business, managing money for the HBOS Group, retail investors, pension funds, insurance groups and other institutions. Insight's strategic product lines are Fixed Income, Cash, Liability Driven Investment, Equities and Absolute Return.

Invista was formed following the initial public offering of the real estate management division of Insight and is a UK-listed real estate fund manager. Invista currently manages 21 real estate funds spread across the UK and continental Europe. This includes seven funds managed on behalf of the HBOS Group as well as other funds managed on behalf of third-party clients.

## **3 Current Trading, Trends and Prospects**

HBOS today announced an interim management statement, the text of which is set out in Part XIII ("HBOS Interim Management Statement 3 November 2008") of this document.

---

(1) Exchange rates used in conversion are based on 30 June 2008, except for those relating to profits before taxation. As at 30 June 2008, £1 : A\$2.08; average for year ended 31 December 2007, £1 : A\$2.39; average for half year ended 30 June 2008, £1 : A\$2.14.

(2) Extracted without material adjustment from unaudited management accounts.

## **PART IX**

### **HISTORICAL FINANCIAL INFORMATION RELATING TO HBOS PLC**

#### **Part A – Financial Information for the three years ended 31 December 2007**

##### **Basis of Financial Information**

The following tables set out consolidated financial information of HBOS for the years ended 31 December 2007, 31 December 2006 and 31 December 2005. The financial information for the years ended 31 December 2007, 31 December 2006 and 31 December 2005 set out in this Part IX has been extracted without material adjustment from the audited accounts of HBOS for each year. The audit reports of HBOS for each of the financial years ended 31 December 2005, 31 December 2006 and 31 December 2007 were unqualified.

The financial statements of HBOS for the years ended 31 December 2005, 31 December 2006 and 31 December 2007 were prepared in accordance with IFRS.

In this Part IX, references to “the Company” are to be taken as references to HBOS and references to “the Group” are taken as references to the HBOS Group. In addition, in this Part IX, references to the “Directors” or the “Board of Directors” are to be taken as references to the HBOS Directors and HBOS Board, respectively.

**HBOS plc Consolidated Income Statement**  
**For the year ended 31 December 2007**

	Notes	2007	2006 £m	2005
Interest income		35,012	26,742	24,134
Interest expense		(27,708)	(19,342)	(17,305)
<b>Net interest income</b>	1	<u>7,304</u>	<u>7,400</u>	<u>6,829</u>
Fees and commission income		2,378	2,175	2,212
Fees and commission expense		(1,118)	(1,012)	(1,178)
Net earned premiums on insurance contracts		5,616	5,648	4,654
Net trading income	1	178	292	218
Change in value of in-force long term assurance business		16	282	394
Net investment income related to insurance and investment business		4,613	6,445	9,342
Other operating income		2,304	1,484	1,146
<b>Net operating income</b> (continuing operations)	1	21,291	22,714	23,617
Change in investment contract liabilities	3	(2,538)	(2,910)	(5,089)
Net claims incurred on insurance contracts		(2,952)	(2,328)	(2,019)
Net change in insurance contract liabilities		(2,244)	(3,894)	(4,220)
Change in unallocated surplus	28	50	(569)	(369)
Administrative expenses	4	(4,979)	(4,623)	(4,611)
Depreciation and amortisation				
Intangible assets other than goodwill	19	(193)	(161)	(149)
Property and equipment	20	(224)	(219)	(226)
Operating lease assets	22	(985)	(812)	(561)
		(1,402)	(1,192)	(936)
Goodwill impairment	19	(5)	(55)	
<b>Operating expenses</b>		<u>(14,070)</u>	<u>(15,571)</u>	<u>(17,244)</u>
Impairment losses on loans and advances	15	(2,012)	(1,742)	(1,599)
Impairment losses on investment securities		(60)	(71)	(51)
<b>Operating profit</b> (continuing operations)		5,149	5,330	4,723
Share of profits of jointly controlled entities	17	234	112	29
Share of profits of associates	17		14	10
Non-operating income	2	91	250	46
<b>Profit before taxation</b>	8	5,474	5,706	4,808
Tax on profit	9	(1,365)	(1,772)	(1,546)
<b>Profit after taxation</b>		<u>4,109</u>	<u>3,934</u>	<u>3,262</u>
Profit of disposal group	12	4	5	
<b>Profit for the year</b>		<u>4,113</u>	<u>3,939</u>	<u>3,262</u>
<i>Attributable to:</i>				
Parent company shareholders		4,045	3,879	3,230
Minority interests		68	60	32
		<u>4,113</u>	<u>3,939</u>	<u>3,262</u>

	<i>Notes</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
Basic earnings per ordinary share				
Continuing operations		106.2p	100.5p	82.2p
Disposal group			0.1p	
<b>Total</b>	10	<u>106.2p</u>	<u>100.6p</u>	<u>82.2p</u>
Diluted earnings per ordinary share				
Continuing operations		105.5p	99.4p	81.3p
Disposal group			0.1p	
<b>Total</b>	10	<u>105.5p</u>	<u>99.5p</u>	<u>81.3p</u>

**HBOS plc Consolidated Balance Sheet  
As at 31 December 2007**

	Notes	2007	2006 £m	2005
<b>Assets</b>				
Cash and balances at central banks		2,572	1,966	1,678
Items in course of collection		945	880	753
Financial assets held for trading	11	54,681	49,139	41,766
Disposal group assets held for sale	12		1,388	
Derivative assets	13	14,141	8,612	10,499
Loans and advances to banks		8,056	11,593	17,356
Loans and advances to customers	14	430,007	376,808	343,768
Investment securities	16	128,398	117,031	104,334
Interests in jointly controlled entities	17	836	420	285
Interests in associates	17	149	181	174
Goodwill and other intangible assets	19	2,790	2,689	2,448
Property and equipment	20	1,494	1,573	1,533
Investment properties	21	4,731	5,010	3,942
Operating lease assets	22	4,643	4,681	3,115
Deferred costs	23	1,101	853	645
Value of in-force long term assurance business	24	3,184	3,104	2,847
Other assets	25	7,468	4,671	4,697
Prepayments and accrued income		1,751	1,214	1,033
<b>Total Assets</b>		<b>666,947</b>	<b>591,813</b>	<b>540,873</b>
<b>Liabilities</b>				
Deposits by banks		41,513	30,557	32,041
Customer accounts		243,221	211,857	200,948
Financial liabilities held for trading	11	22,705	22,334	25,007
Disposal group liabilities held for sale	12		909	
Derivative liabilities	13	12,311	10,755	8,576
Notes in circulation		881	857	830
Insurance contract liabilities	26	26,864	24,977	21,970
Investment contract liabilities	27	52,828	49,486	42,157
Unallocated surplus	28	1,493	1,543	974
Net post retirement benefit liabilities	29	347	912	1,841
Current tax liabilities		370	79	53
Deferred tax liabilities	31	2,530	2,591	1,751
Other liabilities	32	5,072	7,171	5,012
Accruals and deferred income		3,630	3,071	2,764
Provisions	33	175	201	278
Debt securities in issue	34	206,520	183,650	157,961
Other borrowed funds	35	24,253	19,692	20,254
<b>Total Liabilities</b>		<b>644,713</b>	<b>570,642</b>	<b>522,417</b>
<b>Shareholders' Equity</b>				
Issued share capital	36	1,131	1,139	1,157
Share premium	38	2,997	2,856	2,316
Other reserves	38	154	1,161	844
Retained earnings	38	17,567	15,529	13,948
<b>Shareholders' equity</b> (excluding minority interests)		<b>21,849</b>	<b>20,685</b>	<b>18,265</b>
Minority interests	38	385	486	191
<b>Total Shareholders' Equity</b>	38	<b>22,234</b>	<b>21,171</b>	<b>18,456</b>
<b>Total Liabilities and Shareholders' Equity</b>		<b>666,947</b>	<b>591,813</b>	<b>540,873</b>

**HBOS plc Consolidated Statement of Recognised Income and Expense  
For the year ended 31 December 2007**

	2007	2006 <i>£m</i>	2005
Net actuarial gain from defined benefit plans (net of tax)	312	163	(167)
Foreign exchange translation	2	(23)	(4)
Available for sale investments:			
Net change in fair value (net of tax)	(333)	190	133
Net gains transferred to the income statement (net of tax)	(184)	(171)	(118)
Cash flow hedges:			
Effective portion of changes in fair value taken to equity (net of tax)	(216)	209	6
Net (gains)/losses transferred to the income statement (net of tax)	(292)	86	34
Revaluation of existing net assets upon acquisition of jointly controlled entity		(15)	
<b>Net (expense)/income recognised directly in equity</b>	<b>(711)</b>	<b>439</b>	<b>(116)</b>
Profit for the year	4,113	3,939	3,262
<b>Total recognised income and expense</b>	<b>3,402</b>	<b>4,378</b>	<b>3,146</b>
<i>Attributable to:</i>			
Parent company shareholders	3,334	4,318	3,114
Minority interests	68	60	32
	<b>3,402</b>	<b>4,378</b>	<b>3,146</b>

**HBOS plc Consolidated Cash Flow Statement  
For the year ended 31 December 2007**

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
Profit before taxation	5,474	5,706	4,808
<i>Adjustments for:</i>			
Impairment losses on loans and advances	2,012	1,742	1,599
Depreciation and amortisation	1,402	1,192	936
Goodwill impairment	5	55	
Interest on other borrowed funds	1,229	1,157	1,116
Pension charge for defined benefit schemes	146	164	208
Cash contribution to defined benefit schemes	(295)	(860)	
Exchange differences	(769)	3,157	(2,607)
Movement in derivatives held for trading	(1,487)	4,081	(2,158)
Other non-cash items	45	(902)	(72)
Net change in operating assets	(78,863)	(61,268)	58,072
Net change in operating liabilities	68,470	44,743	55,662
	<hr/>	<hr/>	<hr/>
<b>Net cash flows from operating activities before tax</b>	(2,631)	(1,033)	1,420
Income taxes paid	(895)	(991)	(1,317)
	<hr/>	<hr/>	<hr/>
<b>Cash flows from operating activities</b>	(3,526)	(2,024)	103
Cash flows from investing activities	(289)	(1,643)	(3,999)
Cash flows from financing activities	298	(2,106)	(923)
	<hr/>	<hr/>	<hr/>
<b>Net decrease in cash and cash equivalents</b>	(3,517)	(5,773)	(4,819)
Opening cash and cash equivalents	8,191	13,964	18,783
	<hr/>	<hr/>	<hr/>
<b>Closing cash and cash equivalents</b>	4,674	8,191	13,964
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

**Analysis of Cash and Cash Equivalents**

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
Cash and balances at central banks repayable on demand	1,061	663	578
Loans and advances to banks with an original maturity of less than three months	3,613	7,528	13,386
	<hr/>	<hr/>	<hr/>
<b>Closing cash and cash equivalents</b>	4,674	8,191	13,964
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>



## Investing Activities

	2007	2006 £m	2005
Sale and maturity of investment securities			25,597*
Purchase of investment securities			(27,998)*
Sale of other intangible assets	31	27	13
Purchase of other intangible assets	(249)	(194)	(163)
Sale of property and equipment	182	60	135
Purchase of property and equipment	(307)	(280)	(307)
Sale of investment properties	58	2	15
Purchase of investment properties			(16)*
Sale of operating lease assets			604*
Purchase of operating lease assets			(1,185)*
Cash contribution to defined benefit pension schemes			(368)*
Investment in subsidiaries	(41)	(1,241)	(218)
Disposal of subsidiaries	115	87	
Investment in jointly controlled entities and associates	(396)	(202)	(173)
Disposal of jointly controlled entities and associates	176	29	17
Dividends received from jointly controlled entities	132	57	39
Dividends received from associates	10	12	9
<b>Cash flows from investing activities</b>	<b>(289)</b>	<b>(1,643)</b>	<b>(3,999)</b>

## Financing Activities

	2007	2006 £m	2005
Issue of shares	146	548	1,078
Ordinary share buyback including costs	(500)	(982)	(994)
Purchase of own shares	(212)	(99)	(174)
Disposal of own shares	35	52	
Issue of other borrowed funds	4,742	1,571	1,889
Repayments of other borrowed funds	(928)	(777)	(273)
Interest on other borrowed funds relating to the servicing of finance	(1,199)	(1,153)	(1,078)
Minority interest acquired		387	
Minority interest disposed		(30)	
Equity dividends paid	(1,747)	(1,501)	(1,363)
Dividends paid to minority shareholders in subsidiaries	(39)	(22)	(8)
<b>Cash flows from financing activities</b>	<b>298</b>	<b>(2,106)</b>	<b>(923)</b>

\* The 2005 comparatives are as published and have not been restated to reflect the presentational reclassification from Investing Activities to Operating Activities of these items as adopted on the 2007 and 2006 financial information.

**HBOS plc Company Balance Sheet  
As at 31 December 2007**

	Notes	2007	2006 £m	2005
<b>Assets</b>				
Amounts owed by Group entities	18	38,885	27,765	16,202*
Derivative assets	13	162	1	44
Investment securities	16	1	40	49
Intangible assets	19	6	8	
Deferred tax asset	31	85	254	
Other assets	25	395	344	83
Prepayments and accrued income			14	4
Investments in subsidiaries	18	14,475	11,995	15,751*
<b>Total Assets</b>		<b>54,009</b>	<b>40,421</b>	<b>32,133</b>
<b>Liabilities</b>				
Amounts owed to Group entities		29,267	18,297	12,121
Derivative liabilities	13	56	56	
Net post retirement benefit liabilities	29	360	877	
Other liabilities	32	204	213	225
Accruals and deferred income		68	67	52
Other borrowed funds	35	15,503	12,326	11,818
<b>Total Liabilities</b>		<b>45,458</b>	<b>31,836</b>	<b>24,216</b>
<b>Shareholders' Equity</b>				
Issued share capital	36	1,131	1,139	1,157
Share premium	38	2,997	2,856	2,316
Other reserves	38	69	53	27
Retained earnings	38	4,354	4,537	4,417
<b>Total Shareholders' Equity</b>	<b>38</b>	<b>8,551</b>	<b>8,585</b>	<b>7,917</b>
<b>Total Liabilities and Shareholders' Equity</b>		<b>54,009</b>	<b>40,421</b>	<b>32,133</b>

By virtue of the exemption contained within Section 230 of the Companies Act 1985, the income statement of the Company is not presented. Of the profit attributable to shareholders £1,731m (2006 £2,700m, 2005 £1,894m) is dealt with in the accounts of the Company.

\* The 2005 comparatives are as published and have not been restated to reflect the presentational reclassification of £5,883m of funds loaned to subsidiaries within Investment in subsidiaries which has been classified on Amounts owed by Group activities on the 2007 and 2006 financial information.

**HBOS plc Company Statement of Recognised Income and Expense  
For the year ended 31 December 2007**

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
<b>Net actuarial gain/(loss) from defined benefit plans (net of tax)</b>	<u>261</u>	<u>(93)</u>	<u></u>
Net income/(expense) recognised directly in equity	261	(93)	
Profit after taxation	<u>1,731</u>	<u>2,700</u>	<u>1,894</u>
<b>Total recognised income and expense</b>	<u><u>1,992</u></u>	<u><u>2,607</u></u>	<u><u>1,894</u></u>
<i>Attributable to:</i>			
<b>Parent company shareholders</b>	<u>1,992</u>	<u>2,607</u>	<u>1,894</u>

**HBOS plc Company Cash Flow Statement  
For the year ended 31 December 2007**

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
<b>Profit before taxation</b>	1,652	2,664	1,859
Adjustments for:			
Dividends received	(2,013)	(2,790)	(1,533)
Interest on other borrowed funds	776	626	579
Pension charge for defined benefit schemes	(11)	(24)	
Cash contribution to defined benefit schemes	(105)	(685)	
Other non-cash items	9	1	(39)
Net change in operating assets	(738)	(5,467)	(2,668)
Net change in operating liabilities	4,309	7,883	1,179
	<hr/>	<hr/>	<hr/>
<b>Net cash flows from operating activities before tax</b>	3,879	2,208	(623)
Income taxes received	29	41	37
	<hr/>	<hr/>	<hr/>
<b>Cash flows from operating activities</b>	3,908	2,249	(586)
Cash flows from investing activities	(3,822)	(124)	1,389
Cash flows from financing activities	(169)	(1,365)	(532)
	<hr/>	<hr/>	<hr/>
<b>Net (decrease)/increase in cash and cash equivalents</b>	(83)	760	271
Opening cash and cash equivalents	1,260	500	229
	<hr/>	<hr/>	<hr/>
<b>Closing cash and cash equivalents</b>	1,177	1,260	500

**Analysis of Cash and Cash Equivalents**

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
Amounts owed by Group entities with an original maturity of less than three months	1,177	1,260	500
	<hr/>	<hr/>	<hr/>
<b>Closing cash and cash equivalents</b>	1,177	1,260	500
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

**Investing Activities**

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
Investment in subsidiaries	(2,480)	(2,077)	(25)
Advances to Group entities	(3,365)	(846)	(83)
Purchase of investment securities			(36)
Sale of investment securities	10	9	
Dividends received	2,013	2,790	1,533
	<hr/>	<hr/>	<hr/>
<b>Cash flows from investing activities</b>	(3,822)	(124)	1,389
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

## Financing Activities

	2007	2006	2005
		£m	
Issue of shares	146	548	1,078
Ordinary share buyback including costs	(500)	(982)	(994)
Issue of other borrowed funds	2,746	1,255	1,377
Equity dividends paid	(1,747)	(1,501)	(1,363)
Interest on other borrowed funds relating to servicing of finance	(752)	(626)	(572)
Purchase of own shares	(62)	(59)	(58)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Cash flows</b>			
from financing activities	(169)	(1,365)	(532)
	<u>          </u>	<u>          </u>	<u>          </u>

## **Notes to the HBOS plc Financial Information for the years ended 31 December 2005, 2006 and 2007**

The financial information presented for the three years ended 31 December 2007 has been extracted without material adjustment from the audited accounts of HBOS for each of those years. The following Accounting Policies have been extracted without material adjustment from the audited accounts of HBOS in accordance with the Basis of Financial Information as set out on page 76.

### **Accounting Policies**

#### **Financial Statements**

The financial statements of HBOS plc comprise the Consolidated Income Statement and the Consolidated and Company Balance Sheets, Cash Flow Statements and Statements of Recognised Income and Expense together with the related Notes to the Accounts.

#### **Statement of Compliance**

The financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) and interpretations issued by the International Financial Reporting Interpretations Committee (“IFRIC”) as adopted by the European Union. The Group has not utilised the “carve-out” provisions in respect of full fair value and portfolio hedging of core deposits in IAS 39 “Financial Instruments: Recognition and Measurement” as adopted by the European Union and consequently, the financial statements comply with International Financial Reporting Standards. The standards applied by the Group and Company are those endorsed by the European Union and effective at the date the financial statements are approved by the Board.

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

#### **Basis of Preparation**

The financial statements have been prepared under the historical cost basis, except that the following assets and liabilities are stated at their fair values: derivatives, financial instruments held for trading, financial instruments designated at fair value through the income statement, financial instruments classified as available for sale and investment properties. In addition insurance contracts, investment contracts with discretionary participation features and value of in-force long term assurance business included in the insurance and investment business are prepared on the basis set out in the applicable accounting policy.

#### **IFRS Applied in 2007**

The following IFRS standards and IFRIC interpretations have been applied in 2007: IFRS 7 “Financial Instruments: Disclosures”, the amendment to IAS 1 “Presentation of Financial Statements” on capital disclosure, IFRIC 7 “Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies”, IFRIC 8 “Scope of IFRS 2 Share-based Payment”, IFRIC 9 “Reassessment of Embedded Derivatives” and IFRIC 10 “Interim Financial Reporting and Impairment”. There is no material financial impact arising from the application of these standards and interpretations. The financial statements have been updated to include new disclosures arising from these standards and interpretations.

#### **IFRS Not Yet Applied**

The following standards and interpretations have been adopted by the European Union but are not effective for the year ended 31 December 2007 and have not been applied in preparing the financial statements:

IFRS 8 “Operating Segments” which is applicable for periods commencing on or after 1 January 2009. The application of this standard in 2007 would not have had any financial impact. During 2008 the Group will be assessing the standard against its business model and the disclosures will be revised accordingly in the 2009 financial statements.

IFRIC 11 “Group and Treasury Share Transactions” which is effective for periods commencing on or after 1 March 2007. The application of this interpretation in 2007 would not have affected the Group consolidated financial statements because the interpretation deals with accounting for share-

based payments at subsidiary level. At Company level no material adjustment arises since these costs are already recharged.

The following standards and interpretations have not yet been adopted by the European Union, are not effective for the year ended 31 December 2007 and have not been applied in preparing the financial statements. Where appropriate disclosures will be revised in the financial statements in the year in which the standard or interpretation becomes applicable.

IAS 1 “Presentation of Financial Statements” which is effective for periods commencing on or after 1 January 2009. The application of this revised standard in 2007 would not have had any financial impact on the financial statements. It will impact the presentation and format of the primary statements and notes and these disclosures will be revised accordingly in the 2009 financial statements.

Revised IAS 23 “Borrowing Costs” which is applicable to borrowing costs related to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. The application of this revised standard in 2007 would not have had a material impact on the financial statements.

IFRIC 12 “Service Concession Arrangements” which is effective for periods commencing on or after 1 January 2008. The application of this interpretation in 2007 would not have had a material impact on the financial statements.

IFRIC 13 “Customer Loyalty Programmes” which is effective for periods commencing on or after 1 July 2008. The application of this interpretation in 2007 would not have had a material impact on the financial statements.

IFRIC 14 “Defined Benefit Assets and Minimum Funding Requirements” which is effective for periods commencing on or after 1 January 2008. The application of this interpretation in 2007 would not have affected the financial statements given the financial position, funding profile, maturity and rules of the Group’s defined benefit schemes.

The following standards have been issued during 2008, have not been endorsed by the European Union, are not effective for the year ended 31 December 2007 and have not been applied in preparing the financial statements.

IFRS 2 “Share-based Payments” amendment on “Vesting Conditions and Cancellations” which is effective for periods commencing on or after 1 January 2009.

Revised IFRS 3 “Business Combinations (2008)” and Revised IAS 27 “Consolidated and Separate Financial Statements (2008)” are effective for periods commencing on or after 1 July 2009.

Amendments to IAS 32 “Financial Instruments: Presentation” and IAS 1 “Presentation of Financial Statements” – Puttable Financial Instruments and Obligations Arising on Liquidation are effective for periods commencing on or after 1 January 2009.

The Group has been monitoring the progress of these revised standards through the discussion papers and exposure drafts issued and will assess their impact on the financial statements of the Group during 2008.

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

### **Basis of Consolidation**

The consolidated financial statements include the results of the Company and its subsidiary undertakings, together with the Group’s interests in associates and jointly controlled entities.

The financial statements of entities controlled by the Group are consolidated in the Group financial statements commencing on the date control is obtained until the date control ceases. Control is defined as being where the Group has power, directly or indirectly, to govern the financial and operating policies of such entities so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. When assessing whether or not a special purpose entity (“SPE”) that has been sponsored by the Group should be consolidated or not, the Group considers the indicators of control that are included in the Standing Interpretations Committee (“SIC”) Interpretation 12 “Consolidation – Special Purpose Entities” and if these are met the SPE is included in the consolidation.

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

## Designation of Financial Instruments

The Group has classified its financial instruments in accordance with IAS 39 “Financial Instruments: Recognition and Measurement” as follows:

- Non-derivative financial assets where there is no active market and which have fixed or determinable payments are classified as “loans and receivables”.
- The Group’s “trading” portfolio is classified as “held for trading”.
- Derivative instruments are automatically classified as “at fair value through the income statement” unless they form part of an effective hedging relationship.
- Instruments that are deemed on initial recognition to eliminate a measurement mismatch or where they contain an embedded derivative which is not separated from the host contract are designated “at fair value through the income statement”.
- Assets in support of the general insurance and long term assurance business are designated “at fair value through the income statement”.
- Investment contracts within the long term assurance business are designated “at fair value through the income statement”.
- No financial assets are designated as “held to maturity”.
- All other financial assets are classified as “available for sale”.
- All other financial liabilities are classified as “at amortised cost”.

## Recognition and Derecognition of Financial Assets and Liabilities

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

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

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

## Derivatives

Derivatives are measured at fair value and initially recognised on the date the contract is entered into. Where the fair value of a derivative is positive, it is carried as a derivative asset and where negative as a derivative liability. The gain or loss from changes in fair value is taken to net trading income, except for interest from derivatives used for economic hedging purposes that do not qualify for hedge accounting treatment which is taken to net interest income, insurance and investment related derivatives which are taken to net investment income related to insurance and investment business or when cash flow hedge accounting is employed.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of the same. At inception of the hedge relationship formal documentation is drawn up specifying the hedging strategy, the component transactions and the methodology that will be used to measure effectiveness.

Monitoring of hedge effectiveness is undertaken continually. A hedge is regarded as effective if the change in fair value or cash flows of the hedge instrument and the hedged item are negatively correlated within a range of 80 per cent. to 125 per cent., either for the period since effectiveness was last tested or cumulatively since inception.

The Group uses three hedge accounting methods.

Firstly, fair value hedge accounting offsets the change in the fair value of the hedging instrument against the change in the fair value of the hedged item in respect of the risk being hedged. The hedged item is adjusted for the fair value of the risk being hedged irrespective of its financial instrument classification. These changes in fair value are recognised in the income statement through net trading income. Adjustments made to the carrying amount of the hedged item for fair



value hedges will be amortised on an effective interest rate basis over the remaining expected life in line with the presentation of the underlying hedged item. If the hedge is highly effective the net impact on the income statement is minimised.

Secondly, cash flow hedge accounting matches the cash flows of hedged items against the corresponding cash flow of the hedging derivative. The effective part of any gain or loss on a hedging instrument is recognised directly in equity in the cash flow hedge reserve and the hedged item is accounted for in accordance with the policy for that financial instrument. Any ineffective portion of the hedging instrument's fair value is recognised immediately in the income statement through net trading income. The amount deferred in reserves remains until the designated transaction occurs at which time it is released and accounted for in the income statement in line with the treatment of the hedged item. Where the hedge relationship subsequently proves ineffective, or where the hedged item is settled early or is terminated, the associated gains and losses that were recognised directly in reserves are reclassified to the income statement through net trading income. Where the hedging instrument expires or is terminated before the forecast transaction occurs, the associated gains and losses recognised in reserves remain deferred until the forecast transaction occurs.

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

A derivative may be embedded in another financial instrument, known as the host contract. Where the economic characteristics and risks of an embedded derivative are not closely related to those of the host contract, the embedded derivative is separated from the host and held separately on the balance sheet at fair value, except for those instruments that have been designated at fair value through the income statement, where the derivative is not separated from the host instrument. Changes in fair value are taken to the income statement through net trading income, and the host contract is accounted for in accordance with the policy for that class of financial instrument.

If quoted or market values are not available then derivative fair values are determined using valuation techniques that are consistent with techniques commonly used by market participants to price these instruments. These techniques include discounted cash flow analysis and other pricing models. The fair values calculated from these models are regularly compared with prices obtained in actual market transactions to ensure reliability. In all material instances these techniques use only observable market data.

### **Loans and Advances**

Loans and advances held for trading principally consist of reverse repurchase agreements, are carried at fair value and are classified as financial assets held for trading. Gains, losses and related income are taken to net trading income as they arise.

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

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

Loans and advances that are performing in accordance with the underlying contract are classified as neither past due nor impaired. If a customer fails to make a payment that is contractually due the loan is classified as past due. If subsequently all contractually due payments are made the loan reverts to its neither past due nor impaired status.

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

Individual impairment is identified at a counterparty specific level following objective evidence that a financial asset is impaired. This may be after an interest or principal payment is missed, when a banking covenant is breached or when the counterparty is experiencing significant financial difficulties including cash flow problems. Objective evidence may also arise from wider economic and financial market indicators including factors that pertain to a particular industry sector or local economy. The present value of estimated cash flows recoverable is determined after taking into account any security held. The amount of any impairment is calculated by comparing the present value of the cash flows discounted at the loan's original effective interest rate with the carrying value. If impaired, the carrying value is adjusted and the difference charged to the income statement.

The written down value of the impaired loan is compounded back to the net realisable balance over time using the original effective interest rate. This is reported through interest income in the income statement and represents the unwinding of the discount.

A write-off is made when all or part of a claim is deemed uncollectable or forgiven. Write-offs are charged against previously established provisions for impairment or directly to the income statement.

In circumstances where an asset has been individually assessed for impairment and no objective evidence of impairment exists, then it will be subject to a collective assessment.

Collective impairment is identified for groups of assets that share similar risk characteristics. Collective impairment is assessed using a methodology based on existing risk conditions or events that have a strong correlation with a tendency to default.

Loans and advances that are subject to collective impairment provisioning are deemed to be impaired loans where interest or capital payments are past due by more than three months.

Loans and advances that are past due or impaired may have the terms and conditions renegotiated. Loans and advances are classified as renegotiated if they fulfil the definition of a troubled debt restructuring. When the renegotiated contract becomes effective, the loan is subsequently classified as past due, impaired or neither past due nor impaired according to its performance under the renegotiated terms.

Loans and advances to customers include advances that are subject to non-returnable finance arrangements following securitisation of portfolios of mortgages and other advances. The principal benefits of these advances are acquired by special purpose securitisation entities that fund their purchase primarily through the issue of debt securities in issue.

### **Syndications**

Syndication activity is undertaken as part of the Group's credit risk management strategy. The Group considers that loan commitments and subsequent draw down form one contract. The loan is recognised at the date of the draw down and initial fair value is measured at the commitment date. Loans pending syndication are classified as loans and receivables and derecognised upon sell down when the risks and rewards are transferred to a third party.

### **Finance Leases and Operating Leases**

Assets leased to customers that transfer substantially all the risks and rewards incidental to ownership to the customer are classified as finance leases. Together with instalment credit agreements, they are recorded at an amount equal to the net investment in the lease, less any provisions for impairment, within loans and advances to customers.

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

All other assets leased to customers are classified as operating leases. These assets are separately disclosed in the balance sheet and are recorded at cost less accumulated depreciation, which is calculated on a straight-line basis. Operating lease rentals are recognised in operating income on a straight-line basis over the lease term. Operating lease assets are reviewed for impairment when there is an indication of impairment.

## **Investment Securities**

Investment securities held for trading are classified as financial assets held for trading and are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. Investment securities designated at fair value through the income statement are carried at fair value. Gains, losses and related income are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business.

Debt securities other than those held for trading or designated at fair value and for which there is no active market at inception are classified as loans and receivables. They are initially recognised at fair value plus directly related incremental transaction costs and are subsequently carried on the balance sheet at amortised cost using the effective interest rate method less provision for impairment.

All other investment securities are classified as available for sale. They are initially recognised at fair value plus directly related incremental transaction costs and are subsequently carried on the balance sheet at fair value. Unrealised gains or losses arise from changes in the fair values and are recognised directly in equity in the available for sale reserve, except for impairment losses or foreign exchange gains or losses related to debt securities, which are recognised immediately in the income statement in impairment on investment securities or other operating income respectively. Income on debt securities is recognised on an effective interest rate basis and taken to interest income through the income statement. Income from equity shares is credited to other operating income, with income on listed equity shares being credited on the ex-dividend date and income on unlisted equity shares being credited on an equivalent basis. On sale or maturity, previously unrealised gains and losses are recognised in other operating income.

Impairment losses on available for sale equity instruments are not reversed through the income statement. Any increase in the fair value of an available for sale equity instrument after an impairment loss has been recognised is treated as a revaluation and recognised directly in equity. An impairment loss on an available for sale debt instrument is reversed through the income statement, if there is evidence that the increase in fair value is due to an event that occurred after the impairment loss was recognised.

The fair value of investment securities trading in active markets is based on market prices or broker/dealer valuations. Where quoted prices on instruments are not readily and regularly available from a recognised broker, dealer or pricing service, or available prices do not represent regular transactions in the market, the fair value is estimated. These estimates use quoted market prices for securities with similar credit, maturity and yield characteristics or similar valuation models. Asset-backed securities ("ABS") not traded in an active market are valued using valuation models that include non-market observable inputs. These models use observed issuance prices, benchmarking methodology and modelled market correlations. For each asset class within the portfolio, the implied spread arrived at by using this methodology is applied to the securities within that asset class. Additional assessments are then made for possible deterioration in credit risk for each individual security.

The Group uses settlement date accounting when recording the purchase and sale of investment securities, with the exception of those held for trading for which trade date accounting is used.

## **Jointly Controlled Entities and Associates**

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

Associates are entities over which the Group has significant influence, but not control over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity but is not control over those policies.

The attributable shares of results of associates and jointly controlled entities, generally based on audited accounts, are included in the consolidated financial statements using the equity method of accounting. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

## **Goodwill**

The excess of the cost of a business combination over the interest in the net fair value of the identifiable assets, liabilities and contingent liabilities at the date of acquisition of a business is

capitalised as goodwill. The goodwill is allocated to the cash-generating units or groups of cash-generating units that are expected to benefit from the acquisitions concerned. In most cases, the cash-generating units represent the business acquired.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Cash-generating units to which goodwill is allocated are subject to a semi-annual impairment review at 31 March and 30 September and whenever there is an indication that the unit may be impaired, by comparing the value in use with the carrying value. When this indicates that the carrying value of goodwill is not recoverable, it is irrevocably written down through the income statement by the amount of any impaired loss identified. Further details of the calculation are given in the critical accounting estimates and in Note 19. IFRS 3 “Business Combinations” has not been applied retrospectively to business combinations that occurred before 1 January 2004.

### **Software**

Costs associated with the development of software for internal use, subject to *de minimis* limits, are capitalised if the software is technically feasible and the Group has both the intent and sufficient resources to complete the development. Costs are only capitalised if the asset can be reliably measured and will generate future economic benefits to the Group either through sale or use.

Only costs that are directly attributable to bringing the asset into working condition for its intended use are capitalised. These costs include all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in a manner intended by management. Other development expenditure is recognised in the income statement as an expense as incurred.

Capitalised development expenditure and purchased software is stated at cost less accumulated amortisation and impairment losses. Once the software is ready for use, the capitalised costs are amortised over their expected lives, generally four years. Capitalised software is assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The amortisation charge for the asset is then adjusted to reflect the asset’s revised carrying amount.

Subsequent expenditure is only capitalised when it increases the future economic benefits embodied in the specific asset to which it relates.

### **Purchased Value of In-Force Investment Contracts**

The Group’s contractual rights to benefits from providing investment management services in relation to investment contracts acquired in business combinations and portfolio transfers are measured at fair value at the time of acquisition. The resulting asset is referred to as purchased value of in-force investment contracts (“PVIF”) and is amortised over the estimated lives of the contracts on a systematic basis. At each reporting date an assessment is made to determine if there is any indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The amortisation charge is then adjusted to reflect the revised carrying amount.

### **Property and Equipment**

Property and equipment is stated at cost less accumulated depreciation and impairment losses.

Freehold land is not depreciated. Freehold and leasehold property, other than freehold investment properties, is stated at cost and depreciated over fifty years or the length of the lease term if shorter. Improvements to leasehold properties are stated at cost and are depreciated in equal instalments over the lesser of the remaining life of the lease or eight years. Premiums are amortised over the period of the lease.

The cost of equipment, which includes fixtures and fittings, vehicles and computer hardware, less estimated residual value, is written off in equal instalments over the expected lives of the assets, generally between three and eight years.

Subsequent costs are included in the asset’s carrying amount, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably.

Property and equipment is assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The depreciation charge for the asset is then adjusted to reflect the asset's revised carrying amount.

### **Investment Properties**

Investment properties, which are defined as properties held either to earn rental income or for capital appreciation or both, are initially recognised at cost and are fair valued annually. Any gains or losses arising from a change in the fair value are recognised in the income statement in the period that they occur through other operating income, except for those relating to insurance and investment business, which are taken through net investment income related to insurance and investment business. Investment properties are not depreciated.

### **Investments in Subsidiaries**

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

### **Disposal Group**

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

### **Deposits by Banks and Customer Accounts**

Deposits by banks and customer accounts held for trading are classified as financial liabilities held for trading and are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. All other customer accounts and deposits by banks are held at amortised cost using the effective interest rate method.

The fair value of customer deposits with no stated maturity date is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings with no quoted market price is calculated using a cash flow model discounted using interest rates for debts with similar maturities.

### **Repurchase Agreements**

Debt securities sold subject to repurchase agreements are retained within the balance sheet where the Group retains substantially all of the risks and rewards of ownership. Funds received under these arrangements are included within deposits by banks, customer accounts or financial liabilities held for trading. Conversely, debt securities acquired under commitments to resell are not recognised in the balance sheet as debt securities where substantially all the risks and rewards do not pass to the Group. In this case, the purchase price is included within loans and advances to banks, loans and advances to customers, or financial assets held for trading. The difference between sale and repurchase prices for such transactions is reflected in the income statement over the lives of the transactions, within interest payable or interest receivable as appropriate.

### **General Insurance Business**

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

The cost of claims notified but not settled and claims incurred but not reported at the balance sheet date are estimated and provided for. Claims incurred comprise the settlement and handling costs of paid and outstanding claims arising from events occurring during the financial year

together with adjustments to prior year claims provisions. Estimates are based upon an assessment of the likely costs taking account of all known facts. Where the outcome of outstanding cases is unclear, statistical techniques are used which take into account the cost of recent similar claim settlements.

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

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

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

### **Long Term Assurance Business Product Classification**

The Group has classified its long term assurance business in accordance with IFRS 4 “Insurance Contracts” as follows:

- Insurance contracts are contracts containing significant insurance risk;
- Investment contracts with a discretionary participation feature (“DPF”) are contracts that do not contain significant insurance risk but that contain discretionary participation features, which are with-profit contracts; and
- Investment contracts are contracts that have neither significant insurance risk nor a DPF.

### **Insurance Contracts and Investment Contracts with DPF**

Insurance contracts and investment contracts with DPF liabilities written within the with-profit fund, including both traditional and unitised with-profit contracts, are calculated with reference to the expected payout using realistic and, where applicable, market consistent assumptions in accordance with FRS 27. For insurance contracts, premiums are recognised as revenue when due from the policyholder and claims payable are recorded when notified. For unitised with-profit contracts, where the policyholder has the choice to invest in a unit-linked investment fund, deposits and withdrawals are accounted for directly on the balance sheet. Similarly, for investment contracts with DPF, deposits and withdrawals are accounted for directly in the balance sheet.

In 2007, insurance contract liabilities within the non-profit funds are calculated in accordance with the Prudential Sourcebook for Insurers (“INS PRU”) issued by the UK Financial Services Authority, including the impact of PS06/14 “Prudential changes for Insurers” issued in December 2006. Premiums are recognised as revenue when due from the policyholder and claims payable are recorded when notified in the income statement. The cost of claims is estimated based upon an assessment of the likely costs taking account of all known facts.

The accounting policies set out above in respect of the measurement of the insurance contracts written within the with-profit and non-profit funds and investment contracts with DPF liabilities include liability adequacy testing that meets the requirements of IFRS 4 “Insurance Contracts”.

### **Value of In-force Long Term Assurance Business (“VIF”)**

The Group places a value on the insurance contracts and investment contracts with DPF, which represents the present value of future cash flows attributable to the Group with respect to these contracts. The change in VIF is accounted for as revenue.

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

### **Investment Contracts**

The Group’s investment contracts, which include collective investment schemes, are primarily unit-linked. These contracts are managed and evaluated on a fair value basis in accordance with the terms of the contracts as benefits are linked to the fair value of the assets supporting the

contracts. Accordingly, the investment contract liabilities have been designated at fair value through the income statement with fair value changes recognised through change in investment contract liabilities. The fair value of the liabilities is estimated using a valuation technique. In accordance with this technique the liability is established as the bid value of the assets held to match the liability, less an allowance in relation to deductions made to the liability for capital gains tax on the gains relating to the matching assets. Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability with other changes recognised in the income statement.

Revenue in relation to investment management services is recognised as the services are provided. Incremental costs directly attributable to securing the Group's contractual right to benefit from providing investment management services in relation to investment contracts, other than through a business combination or portfolio transfer (refer to the accounting policy for intangible assets), are recognised as an asset if it is probable that they will be recovered. Incremental costs include commissions paid to intermediaries and other similar costs. This asset, referred to as deferred origination costs, is amortised as the related investment management revenue is recognised, and its recoverability assessed at each balance sheet date on a portfolio basis.

### **Unallocated Surplus**

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

### **Post Retirement Schemes**

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

The discount rate used is the market yield on high quality corporate bonds at the balance sheet date that have maturity dates approximating to the terms of the Group's obligation. The calculation is performed by a qualified actuary using the projected unit credit method. Actuarial gains and losses arising are taken directly to equity in the period in which they are incurred.

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

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

### **Taxation**

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity. The tax charge is analysed between tax that is payable in respect of policyholder returns and tax that is payable on shareholders' equity returns. This allocation is based on an assessment of the effective rate of tax that is applicable to shareholders' equity for the year.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following differences are not provided: goodwill not deductible for tax purposes, the initial recognition of assets and liabilities that affects neither accounting nor taxable profit and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, based on tax rates that are enacted or substantially enacted at the balance sheet date.

### **Provisions**

The Group recognises a provision if there is a present obligation as a consequence of either a legal or a constructive obligation resulting from a past event. To recognise this it should be probable that an outflow of economic resources, that can be reliably measured, will be required to

settle the obligation. Provisions are measured as the discounted expected future cash flows taking account of the risks and uncertainties associated with the specific liability where appropriate.

A constructive obligation is only deemed to exist in respect of restructuring provisions once a detailed restructuring plan has been formally approved and the plan has been announced publicly or work on the restructure has commenced.

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

Regulatory provisions held in respect of customer remediation where a legal obligation exists or the Group considers that a constructive obligation exists are set out in Note 33.

### **Debt Securities in Issue**

Debt securities in issue held for trading are classified as financial liabilities held for trading and are carried at fair value. Gains, losses and related income are taken to net trading income as they arise. Debt securities in issue designated at fair value through the income statement are carried at fair value. Gains, losses and related income are taken to other operating income as they arise, except for those related to insurance and investment business which are taken to net investment income related to insurance and investment business. All other debt securities in issue are held at amortised cost. They are initially recognised at fair value plus directly related incremental transaction costs and are subsequently carried on the balance sheet at amortised cost using the effective interest rate method.

Fair values are calculated based on quoted market prices. Where quoted market prices are not available, a cash flow model is used, discounted using an appropriate current yield curve for the remaining term to maturity.

### **Other Borrowed Funds**

Other borrowed funds comprises preference shares that are classified as debt, preferred securities and subordinated liabilities, all of which are held at amortised cost, using the effective interest rate method.

Preference shares are classified as debt where they are redeemable on a specific date, or at the option of the shareholders, or if dividend payments are not discretionary. Dividends on preference shares classified as debt are recognised in the income statement through interest expense.

Preferred securities issued at or close to market values are classified as debt where they are redeemable on a specific date, or at the option of the holders, or if interest payments are not discretionary. The interest payable on such securities is recognised in the income statement through interest expense.

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

### **Netting**

The Group nets loans, deposits and derivative transactions covered by master agreements and when there is a legal right of offset and where simultaneous or net settlement is permitted under the terms of the relevant agreement and where there is the intention and ability to settle on a net or simultaneous basis.

### **Foreign Currencies**

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

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



Monetary assets and liabilities are translated at the closing rate at the date of the balance sheet. Exchange differences arising are recognised in the income statement except for differences arising from net investment hedges and derivatives related to cash flow hedges which are recognised directly in equity.

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

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

The results and financial position of all Group entities that have a functional currency different from sterling are translated into sterling as follows:

- assets and liabilities for each balance sheet presented are translated at the closing rate at the date of the balance sheet;
- goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate; and
- income and expenses are translated at the average exchange rates for the period (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions).

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

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to equity where the hedge is deemed to be effective. When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale. The ineffective portion of any net investment hedge is recognised in the income statement immediately.

Cumulative translation differences for all foreign operations are deemed to be zero at 1 January 2004. Any gain or loss on the subsequent disposal of a foreign operation will exclude translation differences that arose before 1 January 2004, but include later translation differences.

### **Cash and Cash Equivalents**

Cash and cash equivalents are held for the purpose of meeting short term cash commitments rather than investing or other purposes. Cash and cash equivalents consist of cash and balances at central banks that are freely available, and loans and advances to banks with an original maturity of three months or less excluding financial assets that are held for trading purposes.

### **Share-based Payments**

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

### **Effective Interest Rate**

Revenue on financial instruments classified as loans and receivables, available for sale, or financial liabilities at amortised cost, is recognised on an effective interest rate basis. This calculation takes

into account interest received or paid and fees and commissions paid or received that are integral to the yield as well as incremental transaction costs. The effective interest rate is the rate that discounts the expected future cash flows over the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial instrument at initial recognition. These calculations are undertaken on a portfolio basis other than in respect of significant balances, relating principally to larger corporate customers, which are assessed individually. In applying the portfolio basis, the Group makes use of various statistical modelling techniques which are specific to different portfolios in estimating the expected cash flows from early redemptions and related fees to the extent that these are applicable. In calculating the effective interest rates of individually significant balances, the Group takes into account a number of relevant considerations to estimate the cash flows from early redemptions, including previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions at the date of acquisition. The estimation of early redemption cash flows and their impact on the expected life is considered under critical accounting estimates.

### **Fees and Commission**

Fees and commission income and expense is recognised in the income statement as the related service is provided except those that are integral to the effective interest rate calculations or to investment contract deferred origination costs.

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

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

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

### **Guarantees**

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

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

### **Loan Commitments**

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

### **Critical Accounting Judgements**

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

### **Designation of Financial Instruments**

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

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

- The Group's "trading" portfolio is classified as "held for trading". The Group exercises judgement in determining which financial instruments form part of its trading book. This is determined at acquisition by the purpose for which the instrument is acquired and the business area that acquires it;
- Derivative instruments are automatically classified as "at fair value through the income statement" unless they form part of a qualifying hedging relationship. The Group's accounting policy for hedge accounting is described under the policy for derivatives;
- Instruments that are deemed by the Group on initial recognition to eliminate a measurement mismatch or where they contain an embedded derivative which is not separated from the host contract are designated on initial recognition as "at fair value through the income statement". In addition portfolios of assets, liabilities or both that are managed and the performance evaluated on a fair value basis in accordance with a documented risk or investment management strategy are designated on initial recognition "at fair value through the income statement".
- In addition the venture capital exemption is taken for investments where significant influence or joint control is present and the investing area operates as a venture capital business. These investments are designated "at fair value through the income statement". This policy is applied consistently across the Group's portfolios. Judgement is applied when determining whether or not a business area operates as a venture capital business. The judgement is based on consideration of whether, in particular, the primary business activity is investing for current income, capital appreciation or both; whether the investment activities are clearly and objectively distinct from any other activities of the Group; and whether the investee operates as a separate business autonomous from the Group;
- Assets in support of the general insurance and long term assurance businesses are designated by the Group, as "at fair value through the income statement";
- Investment contracts within the long term assurance business are designated by the Group as "at fair value through the income statement";
- The Group has chosen not to designate any financial assets as "held to maturity";
- All other financial assets are automatically classified as "available for sale"; and
- All other financial liabilities are automatically classified as "at amortised cost".

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

### **Impairment of Available for Sale Investments**

The Group has considered the fall in fair values of investments classified as available for sale to ascertain whether any impairment has occurred. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Evidence may include a debt issuer failing to make an interest or principal repayment or breaching a covenant within the security's terms and conditions or a significant or prolonged decline in the fair value of an equity instrument below its cost. Except when a default event has occurred, the determination of whether or not objective evidence of impairment is present requires the exercise of critical accounting judgement by the Group.

### **Unarranged Overdraft Charges**

The Group's accounting policy in respect of regulatory provisions is given in the section on provisions. In the absence of a legal obligation, judgement is necessary in determining the existence of a constructive obligation. In respect of the claims made for refunds of unarranged overdraft charges, the judgement of the Group is that there is no constructive obligation pending the outcome of the legal case. The contingent liability in respect of "ex-gratia" refunds of unarranged overdraft charges is explained in Note 41.

### **Syndications**

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

## **Critical Accounting Estimates**

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

### **Fair Values**

The designation of financial instruments for measurement purposes is set out under the critical accounting judgements above and the valuation methodologies for financial instruments are set out in the appropriate accounting policies.

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

As explained in the accounting policy on investment securities, asset backed securities (“ABS”) not traded in an active market are valued using valuation models that include non-market observable inputs. These models use observed issuance prices, benchmarking methodology and modelled market correlations. For each asset class within the ABS portfolio, the implied spread arrived at by using this methodology is applied to the securities within that asset class. Additional assessments are then made on possible deterioration in credit risk for each individual security.

At 31 December 2007, the value of ABS measured using models with non-market observable inputs comprised investment securities of £5,404m (2006 £nil) within financial assets held for trading and £12,386m (2006 £nil) within assets classified as available for sale.

During the year, a £78m pre-tax negative fair value adjustment was recognised in the income statement, within net trading income, on ABS that were valued using models with non-market observable inputs (2006 £nil). In addition to this a post-tax negative fair value adjustment of £158m (2006 £nil) on ABS classified as available for sale was recognised in equity reserves.

For ABS asset valuations using non-market observable inputs, the effect of a one basis point move in credit spreads would result in a pre-tax movement of £2m for ABS assets classified as held for trading and a post-tax movement of £4m, recognised in equity reserves, on assets classified as available for sale.

The use of non-market observable inputs in the valuation models will diminish as and when activity returns to these markets.

### **Impairment Losses on Loans and Advances**

Impairment loss calculations involve the estimation of future cash flows of loans and advances based on observable data at the balance sheet date and historical loss experience for assets with similar credit risk characteristics. These calculations are undertaken on a portfolio basis other than in respect of significant balances, relating principally to larger corporate customers, which are assessed individually. In applying the portfolio basis the Group makes use of various statistical modelling techniques which are specific to different portfolio types. In calculating individual impairment provisions the Group takes account of a number of relevant considerations including historical experience, future prospects of the customer, value of collateral held and reliability of information.

### **Defined Benefit Schemes**

The expected cash flows used in the calculation of the defined benefit schemes’ liabilities include a number of assumptions around mortality, inflation rates applicable to defined benefits and the average expected service lives of the employees. The selection of these assumptions and the selection of the discount rate have a material impact on the estimation of the pension liabilities. The discount rate used by the Group to calculate the defined benefit scheme liabilities is based on the market yield at the balance sheet date of high quality bonds with a similar duration to that of the schemes’ liabilities. The sensitivity of the scheme liabilities to changes in the principal assumptions used are set out in Note 29.

### **Long Term Assurance Business**

The estimation of the Group’s insurance and investment contracts with discretionary participating features (“DPF”) liabilities and related value of in-force (“VIF”) assets relies on a number of

assumptions in forecasting future experience. The selection of appropriate assumptions requires the application of material judgement and is made with reference to historic trends, taking into account the analysis of actual versus expected experience as well as industry data. The sensitivity of the Group's results to changes in certain key variables on long term insurance contracts and investment contracts with DPF are disclosed in Note 24.

As described in the accounting policy for insurance contracts and investment contracts with DPF and in the description of long term assurance business in Note 26 assumptions are made when calculating the value of these contracts, which also impact on the value of the VIF and the unallocated surplus. The Group applies significant judgement when selecting the rates of persistency to be used in these calculations. The considerations given to lapse and surrender rate assumptions are detailed in Note 26.

### **Effective Interest Rate**

As described in the accounting policy for effective interest rate, the Group uses statistical and mathematical models to calculate the effective yield for loans and advances. The Group applies judgement when determining the expected life of these loans. The underlying products usually allow the customer to make early repayment before the contractual maturity date. In estimating the expected life of the loan, the Group takes into account a number of relevant considerations when the asset is initially recognised to estimate the cash flows from early redemptions including the type of product, previous experience of customer behaviour, credit scoring of the customer and anticipated future market conditions. After initial recognition the cash flows from early redemptions are not reassessed in the effective interest rate calculation in the light of actual experience. If the estimated life of the Retail portfolio were to increase or decrease by one month then the carrying value of the Retail portfolio would increase or decrease by £18m respectively.

### **Goodwill**

Goodwill arises on the acquisition of a business. As explained in the accounting policy for goodwill it is subject to a six monthly impairment review by comparing the value in use with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment.

The value in use calculation uses cash flow projections based upon the five year business plan with cash flows thereafter being extrapolated using growth rates in the range of 2.25 per cent. to 2.50 per cent., reflecting the long term nature of the businesses concerned and the long term trend in growth rate of the respective economy. The pre-tax discount rates used in discounting the projected cash flows are in the range of 10 per cent. to 12.2 per cent. reflecting the perceived risk within those businesses. As at 31 December 2007 the carrying value of goodwill held on the balance sheet is £1,940m (2006 £1,889m, 2005 £1,666m) as shown in Note 19. With the exception of goodwill which has been impaired by £5m during the year leaving a carrying value of £10m, the aggregate headroom between the value in use and carrying value of goodwill plus net assets of the businesses is sufficiently large that changes in growth and discount rates, after allowing for current credit conditions, would have no material impact on the goodwill impairment charge.

## 1 Income

	2007	2006 £m	2005
Included within net interest income are the following:			
Interest income on financial instruments not designated at fair value through the income statement	34,807	26,733	24,134
Interest expense on financial instruments not designated at fair value through the income statement	27,358	19,269	17,261
Net trading income comprises:			
Equity and commodity instruments and related derivatives	92	20	23
Interest bearing securities and related derivatives	58	164	116
Foreign exchange and related derivatives	72	95	79
Fair value hedges:			
Net gains/(losses) from hedging instruments	1,184	(2,674)	
Net (losses)/gains from hedged items	(1,227)	2,688	
Cash flow hedge ineffectiveness recognised	(1)	(1)	
	<u>178</u>	<u>292</u>	
Included within net operating income are the following:			
Cash flow hedges:			
Net gains/(losses) released from equity into income	417	(123)	
Financial instruments at fair value through the income statement:			
Net gains and losses from trading financial instruments and non hedging derivatives	222	324	
Net gains and losses from designated financial instruments	5,229	5,401	
Available for sale financial instruments:			
Dividend income	291	25	125
Net realised gains on sale	263	244	168
Financial instruments designated as loans and receivables:			
Net realised gains on sale	3	1	4

## 2 Non-operating Income

	2007	2006 £m	2005
Non-operating income comprises:			
Profit on the sale and leaseback of certain branch premises	28	22	46
Profit on the part disposal of Rightmove plc (Note 17)	59	17	
Profit on the sale of Insight Investment Management (C.I.) Limited	4		
Profit on the dilution of shareholding in Invista Real Estate Investment Management Holdings plc ("Invista")		22	
Profit on the sale of Retail Financial Services Limited		9	
Profit on the sale of Drive Financial Services LP		180	
	<u>91</u>	<u>250</u>	<u>46</u>

## 3 Change in Investment Contract Liabilities

	2007	2006 £m	2005
Net change in investment contracts designated at fair value through the income statement	2,451	3,034	3,101
Net change in investment contracts with DPF	87	(124)	1,988
	<u>2,538</u>	<u>2,910</u>	<u>5,089</u>

#### 4 Administrative Expenses

	2007	2006 £m	2005
Administrative expenses include:			
Mortgage endowment compensation		95	260
Charge in respect of "ex-gratia" refunds of unarranged overdraft charges (Note 41)	122		
Retail rationalisation costs			84
	<hr/>	<hr/>	<hr/>
Administrative expenses also include:			
Colleague costs (Note 5)	2,911	2,674	2,432
Accommodation, repairs and maintenance	450	421	399
Technology	273	238	220
Marketing and communication	380	367	343

#### 5 Colleagues

	2007	Group 2006	2005	2007	Company 2006	2005
			Number			
The average number of colleagues employed during the year was:						
Full time	57,129	55,234	55,384	53,455	52,033	49,126
Part time	16,958	16,616	16,601	16,265	16,229	16,128
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	74,087	71,850	71,985	69,720	68,262	65,254
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

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

	2007	2006 £m	2005
The aggregate remuneration payable in respect of Group colleagues is included within administrative expenses and comprises:			
Wages and salaries	2,340	2,137	1,940
Social security costs	226	228	181
Pension costs (Note 29)	201	205	225
Other post retirement benefits (Note 29)	5	3	3
Expense arising from share-based payments (Note 37)	139	101	83
	<hr/>	<hr/>	<hr/>
	2,911	2,674	2,432
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

#### 6 Directors' Remuneration

	2007 £'000	2006	2005 £m
Emoluments	11,834	9,577	7,969
Total potential pre-tax gains on share options exercised	715	402	309
Total value of shares vested under long term incentive schemes	4,989	6,681	9,010

Retirement benefits accrued to one Director for part of the year until benefits reached the "Lifetime Allowance". In 2006 retirement benefits accrued for one (2005 5 Directors) Director for the full year and in respect of five Directors until 5 April 2006 at which point their benefits were above the "Lifetime Allowance" at "A-day". Thereafter further service based accrual ceased with all Directors receiving an annual non-pensionable cash allowance of 25 per cent. of salary, payable monthly, in lieu. These payments are included in emoluments.

## 7 Auditors' Remuneration

The aggregate remuneration of KPMG Audit Plc and its associates for audit and other services (excluding value added taxes) included within administrative expenses is analysed below:

	2007	2006	2005
		£m	
Statutory audit of the Company and HBOS consolidation	0.3	0.3	0.3
Fees payable for other services:			
Audit of the Company's subsidiaries and associates	7.7	6.5	5.9
Other services pursuant to legislation	1.0	1.4	2.4
Tax services (compliance and advisory)	0.8	0.9	0.9
Services relating to information technology	0.1	0.3	0.3
Services relating to corporate finance transactions	0.3	0.7	1.0
Other services	1.2	1.1	1.5
<b>Total other services</b>	<u>11.1</u>	<u>10.9</u>	<u>12.0</u>
	<u>11.4</u>	<u>11.2</u>	<u>12.3</u>

Other services pursuant to legislation includes work in support of regulatory reporting and listing rules and includes the review of the half yearly results. Other services relating to corporate finance transactions includes fees for reviews in relation to capital and debt issues, securitisations and covered bond issues.

In addition to the fees included in the consolidated accounts a fee of £nil (2006 £0.2m, 2005 £0.1m) was paid to the auditors in respect of the Company's pension scheme.

In respect of the Company, fees in respect of the statutory audit were £22,000 (2006 £22,000, 2005 £20,000) and other fees amounted to £0.3m (2006 £0.2m, 2005 £1.1m).

Details of the Audit Committee policy covering the engagement of the external auditors to undertake non-audit work on behalf of the Group is given in the Corporate Governance Report.



## 8 Segmental Analysis

### Business Sector

			2007				
	<i>Retail</i>	<i>Corporate</i>	<i>Insurance and Investment</i>	<i>International £m</i>	<i>Treasury and Asset Management</i>	<i>Group Items</i>	<i>Total</i>
Net interest income – internal	(1,050)	(1,330)	(70)	(1,269)	3,719		
Net interest income – external	5,149	3,381	(28)	2,357	(3,555)		7,304
Net fee and commission income – internal	190	7	(168)	21	(50)		
Net fee and commission income – external	1,075	393	(521)	45	268		1,260
Net trading income – external	(7)	65	(7)	(3)	130		178
Other operating income – internal	19	15		45	(79)		
Other operating income – external	58	2,044	9,611	652	184		12,549
<b>Net operating income</b>	<b>5,434</b>	<b>4,575</b>	<b>8,817</b>	<b>1,848</b>	<b>617</b>		<b>21,291</b>
Administrative expenses – internal	(672)	(151)	(113)	(6)	(42)	984	
Administrative expenses – external	(1,523)	(689)	(680)	(665)	(296)	(1,126)	(4,979)
Depreciation and amortisation	(70)	(1,018)	(57)	(54)	(4)	(199)	(1,402)
Goodwill impairment			(5)				(5)
Other operating expenses			(7,406)	(278)			(7,684)
<b>Operating expenses</b>	<b>(2,265)</b>	<b>(1,858)</b>	<b>(8,261)</b>	<b>(1,003)</b>	<b>(342)</b>	<b>(341)</b>	<b>(14,070)</b>
Impairment losses on loans and advances	(1,294)	(602)		(116)			(2,012)
Impairment losses on investment securities	(22)	(37)		(1)			(60)
<b>Operating profit</b>	<b>1,853</b>	<b>2,078</b>	<b>556</b>	<b>728</b>	<b>275</b>	<b>(341)</b>	<b>5,149</b>
Share of profits of jointly controlled entities and associates	(9)	232	(2)	17	(4)		234
Non-operating income	87				4		91
<b>Profit before taxation</b>	<b>1,931</b>	<b>2,310</b>	<b>554</b>	<b>745</b>	<b>275</b>	<b>(341)</b>	<b>5,474</b>
<b>Total assets</b>	<b>260,055</b>	<b>121,841</b>	<b>88,454</b>	<b>76,087</b>	<b>119,807</b>	<b>703</b>	<b>666,947</b>
<b>Included in total assets:</b>							
Interests in jointly controlled entities and associates	83	786	(41)	133	24		985
Loans and advances to customers	253,389	109,292		67,094	232		430,007
<b>Total liabilities</b>	<b>221,526</b>	<b>57,777</b>	<b>83,297</b>	<b>35,806</b>	<b>245,604</b>	<b>703</b>	<b>644,713</b>
<b>Included in total liabilities:</b>							
Customer accounts	158,320	44,048	101	23,585	17,167		243,221
Capital expenditure on property and equipment and software	6	43	11	83	16	397	556

In March 2007 the Group announced a divisional reorganisation under which the Group's European Corporate business became part of Corporate division moving from International division. Accordingly the 2006 comparatives have been restated to reflect the new structure. The 2005 comparatives have not been restated to reflect the new structure.

	<i>Retail</i>	<i>Corporate</i>	<i>Insurance and Investment</i>	<i>2006 International<sup>(2)</sup> £m</i>	<i>Treasury and Asset Management</i>	<i>Group Items</i>	<i>Total</i>
Net interest income – internal	(395)	(547)	(70)	(1,149)	2,161		
Net interest income – external	4,583	2,511	(23)	2,285	(1,956)		7,400
Net fee and commission income – internal	186	11	(185)	4	(16)		
Net fee and commission income – external	1,112	347	(480)	25	159		1,163
Net trading income – external	9	30		4	249		292
Other operating income – internal	(1)				1		
Other operating income – external	44	1,374	11,561	859	21		13,859
<b>Net operating income</b>	<b>5,538</b>	<b>3,726</b>	<b>10,803</b>	<b>2,028</b>	<b>619</b>		<b>22,714</b>
Administrative expenses – internal	(658)	(165)	(98)	(2)	(22)	945	
Administrative expenses – external	(1,495)	(616)	(671)	(581)	(266)	(994)	(4,623)
Depreciation and amortisation	(69)	(827)	(51)	(49)	(4)	(192)	(1,192)
Goodwill impairment		(41)	(14)				(55)
Other operating expenses			(9,242)	(459)			(9,701)
Operating expenses	(2,222)	(1,649)	(10,076)	(1,091)	(292)	(241)	(15,571)
Impairment losses on loans and advances	(1,097)	(429)		(216)			(1,742)
Impairment losses on investment securities		(69)		(2)			(71)
Operating profit	2,219	1,579	727	719	327	(241)	5,330
Share of profits of jointly controlled entities and associates	2	156	(37)	4	1		126
Non-operating income	48			180	22		250
<b>Profit before taxation</b>	<b>2,269</b>	<b>1,735</b>	<b>690</b>	<b>903</b>	<b>350</b>	<b>(241)</b>	<b>5,706</b>
<b>Total assets<sup>(1)</sup></b>	<b>242,960</b>	<b>100,860</b>	<b>82,656</b>	<b>57,900</b>	<b>106,658</b>	<b>779</b>	<b>591,813</b>
<b>Included in total assets:</b>							
Interests in jointly controlled entities and associates	57	536	(43)	51			601
Loans and advances to customers	237,710	89,557		48,684	857		376,808
<b>Total liabilities<sup>(1)</sup></b>	<b>237,410</b>	<b>92,410</b>	<b>77,421</b>	<b>57,794</b>	<b>104,828</b>	<b>779</b>	<b>570,642</b>
<b>Included in total liabilities:</b>							
Customer accounts	144,577	39,519		17,509	10,252		211,857
Capital expenditure on property and equipment and software	7	39	18	72	10	351	497

Notes:

(1) The total assets and total liabilities of Corporate include £1,388m and £909m respectively, being the assets and liabilities of the disposal group.

(2) International division includes the income and expenses of Drive which was disposed of during 2006.

	2005						
	<i>Retail</i>	<i>Corporate</i>	<i>Insurance and Investment</i>	<i>International £m</i>	<i>Treasury and Asset Management</i>	<i>Group Items</i>	<i>Total</i>
Net interest income	4,028	1,695	(95)	1,018	183		6,829
Net fee and commission income	1,253	293	(651)	30	109		1,034
Net trading income	4	14		3	197		218
Other operating income	58	1,079	13,895	484	20		15,536
<b>Net operating income</b>	<b>5,343</b>	<b>3,081</b>	<b>13,149</b>	<b>1,535</b>	<b>509</b>		<b>23,617</b>
Administrative expenses	(2,402)	(695)	(755)	(501)	(243)	(15)	(4,611)
Depreciation and amortisation	(66)	(558)	(47)	(53)	(4)	(208)	(936)
Other operating expenses			(11,528)	(169)			(11,697)
<b>Operating expenses</b>	<b>(2,468)</b>	<b>(1,253)</b>	<b>(12,330)</b>	<b>(723)</b>	<b>(247)</b>	<b>(223)</b>	<b>(17,244)</b>
Impairment losses on loans and advances	(991)	(428)		(180)			(1,599)
Impairment on investment securities		(45)		(6)			(51)
<b>Operating profit</b>	<b>1,884</b>	<b>1,355</b>	<b>819</b>	<b>626</b>	<b>262</b>	<b>(223)</b>	<b>4,723</b>
Share of profits of jointly controlled entities and associated undertakings	9	65	(34)	(2)	1		39
Non-operating income	46						46
<b>Profit before taxation</b>	<b>1,939</b>	<b>1,420</b>	<b>785</b>	<b>624</b>	<b>263</b>	<b>(223)</b>	<b>4,808</b>
<b>Total assets</b>	<b>224,868</b>	<b>87,195</b>	<b>71,623</b>	<b>49,730</b>	<b>106,633</b>	<b>824</b>	<b>540,873</b>
<b>Included in total assets:</b>							
Interests in jointly controlled entities and associated undertakings	61	490	(114)	21	1		459
<b>Total liabilities</b>	<b>219,601</b>	<b>82,735</b>	<b>66,582</b>	<b>47,291</b>	<b>105,384</b>	<b>824</b>	<b>522,417</b>
Capital expenditure on property and equipment and software	6	1	51	112	11	284	465

## Geographical

The table below analyses the Group results and assets by geographical area based on the location of the customer. For funding costs where the location of the customer cannot be ascertained, the interest expense is matched to the location of the customer generating the interest income.

	2007			2006		
	UK	Rest of world	Total £m	UK	Rest of world	Total
Net interest income	6,044	1,260	7,304	6,393	1,007	7,400
Net fees and commission income	1,110	150	1,260	937	226	1,163
Net trading income	144	34	178	284	8	292
Other operating income	11,135	1,414	12,549	12,652	1,207	13,859
<b>Net operating income</b>	<b>18,433</b>	<b>2,858</b>	<b>21,291</b>	<b>20,266</b>	<b>2,448</b>	<b>22,714</b>
Administrative expenses	(4,289)	(690)	(4,979)	(4,044)	(579)	(4,623)
Depreciation and amortisation	(1,341)	(61)	(1,402)	(1,121)	(71)	(1,192)
Goodwill impairment	(5)		(5)	(55)		(55)
Other operating expenses	(6,743)	(941)	(7,684)	(8,857)	(844)	(9,701)
<b>Operating expenses</b>	<b>(12,378)</b>	<b>(1,692)</b>	<b>(14,070)</b>	<b>(14,077)</b>	<b>(1,494)</b>	<b>(15,571)</b>
Impairment losses on loans and advances	(1,893)	(119)	(2,012)	(1,521)	(221)	(1,742)
Impairment on investment securities	(59)	(1)	(60)	(69)	(2)	(71)
<b>Operating profit</b>	<b>4,103</b>	<b>1,046</b>	<b>5,149</b>	<b>4,599</b>	<b>731</b>	<b>5,330</b>
Share of profits of jointly controlled entities and associated undertakings	51	183	234	65	61	126
Non-operating income	91		91	70	180	250
<b>Profit before taxation</b>	<b>4,245</b>	<b>1,229</b>	<b>5,474</b>	<b>4,734</b>	<b>972</b>	<b>5,706</b>
<b>Total assets</b>	<b>532,572</b>	<b>134,375</b>	<b>666,947</b>	<b>499,767</b>	<b>92,046</b>	<b>591,813</b>
<b>Included in total assets:</b>						
Interests in jointly controlled entities and associates	703	282	985	536	65	601
<b>Total liabilities</b>	<b>498,417</b>	<b>146,296</b>	<b>644,713</b>	<b>484,284</b>	<b>86,358</b>	<b>570,642</b>
Capital expenditure on property and equipment and software	473	83	556	425	72	497

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

	<i>UK</i>	<i>2005 Rest of world £m</i>	<i>Total</i>
Net interest income	5,793	1,036	6,829
Net fees and commission income	977	57	1,034
Net trading income	211	7	218
Other operating income	15,078	458	15,536
<b>Net operating income</b>	<u>22,059</u>	<u>1,558</u>	<u>23,617</u>
Administrative expenses	(4,102)	(509)	(4,611)
Depreciation and amortisation	(887)	(49)	(936)
Goodwill impairment			
Other operating expenses	(11,619)	(78)	(11,697)
<b>Operating expenses</b>	<u>(16,608)</u>	<u>(636)</u>	<u>(17,244)</u>
Impairment losses on loans and advances	(1,440)	(159)	(1,599)
Impairment on investment securities	(30)	(21)	(51)
<b>Operating profit</b>	<u>3,981</u>	<u>742</u>	<u>4,723</u>
Share of profits of jointly controlled entities and associated undertakings	41	(2)	39
Non-operating income	46		46
<b>Profit before taxation</b>	<u>4,068</u>	<u>740</u>	<u>4,808</u>
<b>Total assets</b>	<u>468,529</u>	<u>72,344</u>	<u>540,873</u>
<b>Included in total assets:</b>			
Interests in jointly controlled entities and associated undertakings	443	16	459
<b>Total liabilities</b>	<u>460,183</u>	<u>62,234</u>	<u>522,417</u>
Capital expenditure on property and equipment and software	353	112	465
<b>9 Taxation</b>			
	<i>2007</i>	<i>2006 £m</i>	<i>2005</i>
<b>Current tax</b>			
Corporation tax charge at 30%	1,124	978	876
Relief for overseas taxation	(73)	(73)	(36)
Overseas taxation	293	206	161
	<u>1,344</u>	<u>1,111</u>	<u>1,001</u>
Deferred tax charge (Note 31)	199	661	545
Deferred tax changes in rates of corporation tax (Note 31)	(178)		
	<u>21</u>	<u>661</u>	<u>545</u>
<b>Total income tax on profit</b>	<u>1,365</u>	<u>1,772</u>	<u>1,546</u>
The above tax expense is made up as follows:			
Tax on policyholder returns	18	220	200
Tax on shareholder returns	1,347	1,552	1,346

The effective tax rate for the year is 25 per cent. (2006 31 per cent.) which is lower (2006 higher) than the standard rate of corporation tax in the UK (30 per cent.). The differences are explained below:

	2007	2006	2005
		<i>£m</i>	
<b>Profit before taxation</b>	5,474	5,706	4,808
Profit multiplied by the standard rate of corporation tax in the UK of 30% (2006 30%, 2005 30%)	1,642	1,712	1,442
Effects of:			
Changes in rates of corporation tax on deferred tax assets and liabilities	(178)		
(Income not chargeable)/expenses not deductible for tax purposes	(48)	9	(20)
Net effect of differing tax rates overseas	29	16	(51)
Book gains covered by tax exemptions/indexation	(90)	(109)	(56)
Policyholder tax/differing tax rates for life assurance business	13	154	253
Impairment on investment securities	16	23	12
Adjustments in respect of previous periods	(14)	(7)	(34)
Other	(5)	(26)	
<b>Total income tax on profit</b>	<u>1,365</u>	<u>1,772</u>	<u>1,546</u>
<b>Current tax credit recognised directly in equity</b>			
Relating to share plans	(21)	(24)	
Relating to available for sale investments	(117)	(10)	8
	<u>(138)</u>	<u>(34)</u>	<u>8</u>
<b>Deferred tax (credit)/charge recognised directly in equity (Note 31)</b>			
Relating to share plans	64	(62)	
Relating to available for sale investments	(65)	20	(3)
Relating to cash flow hedges	(219)	125	17
Relating to employee benefits	130	56	(72)
Relating to long term assurance	5		
Relating to other	(1)		
	<u>(86)</u>	<u>139</u>	<u>(58)</u>

In addition there is £1m (2006 £nil, 2005 £nil) recognised in equity relating to changes in the rates of corporation tax (Note 31).

## 10 Earnings per ordinary share

Basic and diluted earnings per ordinary share are based upon Group profit attributable to ordinary shareholders of £3,965m (2006 £3,820m, 2005 £3,194m) which is calculated as follows:

	2007	2006	2005
		<i>£m</i>	
Profit attributable to parent company shareholders	4,045	3,879	3,230
Profit attributable to preference shareholders	(80)	(59)	(36)
<b>Profit attributable to ordinary shareholders</b>	<u>3,965</u>	<u>3,820</u>	<u>3,194</u>
Profit of disposal group held for sale attributable to ordinary shareholders		(3)	
<b>Profit attributable to ordinary shareholders for continuing operations</b>	<u>3,965</u>	<u>3,817</u>	<u>3,194</u>

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

	2007	2006	2005
	<i>Number million</i>		
Actual weighted average number of shares in issue	3,735	3,796	3,888
Adjustment for weighted average number of shares on which options have been granted but not yet exercised	23	42	39
<b>Potential weighted average number of shares in issue</b>	<u>3,758</u>	<u>3,838</u>	<u>3,927</u>

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

	2007	2006	2005
	<i>pence</i>		
<b>Basic earnings per ordinary share</b>			
Continuing operations	106.2	100.5	82.2
Disposal group		0.1	
<b>Total</b>	<u>106.2</u>	<u>100.6</u>	<u>82.2</u>
<b>Diluted earnings per ordinary share</b>			
Continuing operations	105.5	99.4	81.3
Disposal group		0.1	
<b>Total</b>	<u>105.5</u>	<u>99.5</u>	<u>81.3</u>

## 11 Financial Instruments Held for Trading

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

	2007	2006	2005
	<i>£m</i>		
<b>Financial assets held for trading</b>			
Debt securities	36,723	34,884	29,352
Loans and advances to banks	11,601	11,870	9,271
Loans and advances to customers	6,357	2,379	3,135
Other assets		6	8
<b>Total</b>	<u>54,681</u>	<u>49,139</u>	<u>41,766</u>
<b>Financial liabilities held for trading</b>			
Debt securities in issue	469	376	406
Deposits by banks	8,989	10,014	2,875
Customer accounts	13,247	11,551	21,509
Other liabilities		393	217
<b>Total</b>	<u>22,705</u>	<u>22,334</u>	<u>25,007</u>

## 12 Disposal group

The assets and liabilities of the disposal group were acquired in 2006 with a view to subsequent disposal. They comprise the Mother Topco Limited group of companies, that includes McCarthy & Stone plc, a UK provider of retirement homes in which the Group had a 58.3 per cent. equity interest at 31 December 2006. The assets and liabilities were sold during 2007 and within twelve months of the acquisition date. As the disposal was made at the value at which the group was held at 31 December 2006 no additional profit arose in 2007 that is attributable to the shareholders of the HBOS Group.

### 13 Derivatives

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

Group	2007 Fair value			2006 Fair value			2005 Fair value	
	Asset	Liability	Notional principal amount	Asset £m	Liability	Notional principal amount	Asset	Liability
<b>Derivatives held for trading</b>								
<b>Exchange rate related contracts</b>								
Forward foreign exchange	1,035	856	59,160	409	923	52,351	707	530
Cross currency swaps	667	297	24,887	371	450	12,769	128	229
Options	1	1	1,182	26	14	1,139	33	38
	<u>1,703</u>	<u>1,154</u>	<u>85,229</u>	<u>806</u>	<u>1,387</u>	<u>66,259</u>	<u>868</u>	<u>797</u>
<b>Interest rate related contracts</b>								
Interest rate swaps	5,855	5,606	475,354	3,705	3,821	339,545	3,878	4,273
Forward rate agreements	119	111	248,122	46	45	123,912	28	31
Options	225	287	44,017	176	100	42,251	205	117
Futures	20	40	48,640	222	250	46,433	170	176
	<u>6,219</u>	<u>6,044</u>	<u>816,133</u>	<u>4,149</u>	<u>4,216</u>	<u>552,141</u>	<u>4,281</u>	<u>4,597</u>
<b>Equity/index and commodity related contracts</b>								
Options and swaps	1,412	870	4,604	1,188	714	4,127	979	572
<b>Credit related contracts</b>								
Credit default swaps	47							
<b>Total derivatives held for trading</b>	<u>9,381</u>	<u>8,068</u>	<u>905,966</u>	<u>6,143</u>	<u>6,317</u>	<u>622,527</u>	<u>6,128</u>	<u>5,966</u>
<b>Derivatives held as qualifying hedges</b>								
	4,760	4,243	429,082	2,469	4,438	334,590	4,371	2,610
	<u>14,141</u>	<u>12,311</u>	<u>1,335,048</u>	<u>8,612</u>	<u>10,755</u>	<u>957,117</u>	<u>10,499</u>	<u>8,576</u>

The Group uses interest rate swaps, cross currency swaps and other derivative instruments to hedge and reduce the interest rate and currency exposures that are inherent in any banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of the macro cash flow, micro fair value and net investment hedge approaches.



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

Group	2007 Fair value			2006 Fair value			2005 Fair value	
	Asset	Liability	Notional principal amount	Asset £m	Liability	Notional principal amount	Asset	Liability
<b>Derivatives held as qualifying hedges</b>								
Derivatives designated as fair value hedges								
Interest rate swaps	732	575	39,367	501	441	32,155	1,106	432
Forward foreign exchange		27	82		7	1,244		3
Cross currency swaps	1,679	1,682	47,756	246	2,240	57,582	1,448	944
Options			472		4	839		5
	<u>2,411</u>	<u>2,284</u>	<u>87,677</u>	<u>747</u>	<u>2,692</u>	<u>91,820</u>	<u>2,554</u>	<u>1,384</u>
<b>Derivatives designated as cash flow hedges</b>								
Interest rate swaps	1,558	1,801	199,633	1,643	1,121	140,366	1,480	1,197
Forward rate agreements	10	4	68,974	20	9	43,070	27	3
Cross currency swaps	756	139	31,782	14	605	22,439	299	9
Futures	25	15	41,016	45	11	36,895	11	17
	<u>2,349</u>	<u>1,959</u>	<u>341,405</u>	<u>1,722</u>	<u>1,746</u>	<u>242,770</u>	<u>1,817</u>	<u>1,226</u>
<b>Total derivatives held as qualifying hedges</b>	<u>4,760</u>	<u>4,243</u>	<u>429,082</u>	<u>2,469</u>	<u>4,438</u>	<u>334,590</u>	<u>4,371</u>	<u>2,610</u>

The Company has derivatives designated as fair value hedges. These comprise cross currency swaps with an asset fair value of £154m (2006 £1m, 2005 £44m) and a liability fair value of £49m (2006 £55m, 2005 £nil) and interest rate swaps with an asset fair value of £8m (2006 £nil, 2005 £nil) and a liability fair value of £7m (2006 £1m, 2005 £nil).

#### 14 Loans and Advances to Customers

	2007	2006	2005
	£m		
Retail secured lending	235,849	219,828	
Retail unsecured lending	19,831	20,009	
Corporate, International and Treasury	177,700	140,060	
	<u>433,380</u>	<u>379,897</u>	<u>346,706</u>
Gross loans and advances to customers	433,380	379,897	346,706
Impairment losses on loans and advances (Note 15)	(3,373)	(3,089)	(2,938)
	<u>430,007</u>	<u>376,808</u>	<u>343,768</u>

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

	2007	2006	2005
	£m		
Agriculture, forestry and fishing	647	686	1,316
Energy	1,269	1,571	1,800
Manufacturing industry	4,332	4,392	6,351
Construction and property	35,099	30,177	36,913
Hotels, restaurants and wholesale and retail trade	8,620	8,705	12,601
Transport, storage and communication	4,834	6,560	4,873
Financial	4,312	5,466	10,815
Other services	25,749	16,961	19,369
Individuals			
– Home mortgages	235,771	219,716	213,842
– Other personal lending	22,229	20,196	23,463
Non-UK residents	90,518	65,467	15,363
	<u>433,380</u>	<u>379,897</u>	<u>346,706</u>

	2007	2006
	£m	
Loans and advances that are neither past due nor impaired	412,047	358,536
Loans and advances that are past due but not impaired (Note 43)	10,786	12,602
Impaired loans (Note 43)	10,547	8,759
	<u>433,380</u>	<u>379,897</u>

Included in loans and advances that are neither past due nor impaired are £229m (2006 £380m) of troubled debt restructured loans that would have been past due or impaired had their terms not been renegotiated.

Loans and advances to customers include advances that are securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities, funded by the issue of debt on terms whereby some of the risks and rewards of the portfolio are retained by the subsidiary. Accordingly, all these advances are retained on the Group's balance sheet with the debt issued included within debt securities in issue (Note 34).

The Group's principal securitisation programmes and the type of loans and advances securitised are as follows:

<i>Programme</i>	<i>Type of loan</i>	2007	2006
		£m	
Permanent	UK residential mortgages	31,577	35,036
Mound	UK residential mortgages	4,545	5,692
Swan	Australian residential mortgages	2,726	1,756
Candide	Dutch residential mortgages	2,491	2,683
Prominent	Commercial loans	1,101	798
Covered Bonds	UK residential mortgages	34,704	23,476
Social Housing Covered Bonds	UK residential mortgages	2,362	2,362
Pendeford	UK residential mortgages	2,508	
Melrose	Commercial loans	750	817
Other	UK residential mortgages	104	110
		<u>82,868</u>	<u>72,730</u>

In 2005 loans and advances to customers included securitised advances of £53,386m.

In addition to the programmes above loans and advances totalling £14,089m (2006 £6,629m, 2005 £nil) relating to UK residential mortgages have been securitised using credit default swaps.

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

	2007	2006	2005
	£m		
Gross investment in finance receivables:			
Within one year	3,151	2,993	2,962
Between one and five years	5,051	4,719	4,570
More than five years	4,211	4,452	3,605
	<u>12,413</u>	<u>12,164</u>	<u>11,137</u>
Less: unearned finance income	(3,118)	(3,213)	(2,675)
<b>Present value of minimum lease payments</b>	<u>9,295</u>	<u>8,951</u>	<u>8,462</u>
Analysed as:			
Within one year	2,616	2,477	2,417
Between one and five years	4,004	3,531	3,440
More than five years	2,675	2,943	2,605
<b>Finance lease receivables</b>	<u>9,295</u>	<u>8,951</u>	<u>8,462</u>

At 31 December 2007 total unguaranteed residual values accrued to the benefit of the Group amounted to £20m (2006 £47m, 2005 £90m). At 31 December 2007 total accumulated allowance for uncollectable minimum lease payments receivable amounted to £65m (2006 £31m, 2005 £28m).

## 15 Impairment Provisions and Losses on Loans and Advances

<i>Impairment provisions</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
At 1 January	3,089	2,938	2,536
New impairment provisions less releases	2,111	1,819	1,665
Amounts written off	(1,726)	(1,485)	(1,191)
Acquisitions			7
Disposal of subsidiary undertakings		(65)	
Discount unwind/interest income on impaired loans and advances to customers	(129)	(99)	(89)
Foreign exchange translation	28	(19)	10
<b>At 31 December</b>	<b>3,373</b>	<b>3,089</b>	<b>2,938</b>
Impairment provisions are held in respect of:			
Retail secured lending	330	408	
Retail unsecured lending	1,919	1,700	
Corporate and International	1,124	981	
	<b>3,373</b>	<b>3,089</b>	
<i>Impairment losses</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
New impairment provisions less releases	2,111	1,819	1,665
Recoveries of amounts previously written off	(99)	(77)	(66)
<b>Net charge to income statement</b>	<b>2,012</b>	<b>1,742</b>	<b>1,599</b>

## 16 Investment Securities

<i>Group</i>	<i>2007</i>				
	<i>Policyholder assets at fair value through the income statement</i>	<i>At fair value through the income statement</i>	<i>Available for sale £m</i>	<i>Loans and receivables</i>	<i>Total</i>
<b>Listed</b>					
Debt securities	20,712	7,774	31,944		60,430
Equity shares	46,875	393	261		47,529
<b>Total listed</b>	<b>67,587</b>	<b>8,167</b>	<b>32,205</b>		<b>107,959</b>
<b>Unlisted</b>					
Debt securities	2	1,022	14,833	1,266	17,123
Equity shares	94	274	2,948		3,316
<b>Total unlisted</b>	<b>96</b>	<b>1,296</b>	<b>17,781</b>	<b>1,266</b>	<b>20,439</b>
<b>Total</b>	<b>67,683</b>	<b>9,463</b>	<b>49,986</b>	<b>1,266</b>	<b>128,398</b>
<b>Comprising:</b>					
Debt securities	20,714	8,796	46,777	1,266	77,553
Equity shares	46,969	667	3,209		50,845

Group	2006				Total
	Policyholder assets at fair value through the income statement	At fair value through the income statement	Available for sale £m	Loans and receivables	
<b>Listed</b>					
Debt securities	19,821	4,170	26,821		50,812
Equity shares	45,525	197	51		45,773
<b>Total listed</b>	<b>65,346</b>	<b>4,367</b>	<b>26,872</b>		<b>96,585</b>
<b>Unlisted</b>					
Debt securities	39	1,710	15,772	493	18,014
Equity shares		222	2,210		2,432
<b>Total unlisted</b>	<b>39</b>	<b>1,932</b>	<b>17,982</b>	<b>493</b>	<b>20,446</b>
<b>Total</b>	<b>65,385</b>	<b>6,299</b>	<b>44,854</b>	<b>493</b>	<b>117,031</b>
<b>Comprising:</b>					
Debt securities	19,860	5,880	42,593	493	68,826
Equity shares	45,525	419	2,261		48,205

Group	2005				Total
		At fair value through the income statement	Available for sale £m	Loans and receivables	
<b>Listed</b>					
Debt securities		25,641	22,088		47,729
Equity shares		34,144	36		34,180
<b>Total listed</b>		<b>59,785</b>	<b>22,124</b>		<b>81,909</b>
<b>Unlisted</b>					
Debt securities		1,499	19,112	788	21,399
Equity shares		335	691		1,026
<b>Total unlisted</b>		<b>1,834</b>	<b>19,803</b>	<b>788</b>	<b>22,425</b>
<b>Total</b>		<b>61,619</b>	<b>41,927</b>	<b>788</b>	<b>104,334</b>
<b>Comprising:</b>					
Debt securities		27,140	41,200	788	69,128
Equity shares		34,479	727		35,206

The fair value movement during the year on investment securities held at fair value through the income statement is a gain of £1,014m (2006 £3,679m, 2005 £9,062m) and the fair value movement during the year on investment securities classified as available for sale is a loss of £516m (2006 a gain of £135m, 2005 a gain of £224m). Within the fair value movement for available for sale is a loss of £105m (2006 loss of £136m, 2005 gain of £34m) relating to assets subject to fair value hedging, which is included in net trading income.

In keeping with normal market practice, the Group enters into securities lending transactions and repurchase agreements, whereby cash and securities are temporarily received or transferred as collateral. Debt securities with a value of £13,707m (2006 £2,989m, 2005 £1,827m) were subject to

agreement to repurchase, where the transferee obtains the right to pledge or sell the asset they receive. Debt securities also include securities pledged as collateral as part of securities lending transactions amounting to £11,918m (2006 £11,818m, 2005 £11,787m).

Debt securities include asset backed securities of £18,563m (2006 £19,017m, 2005 £19,497m) which are held in the Group's Grampian conduit. This is a series of bankruptcy remote special purpose entities ("SPEs") that are funded by the issue of commercial paper and banking facilities. The commercial paper is included within debt securities in issue (Note 34). As some of the rewards and risks of the portfolio are retained by the Group, including the provision of liquidity facilities by Bank of Scotland plc to the conduit, the assets and liabilities of the conduit are consolidated as part of the Group. The Group also has a smaller conduit, Landale, of which three of the five SPEs are consolidated. These hold debt securities of £604m (2006 £271m) which are included in the total of available for sale investments. Details of the Landale SPEs that are not consolidated by the Group are given in Note 46. There are no impairment provisions held in respect of the Group's investment securities.

Investment securities held by the Company are designated as available for sale and comprise £1m (2006 £4m, 2005 £13m) unlisted equity shares and £nil (2006 £36m, 2005 £36m) of listed debt securities. The fair value at 31 December 2007 is £1m (2006 £40m, 2005 £49m) and the fair value movement during the year was £nil (2006 £nil, 2005 £nil).

Securities held as collateral as stock borrowed or under reverse repurchase agreements amounted to £39,975m (2006 £33,773m, 2005 £46,918m). These are not recognised as assets and are therefore not included above. Of this amount the Group had resold or repledged £28,817m (2006 £25,309m, 2005 £38,466m) as collateral for its own transactions.

## 17 Interests in Jointly Controlled Entities and Associates

<i>Interests in jointly controlled entities</i>	<i>Acquired book value</i>	<i>Equity adjustments</i>	<i>Share of net assets</i> <i>£m</i>	<i>Goodwill</i>	<i>Carrying value</i>
<b>At 1 January 2007</b>	520	(105)	415	5	420
Exchange translation	12		12		12
Acquisitions and subscriptions of capital	287		287		287
Transfer to associates	(3)	4	1		1
Transfer from associates	63	15	78		78
Disposals	(60)	(4)	(64)		(64)
Profit after tax		234	234		234
Dividends paid		(132)	(132)		(132)
<b>At 31 December 2007</b>	<b>819</b>	<b>12</b>	<b>831</b>	<b>5</b>	<b>836</b>

The transfer from associates to jointly controlled entities is in respect of the Group's interest in Sainsbury's Bank plc, following the acquisition on 8 February 2007 of an additional 5 per cent. interest taking the Group's shareholding to 50 per cent.

<i>Interests in jointly controlled entities</i>	<i>Acquired book value</i>	<i>Equity adjustments</i>	<i>Share of net assets</i> <i>£m</i>	<i>Goodwill</i>	<i>Book value</i>
<b>At 1 January 2006</b>	337	(150)	187	98	285
Acquisitions and subscriptions of capital	178		178	3	181
Transfer from investment securities	113		113		113
Disposals	(21)	1	(20)		(20)
Reclassification of Lex on acquisition as a subsidiary (Note 19)	(87)	(11)	(98)	(96)	(194)
Equity accounting adjustments		55	55		55
<b>At 31 December 2006</b>	<b>520</b>	<b>(105)</b>	<b>415</b>	<b>5</b>	<b>420</b>

<i>Interests in jointly controlled entities</i>	<i>Acquired book value</i>	<i>Equity adjustments</i>	<i>Share of net tangible assets £m</i>	<i>Goodwill</i>	<i>Book value</i>
<b>At 31 December 2004</b>	195	(97)	98	98	196
Change in accounting policy		(43)	(43)		(43)
<b>At 1 January 2005</b>	195	(140)	55	98	153
Acquisitions and subscriptions of capital	148		148		148
Disposals	(6)		(6)		(6)
Equity accounting adjustments		(10)	(10)		(10)
<b>At 31 December 2005</b>	<u>337</u>	<u>(150)</u>	<u>187</u>	<u>98</u>	<u>285</u>

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

	<i>Profit after tax</i>	<i>Current assets</i>	<i>Non-current assets</i>	<i>Current liabilities</i>	<i>Non-current liabilities</i>	<i>Equity</i>
	<i>£m</i>					
2007	234	5,802	5,253	(5,126)	(5,093)	836
2006	112	3,604	5,290	(4,462)	(4,012)	420
2005	29	1,918	4,298	(2,107)	(3,824)	285

The Group's unrecognised share of losses for the year is £22m (2006 £36m, 2005 £22m). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis is £68m (2006 £82m, 2005 £53m).

<i>Interests in associates</i>	<i>Acquired book value</i>	<i>Equity adjustments</i>	<i>Share of net assets £m</i>	<i>Goodwill</i>	<i>Book value</i>
<b>At 1 January 2007</b>	133	48	181		181
Exchange translation	1		1		1
Acquisitions and subscriptions of capital	109		109		109
Transfer to jointly controlled entities	(63)	(15)	(78)		(78)
Transfer from jointly controlled entities	3	(4)	(1)		(1)
Disposals	(40)	(13)	(53)		(53)
Dividends paid		(10)	(10)		(10)
<b>At 31 December 2007</b>	<u>143</u>	<u>6</u>	<u>149</u>		<u>149</u>

<i>Interests in associates</i>	<i>Acquired book value</i>	<i>Equity adjustments</i>	<i>Share of net assets £m</i>	<i>Goodwill</i>	<i>Book value</i>
<b>At 1 January 2006</b>	128	46	174		174
Acquisitions and subscriptions of capital	21		21		21
Disposals	(9)		(9)		(9)
Amounts written off	(7)		(7)		(7)
Equity accounting adjustments		2	2		2
<b>At 31 December 2006</b>	<u>133</u>	<u>48</u>	<u>181</u>		<u>181</u>

<i>Interests in associates</i>	<i>Acquired book value</i>	<i>Equity adjustments</i>	<i>Share of net tangible assets £m</i>	<i>Goodwill</i>	<i>Book value</i>
<b>At 31 December 2004</b>	114	46	160		160
Change in accounting policy		(1)	(1)		(1)
<b>At 1 January 2005</b>	114	45	159		159
Acquisitions and subscriptions of capital	25		25		25
Disposals	(11)		(11)		(11)
Equity accounting adjustments		1	1		1
<b>At 31 December 2005</b>	<u>128</u>	<u>46</u>	<u>174</u>		<u>174</u>

The Group's share of associates include the following:

	<i>Profit after tax</i>	<i>Assets</i>	<i>Non-current assets £m</i>	<i>Liabilities</i>	<i>Non-current Liabilities</i>	<i>Equity</i>
2007		1,652		(1,503)		149
2006	14	3,284		(3,103)		181
2005	10	1,291	1,168	(1,257)	(1,028)	174

The Group's unrecognised share of losses for the year is £5m (2006 £nil, 2005 £1m). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis is £4m (2006 £nil, 2005 £nil).

The Group's main jointly controlled entities and associates in operation at 31 December 2007 are as follows:

<i>Jointly controlled entities</i>	<i>Nature of business</i>		<i>Issued share capital</i>	<i>Group's interest</i>	<i>Statutory accounts made up to</i>	<i>Principal area of operations</i>
AA Personal Finance Limited	Finance	ordinary	3,000,002	50%	December 2007	UK
esure Holdings Ltd	Insurance	ordinary	3,330,000	70%	December 2007	UK
		preference	175,170,000	100%		
Green Property Investment						
Fund 1 plc	Investment	ordinary	48,768,400	50%	June 2007	Ireland
Sainsbury's Bank plc <sup>(1)</sup>	Banking	ordinary	70,000,000	50%	December 2007	UK
<b>Associates</b>						
Rightmove plc	Property website	ordinary	129,399,978	13%	December 2007	UK

Notes:

(1) The account of Sainsbury's Bank plc has been equity accounted in the Group's Consolidated accounts on the basis of accounts prepared for the year to 31 December 2006. On 8 February 2007 the Group's interest increased from 45 per cent. to 50 per cent. and Sainsbury's Bank plc became a jointly controlled entity, having been an associate in 2006.

(2) In addition First Alternative Holdings Limited was a jointly controlled entity as at 31 December 2006.

Except for the Green Property Investment Fund 1 plc which is incorporated in Ireland, all of the interests in jointly controlled entities and associates above are incorporated in the UK. Rightmove plc is listed on the London Stock Exchange and the Group's interest had a market valuation of £76m at 31 December 2007. The Group reduced its holding in Rightmove plc from 22 per cent. to 13 per cent. during the year (Note 2) and continues to consider the investment as an associate as a result of the influence arising from the Group's representation on its Board. All other interests are unlisted. All interests in jointly controlled entities and associates are held by subsidiaries. Where entities have accounts that are drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

## 18 Investments in subsidiaries

Investments in subsidiaries comprise investments in ordinary shares and capital contributions carried at cost. There are no impairment provisions in respect of investments in subsidiaries.

	<i>Ordinary shares</i>	<i>Capital contributions</i>	<i>Total</i>
	<i>£m</i>		
At 1 January 2007	10,962	1,033	11,995
Subscriptions of capital	2,480		2,480
<b>At 31 December 2007</b>	<b>13,442</b>	<b>1,033</b>	<b>14,475</b>

	<i>Ordinary shares</i>	<i>Capital contributions</i>	<i>Loans</i>	<i>Total</i>
	<i>£m</i>			
At cost at 1 January 2006	9,918		5,833	15,751
Subscriptions of capital	1,044	1,033		2,077
Net advances			846	846
<b>At cost at 31 December 2006</b>	<b>10,962</b>	<b>1,033</b>	<b>6,679</b>	<b>18,674</b>

	<i>Ordinary shares</i>	<i>Loans</i>	<i>Total</i>
	<i>£m</i>		
At cost at 1 January 2005	9,893	5,750	15,643
Subscriptions of capital	25		25
Net advances		83	83
<b>At cost at 31 December 2005</b>	<b>9,918</b>	<b>5,833</b>	<b>15,751</b>

Amounts owed by Group entities of £38,885m (2006 £27,765m, 2005 £16,202m) include £10,044m (2006 £6,679m, 2005 £5,833m) of other borrowed funds loaned to subsidiaries.

The main subsidiaries at 31 December 2007 are as follows:

	<i>Company's interest in ordinary share capital and voting rights</i>	<i>Principal business</i>	<i>Country of incorporation</i>
Bank of Scotland plc and subsidiaries, including:	100%	Banking, financial and related services	UK
Bank of Scotland (Ireland) Ltd	100%	Banking	Ireland
HBOS Australia Pty Ltd and subsidiaries, including:			
Bank of Western Australia Ltd	100%	Banking	Australia
HBOS Covered Bonds LLP	100% <sup>(1)</sup>	Residential mortgage funding	UK
Halifax Share Dealing Ltd	100%	Execution only stockbroking	UK
HBOS Insurance & Investment Group Ltd and subsidiaries, including:	100%	Investment holding	UK
Halifax General Insurance Services Ltd	100%	General insurance brokerage	UK
St. Andrew's Insurance plc	100%	General insurance	UK
Clerical Medical Investment Group Ltd	100%	Life assurance	UK
Clerical Medical Managed Funds Ltd	100%	Life assurance	UK
Halifax Life Ltd	100%	Life assurance	UK
Halifax Investment Fund Managers Ltd	100%	OEIC management	UK
Insight Investment Management Ltd	100%	Investment management	UK
Invista Real Estate Investment Management Holdings plc	55%	Property investment management	UK
St. Andrews Life Assurance plc	100%	Pensions	UK
St. James's Place plc	60%	Financial services	UK

Note:

(1) HBOS Covered Bonds LLP does not have ordinary share capital. The Group consolidates a 100 per cent. interest in this entity.

On 17 September 2007 in accordance with the provisions of the HBOS Group Reorganisation Act 2006 ("the Act"), the Governor and Company of the Bank of Scotland registered as a public limited company under the Companies Act and changed its name to Bank of Scotland plc. On the same day, under the Act, the business activities, assets (including investments in subsidiaries) and liabilities of CAPITAL BANK plc, Halifax plc and HBOS Treasury Services plc transferred to Bank of Scotland plc.



## 19 Goodwill and Other Intangible Assets

<i>Group</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
Goodwill	1,940	1,889	1,666
Other intangibles	850	800	782
	<u>2,790</u>	<u>2,689</u>	<u>2,448</u>

<i>Goodwill</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
At 1 January	1,889	1,666	1,671
Exchange translation	38	(14)	(1)
Acquired through business combinations	8	200	(4)
Additions	25		7
Transfer from jointly controlled entities		96	
Disposals	(15)	(4)	(7)
Impairment losses charged to the income statement	(5)	(55)	
<b>At 31 December</b>	<u>1,940</u>	<u>1,889</u>	<u>1,666</u>

The Group carries out semi-annual and, if necessary, other impairment reviews of cash-generating units to which goodwill is allocated as described in the accounting policy on goodwill. The critical accounting estimate in respect of goodwill explains the assumptions used and sensitivity of the impairment testing. Arising from this, the impairment loss of £5m in the year primarily relates to a partial write-down of the goodwill held in respect of fund management business in Insurance and Investment division following the latest semi-annual impairment review. The impairment loss of £55m in 2006 principally relates to the full write down of the goodwill held in respect of a Corporate specialist leasing company following an impairment review.

Goodwill is analysed on a divisional basis as follows:

	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
Retail	455	443	426
Corporate	277	280	42
Insurance and Investment	832	835	853
International	337	292	306
Treasury and Asset Management	39	39	39
<b>Total</b>	<u>1,940</u>	<u>1,889</u>	<u>1,666</u>

<i>Other intangible assets</i>	2007			2006			2005		
	<i>Purchased value of in-force investment contracts</i>	<i>Software and other intangible assets</i>	<i>Total</i>	<i>Purchased value of in-force investment contracts</i>	<i>Software and other intangible assets £m</i>	<i>Total</i>	<i>Purchased value of in-force investment contracts</i>	<i>Software and other intangible assets</i>	<i>Total</i>
<b>Cost</b>									
At 1 January	396	1,069	1,465	396	902	1,298	394	741	1,135
Exchange translation		24	24		(2)	(2)		2	2
Acquired through business combination		7	7		6	6	2	20	22
Additions		249	249		197	197		158	158
Disposals		(16)	(16)		(34)	(34)		(19)	(19)
<b>At 31 December</b>	<b>396</b>	<b>1,333</b>	<b>1,729</b>	<b>396</b>	<b>1,069</b>	<b>1,465</b>	<b>396</b>	<b>902</b>	<b>1,298</b>
<b>Amortisation</b>									
At 1 January	45	620	665	21	495	516		379	379
Exchange translation		23	23		(1)	(1)		1	1
Amortisation charge for the year	30	163	193	24	137	161	21	128	149
Disposals		(2)	(2)		(11)	(11)		(13)	(13)
<b>At 31 December</b>	<b>75</b>	<b>804</b>	<b>879</b>	<b>45</b>	<b>620</b>	<b>665</b>	<b>21</b>	<b>495</b>	<b>516</b>
<b>Carrying value</b>									
At 1 January	351	449	800	375	407	782			
At 31 December	321	529	850	351	449	800	375	407	782

The Company has other intangible assets at a cost of £10m (2006 £10m, 2005 £nil) less accumulated amortisation of £4m (2006 £2m, 2005 £nil), of which £2m (2006 £2m, 2005 £nil) is the amortisation charge for the year.

## 20 Property and Equipment

	2007			2006			2005		
	<i>Property</i>	<i>Equipment</i>	<i>Total</i>	<i>Property</i>	<i>Equipment £m</i>	<i>Total</i>	<i>Property</i>	<i>Equipment</i>	<i>Total</i>
<b>Cost</b>									
At 1 January	1,662	1,613	3,275	1,533	1,567	3,100	1,534	1,433	2,967
Exchange translation	5	11	16	(3)	(6)	(9)	2	6	8
Acquired through business combination		1	1	15	5	20			
Additions	123	184	307	134	146	280	72	235	307
Disposals	(38)	(187)	(225)	(38)	(90)	(128)	(37)	(107)	(144)
Disposal of subsidiary undertakings				(2)	(9)	(11)			
Transfer (to)/from investment property (Note 21)	(19)		(19)	23		23	(38)		(38)
<b>At 31 December</b>	<b>1,733</b>	<b>1,622</b>	<b>3,355</b>	<b>1,662</b>	<b>1,613</b>	<b>3,275</b>	<b>1,533</b>	<b>1,567</b>	<b>3,100</b>
<b>Depreciation</b>									
At 1 January	590	1,112	1,702	550	1,017	1,567	520	911	1,431
Exchange translation	5	7	12		(5)	(5)		3	3
Depreciation charge for the year	59	165	224	53	166	219	53	173	226
Disposals	(26)	(51)	(77)	(12)	(60)	(72)	(23)	(70)	(93)
Disposal of subsidiary undertakings				(1)	(6)	(7)			
<b>At 31 December</b>	<b>628</b>	<b>1,233</b>	<b>1,861</b>	<b>590</b>	<b>1,112</b>	<b>1,702</b>	<b>550</b>	<b>1,017</b>	<b>1,567</b>
<b>Carrying value</b>									
At 1 January	1,072	501	1,573	983	550	1,533	1,014	522	1,536
At 31 December	1,105	389	1,494	1,072	501	1,573	983	550	1,533

Included within Group property and equipment are assets that are in the course of construction amounting to £306m (2006 £353m, 2005 £209m) which are not depreciated until the assets are brought into use. These are primarily properties that will be classified as investment properties upon completion.

## 21 Investment Properties

	2007	2006	2005
	<i>£m</i>		
At 1 January	5,010	3,942	3,571
Additions			16
Disposals	(58)	(2)	(15)
Net movement in properties held by policyholder funds	351	655	(117)
Fair value movement	(591)	438	449
Transfer from/(to) property and equipment (Note 20)	19	(23)	38
<b>At 31 December</b>	<b>4,731</b>	<b>5,010</b>	<b>3,942</b>

Investment properties are carried at their fair value as determined by independent qualified surveyors having recent experience in the location and category of the property being valued. Fair values were determined having regard to recent market transactions for similar properties.

Rental income and expenses in respect of the above properties amounted to £221m and £11m respectively (2006 £249m and £25m respectively, 2005 £237m and £19m respectively). At 31 December 2007 investment properties of £4,697m (2006 £4,917m, 2005 £3,857m) are held in the Insurance and Investment business.

## 22 Operating Lease Assets

Assets leased to customers include the following amounts in respect of operating lease assets:

	2007			2006			2005		
	<i>Cost</i>	<i>Depreciation</i>	<i>Carrying value</i>	<i>Cost</i>	<i>Depreciation</i>	<i>Carrying value</i>	<i>Cost</i>	<i>Depreciation</i>	<i>Carrying value</i>
	<i>£m</i>								
At 1 January	6,164	(1,483)	4,681	4,370	(1,255)	3,115	3,997	(967)	3,030
Exchange translation	(28)	30	2	(88)	34	(54)	67	(2)	65
Acquired through business combination				1,428		1,428			
Additions	1,785		1,785	1,804		1,804	1,185		1,185
Disposals	(1,438)	598	(840)	(1,350)	550	(800)	(879)	275	(604)
Depreciation charge for the year		(985)	(985)		(812)	(812)		(561)	(561)
<b>At 31 December</b>	<b>6,483</b>	<b>(1,840)</b>	<b>4,643</b>	<b>6,164</b>	<b>(1,483)</b>	<b>4,681</b>	<b>4,370</b>	<b>(1,255)</b>	<b>3,115</b>

Future minimum lease payments under non-cancellable operating leases are due to be received in the following periods:

	2007	2006	2005
	<i>£m</i>		
Not later than one year	864	1,264	689
Later than one year and not later than five years	1,920	1,578	330
Later than five years	689	802	965
	<b>3,473</b>	<b>3,644</b>	<b>1,984</b>

## 23 Deferred Costs

	2007	2006	2005
	<i>£m</i>		
Deferred acquisition costs	352	278	202
Deferred origination costs	749	575	443
	<b>1,101</b>	<b>853</b>	<b>645</b>

## 24 Value of In-Force Long Term Assurance Business

	2007	2006	2005
		£m	
At 1 January	3,104	2,847	2,172
Acquisitions			272
Disposals		(16)	
Unwind of discount rate	245	227	167
Transfer to the income statement	(415)	(479)	(312)
Effect of experience	(201)	8	131
New business	567	558	406
Changes in assumptions	(180)	(32)	2
Exchange translation	64	(9)	9
<b>At 31 December</b>	<u>3,184</u>	<u>3,104</u>	<u>2,847</u>

### Assumptions

The key assumptions used in the measurement of the value of in-force long term assurance business relating to insurance contracts and investment contracts with a discretionary participating feature (“DPF”) are determined by the Board of Directors.

The economic assumptions that have the greatest effect on the calculation of the value of in-force long term assurance business are set out below. These assumptions require the application of material judgement and are chosen to represent a long term view of the likely economic environment.

The experience assumptions set out in Note 26 also have a significant effect on the cash flow projections. The selection of these assumptions also requires the application of material judgement and is made with reference to historic trends, taking into account the analysis of actual versus expected experience as well as industry data.

Additional information on the long term assurance business risk is set out in the Risk Management note.

### Risk discount rate

The risk discount rate, the rate used to calculate the present value of the future projected cash flows, is based on the long term view of the risk free rate of return. As a long term view, it necessarily involves the application of judgement. The risk discount rate is increased to reflect the uncertainty associated with the projected cash flows. This increase can be broken down into two principal components, being the investment risk component and the insurance risk component.

The investment risk component represents an allowance for uncertainty as to the level of future margins that will actually be achieved by the Group’s investments. The level of the investment risk component is chosen so as to avoid capitalising any investment risk premiums over the long term view of the risk free rate of return.

The insurance risk component represents an additional allowance in the risk discount rate to reflect the potential volatility of, and uncertainty around, the future level of insurance risk inherent in the contracts.

The breakdown of the risk discount rate is shown in the table below:

	2007	2006	2005
		%	
Long term view of risk free rate of return	5.0	5.0	5.0
Investment risk component	1.0	1.0	1.0
Insurance risk component	2.0	2.0	2.0
<b>Total</b>	<u>8.0</u>	<u>8.0</u>	<u>8.0</u>

In isolation of any other assumption changes, an increase in the risk discount rate would result in a decrease in the value of in-force long term assurance business reducing profits and vice versa.

## Investment return

Assumptions are set for each individual asset class based on the long term view of expected returns, and weighted to produce an investment return assumption for each particular class of business. The weighting is based on the long term asset allocation strategy for each class of business. The table below sets out the long term view of the expected returns for the principal asset classes:

	2007	2006	2005
Return on fixed interest securities	5.0-5.5	5.0-5.5	5.0-5.5
Return on equities	7.5	7.5	7.5

In isolation, an increase in the investment return assumption would lead to an increase in profits, and vice versa.

## Expenses

Operating expense assumptions reflect the projected costs of maintaining and servicing in-force insurance contracts and investment contracts with DPF and associated overhead expenses. The current level of expenses is taken as an appropriate expense base. The current expenses are analysed having regard to the volume and type of business in force to derive per contract expense assumptions. These per policy expense assumptions are assumed to increase over the course of the projections in line with expected expenses over the plan period reverting to an assumed expense inflation rate of 3 per cent. (2006 3 per cent., 2005 3 per cent.) thereafter.

## Changes in assumptions

There were no significant changes in the economic assumptions during 2007 or 2006 used in the derivation of the value of in-force long term assurance business. However, there were a number of changes to the underlying experience assumptions used to estimate the cash flows from the long term assurance business. Additionally, certain non-profit reserving methodologies have been updated to take account of the adoption of PS06/14 in 2007. This has the effect of decreasing both the value of in-force long term assurance business asset and insurance contract liabilities. Overall this has a net positive impact in 2007. These are discussed further in Note 26.

## Sensitivities

The tables below indicate the stand alone impact of changes to certain key variables on long term assurance business, this includes the impact on long term insurance contracts, investment contracts with DPF, value of in-force long term assurance business and related financial assets in support of the long term business but excluding those relating to investment contract liabilities.

	2007	Increase/ (decrease)
	Change in variable £m	in profit after tax
Interest rates increase into perpetuity	25bps	(23)
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(106)
Maintenance expenses fall and thereafter increase by the estimated expense inflation rate	(10)%	43
Mortality/morbidity rates decrease across all non annuity policy types and age groups	(5)%	30
Mortality rates decrease across all annuity policy types and age groups	(5)%	(20)
Lapse and surrender rates decrease across all policy types and cohorts over the duration of their lives (excluding paid-up policies)	(10)%	77

	2006	
	<i>Change in variable</i>	<i>Increase/ (decrease) in profit after tax</i>
	<i>£m</i>	
Interest rates increase into perpetuity	25bps	(24)
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(77)
Maintenance expenses fall and thereafter increase by the estimated expense inflation rate	(10)%	44
Mortality/morbidity rates decrease across all non annuity policy types and age groups	(5)%	27
Mortality rates decrease across all annuity policy types and age groups	(5)%	(18)
Lapse and surrender rates decrease across all policy types and cohorts over the duration of their lives (excluding paid-up policies)	(10)%	64

The table below indicates the stand alone impact of changes to certain key variables on long term insurance contracts and investment contracts with DPF only.

	2006		
	<i>Change in variable</i>	<i>Impact on profit before tax</i>	<i>Impact on shareholders' equity</i>
		<i>£m</i>	
Interest rates increase into perpetuity	100bps	(178)	(97)
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(126)	(77)
Maintenance expenses fall and thereafter increase by the estimated expense inflation rate	(10)%	60	44
Mortality/morbidity rates decrease across all policy types and age groups	(5)%	(8)	(4)
Lapse and surrender rates decrease across all policy types and cohorts over the duration of their lives (excluding paid-up policies)	(10)%	105	64

	2005		
	<i>Change in variable</i>	<i>Impact on profit before tax</i>	<i>Impact on shareholders' equity</i>
		<i>£m</i>	
Interest rates increase into perpetuity	100bps	(119)	(79)
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(99)	(60)
Maintenance expenses fall and thereafter increase by the estimated expense inflation rate	(10)%	63	43
Mortality/morbidity rates decrease across all policy types and age groups	(5)%	(4)	(3)
Lapse and surrender rates decrease across all policy types and cohorts over the duration of their lives (excluding paid-up policies)	(10)%	126	79

Although the tables above demonstrate the impact of individual variable changes, in practice due to the correlation between certain variables change in one variable would normally be expected to have an impact on other assumptions. It should also be noted that in some instances these sensitivities are non-linear.

## 25 Other Assets

	2007	Group 2006	2005 £m	2007	Company 2006	2005
Reinsurance assets (Note 26)	963	874	104			
Group relief recoverable				380	291	83
Other assets	6,505	3,797	4,593	15	53	
	<u>7,468</u>	<u>4,671</u>	<u>4,697</u>	<u>395</u>	<u>344</u>	<u>83</u>

## 26 Insurance Contract Liabilities

	2007			2006			2005		
	Gross liabilities	Reinsurance assets (Note 25)	Net of reinsurance	Gross liabilities	Reinsurance assets (Note 25) £m	Net of reinsurance	Gross liabilities	Reinsurance assets (Note 25)	Net of reinsurance
<b>Long term insurance contract liabilities</b>									
Insurance contracts within the with-profit fund	5,640		5,640	5,934		5,934	6,244		6,244
Insurance contracts within the non-profit funds	20,274	(956)	19,318	18,179	(864)	17,315	14,904	(92)	14,812
	<u>25,914</u>	<u>(956)</u>	<u>24,958</u>	<u>24,113</u>	<u>(864)</u>	<u>23,249</u>	<u>21,148</u>	<u>(92)</u>	<u>21,056</u>
<b>General insurance contract liabilities</b>									
Provision for unearned premiums	652	(7)	645	615	(9)	606	582	(9)	573
Claims provisions including claims incurred but not reported ("IBNR")	298		298	249	(1)	248	240	(3)	237
	<u>950</u>	<u>(7)</u>	<u>943</u>	<u>864</u>	<u>(10)</u>	<u>854</u>	<u>822</u>	<u>(12)</u>	<u>810</u>
<b>Total insurance contract liabilities</b>	<u>26,864</u>	<u>(963)</u>	<u>25,901</u>	<u>24,977</u>	<u>(874)</u>	<u>24,103</u>	<u>21,970</u>	<u>(104)</u>	<u>21,866</u>

The change in insurance contract liabilities (net of reinsurance) is analysed as follows:

	2007	2006	2005
	£m		
At 1 January	24,103	21,082	17,174
Acquisitions			1,326
Changes in assumptions	(279)	(116)	135
Additional insurance liabilities arising	1,895	3,178	3,213
Exchange translation	182	(41)	18
<b>At 31 December</b>	<u>25,901</u>	<u>24,103</u>	<u>21,866</u>

### Long Term Insurance Contract Liabilities

The Group principally writes the following long term contracts which contain insurance risk. The contracts also contain financial risk. The principal risks associated with each type of contract are described below.

Life assurance – The policyholder is insured against death or permanent disability usually for predetermined amounts (principally mortality and disability risk).

Annuity products – The policyholder is entitled to payments for the duration of their life and is therefore insured for living longer than expected (principally longevity and market risk).

With-profit business – The primary purpose of these products is to provide a long term smoothed investment vehicle to the policyholder, protecting them against short term market fluctuations. The policyholder is also usually insured against death and the policy may carry an annuity option at maturity (principally market risk).

Unit-linked business – The primary purpose of these products is to provide an investment vehicle but where the policyholder is also insured against death (principally market risk).

Additional information on the risk associated with the long term assurance business is set out in the Risk Management note.

The table below sets out the extent of the above exposures based on the carrying value of the liabilities:

	2007			2006			2005		
	Insurance contract liabilities	Reinsurers' share of contract liabilities	Net insurance contract liabilities	Insurance contract liabilities	Reinsurers' share of contract liabilities £m	Net insurance contract liabilities	Insurance contract liabilities	Reinsurers' share of contract liabilities	Net insurance contract liabilities
Life assurance	327	(28)	299	684	(80)	604	508		508
Annuity products	2,041		2,041	2,061		2,061	2,026		2,026
With-profit	5,640		5,640	5,934		5,934	6,244		6,244
Unit-linked	17,893	(921)	16,972	15,430	(784)	14,646	12,313	(91)	12,222
Other	13	(7)	6	4		4	57	(1)	56
<b>Total</b>	<b>25,914</b>	<b>(956)</b>	<b>24,958</b>	<b>24,113</b>	<b>(864)</b>	<b>23,249</b>	<b>21,148</b>	<b>(92)</b>	<b>21,056</b>

### Guarantees and options

The products with the most significant guarantees and options are certain with-profit bonds which allow surrenders at specified dates without market value adjustments being applied and withdrawals to be taken without penalty; certain contracts which provide guaranteed minimum levels of return on policyholder contributions made to the contract; and certain pension contracts containing an option that allows the policyholder to take an annuity benefit at any time between their 60th and 75th birthday on annuity rates that were guaranteed at the outset of the contract. There are no other material guarantees and options within the long term assurance business other than those discussed above.

For contracts where there are guarantees and options the most significant factor in determining the cost of the guarantees and options (other than economic conditions in which the option or guarantee has value) is the actual take up rate of options. The most significant factor in determining take up rates is customer behaviour which is influenced by a number of factors including the value of the contract, and the financial circumstances of the individuals. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

In order to measure the risk of these guarantees, the Group makes use of statistical modelling techniques where appropriate to determine the possible and most likely range of outcomes. To help mitigate the risks, the Group makes use of matching techniques in order to hedge part of the expected cash flows arising under the guarantees in these contracts with financial instruments.

### Experience and valuation rates of interest assumptions

The assumptions used in the measurement of insurance liabilities are determined by the Board of Directors. Material judgement is required in the choice of assumptions relating to insurance contracts.

The assumptions that have the greatest effect on the measurement of the insurance contract liabilities are set out by type of business below.

### Mortality and longevity rates

The process used to determine the Group's mortality and longevity assumptions starts with an internal investigation of the Group's actual mortality experience over the last five years. This investigation is updated regularly.

The results of this investigation are considered in the context of a number of factors including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period being considered, any known or expected trends in underlying data and relevant published market data.

The rates derived from the Group's experience are adjusted in the light of the factors mentioned above to derive a set of "best estimate" rates. No deliberate margins for prudence are introduced as part of this process. These "best estimate" assumptions will be used in the projection of "best estimate" cash flows, such as the measurement of the value of in-force long term assurance business.



For insurance contracts within the non-profit funds, the liabilities are assessed on a prudent basis and hence the rates used need to include a margin for adverse deviation that will increase liabilities and provide some protection from the risk that actual experience is worse than the “best estimate” assumptions.

For insurance contracts within the with-profit fund, the liabilities are required to be determined using the realistic or “best estimate” assumptions.

The mortality tables used are as follows:

	2007	2006	2005
<b>Non-profit policies</b>			
Pension annuities			
Males	98% PMA92 mc (1.5% minimum improvement)	95% PMA92 mc	95% PM92 mc
Females	80% PFA92 75% mc (1% minimum improvement)	80% PFA92 75% mc	80% PFA92 75%mc
Term assurances			
Males	24%-79% TM92	43%-145% TM92	43%-145% TM92
Females	26%-95% TF92	55%-160% TF92	55%-160% TF92
<b>Unit-linked policies</b>			
Life assurance and pensions	58%-143% AM92/AF92	60%-150% AM92/AF92	60%-150% AM92/AF92
<b>With-profit policies</b>			
Life assurance and pensions	49%-132% AM92/AF92	75%-85% AM92/AF92	60%-100% AM92/AF92

For life assurance policies, increased mortality rates would lead to a larger number of claims and claims occurring sooner than anticipated, increasing the expenditure and reducing profits. For annuity contracts, the opposite is true.

### Lapse and surrender rates (persistence)

A lapse occurs when the termination of a contract results from the non-payment of premiums due under that contract. A surrender occurs when a policyholder decides to voluntarily terminate their contract. Paid-up and partial surrender are additional forms of lapse and surrender.

The process used to determine contract lapse and surrender rates is similar to that used to determine mortality and longevity rates. The previous experience of the Group from 2004 (2003) to 2006 (2005) is analysed using statistical techniques. As the experience can vary considerably between different product types and for contracts which have been in force for different periods, the internal analysis breaks the data down into broadly homogeneous groups for the purposes of this analysis. This analysis is updated regularly.

The most recent experience is considered along with the results of previous analyses in order to determine a “best estimate” view of what persistence experience will be in the future. In determining this “best estimate” view, a number of factors are considered including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period being considered, any known or expected trends in underlying data and relevant published market data.

These “best estimate” assumptions will be used in the projection of “best estimate” cash flows, such as the measurement of the value of in-force long term assurance business. For insurance contracts within the non-profit funds, the liabilities are calculated assuming a prudent scenario. For insurance contracts within the with-profit fund, the liabilities are required to be determined using the realistic or “best estimate” assumptions.

Lapse and surrender rates vary according to both contract type and the length of time a contract has been in force. No lapse and surrender rates have been presented because it is impractical to summarise the information in a meaningful manner.

The impact of an increase in lapse and surrender rates on contracts without guarantees and options would most likely result in a decrease in profits, as the contracts would no longer be in force to generate cash flows in the future. However, for certain policies with valuable guarantees and options (principally within the with-profit fund), increased lapse and surrender rates may be beneficial to the Group as the policyholder loses the ability to exercise the potentially valuable guarantee or option when their policy terminates.

### Valuation rate of interest

The valuation rate of interest is the rate used to discount the projected cash flows on the contracts in order to determine the value of the liabilities as at the reporting date.

For insurance contracts within the non-profit funds, the liabilities are calculated using an estimate of the prudent valuation rate of interest determined according to specific rules set out by the Financial Services Authority.

For insurance contracts within the with-profit fund, the liabilities are calculated using a realistic or market consistent valuation rate of interest based on the prevailing economic conditions at the time of the liability assessment without further adjustment.

The valuation rates of interest used are as follows:

	<i>2007</i>	<i>2006</i>	<i>2005</i>
<b>Non-profit policies</b>			
Pension annuities	4.1%-5.3%	4.4%-4.8%	4.0%
Term assurances	3.5%-4.4%	3.0%-3.75%	2.6%-3.5%
<b>Unit-linked policies</b>			
Life assurance	3.3%-4.0%	3.0%-3.5%	2.6%-3.5%
Pensions	4.1%-4.9%	3.75%-4.4%	3.25%-3.5%

In isolation, an increase in the valuation rate of interest decreases liabilities leading to an increase in profits or vice versa.

### Discretionary participating bonus rates

The distributions to policyholders with insurance and investment contracts with DPF are determined by the Board of Directors of subsidiaries based on local regulations and in line with arrangements in individual policy contracts. For insurance and investment contracts with DPF in the with-profit fund, the distributions to policyholders are governed by the fund's Principles and Practices of Financial Management. No material changes were made to the distribution policies for insurance and investment contracts with DPF during the year under review.

### Changes in experience and valuation rate of interest assumptions

There were a number of changes made to assumptions used to calculate the value of policyholder liabilities in 2007, 2006 and 2005. The most significant changes to the liability valuations were due to changes in valuation rates of interest, which were updated to reflect the prevailing economic conditions at the balance sheet date. Additionally, certain non-profit reserving methodologies have been updated to take account of the adoption of PS06/14 in 2007. This has the effect of decreasing both the value in-force long term assurance business asset and the long term insurance contract liabilities.

## General Insurance Contract Liabilities

The insurance business's general insurance claim provisions including IBNR by policy type are set out in the table below:

	2007			2006			2005		
	Gross claims provisions	Reinsurers' share of provisions	Net claims provisions	Gross claims provisions	Reinsurers' share of claims provisions £m	Net claims provisions	Gross claims provisions	claims provisions	Net claims provisions
Repayment insurance	94		94	110		110	113	(2)	111
Household insurance	192		192	135		135	123		123
Other insurance	12		12	4	(1)	3	4	(1)	3
<b>Total</b>	<b>298</b>		<b>298</b>	<b>249</b>	<b>(1)</b>	<b>248</b>	<b>240</b>	<b>(3)</b>	<b>237</b>

## Assumptions

For general insurance contracts, claims provisions (comprising provisions for claims reported by policyholder and IBNR claims) are established to cover the ultimate costs of settling the liabilities in respect of claims that have occurred and are estimated based on known facts and anticipated experience at the balance sheet date. The provisions are refined as part of a regular ongoing process as claims experience develops, certain claims are settled and further claims are reported. Outstanding claims provisions are not discounted for the time value of money.

The measurement process primarily includes projection of future claims costs through a combination of actuarial and statistical projection techniques. In certain cases, where there is a lack of reliable historical data on which to estimate claims development, relevant benchmarks of similar business are used in developing claims estimates.

The principal assumption underlying the estimates is the general insurance business's past claims development experience. This includes assumptions in respect of average claims costs, claims handling costs, claims inflation factors, and claim numbers for each accident year. Judgement is used to assess the extent to which external factors such as judicial decisions and government legislation affect the estimates.

Additional information on the Group's general insurance risk is given in the Risk Management note.

## 27 Investment Contract Liabilities

	2007	2006	2005
		£m	
Investment contract liabilities	40,387	34,806	26,446
Investment contract liabilities with DPF	7,192	8,694	10,691
	47,579	43,500	37,137
Investment contracts related to collective investment schemes	5,249	5,986	5,020
<b>Total investment contract liabilities</b>	<b>52,828</b>	<b>49,486</b>	<b>42,157</b>

## 28 Unallocated Surplus

	2007	2006	2005
		£m	
At 1 January	1,543	974	605
Change in the year	(50)	569	369
<b>At 31 December</b>	<b>1,493</b>	<b>1,543</b>	<b>974</b>

The nature of certain insurance and investment contracts with DPF within the with-profit fund is such that the allocation of the surplus assets between the policyholder and the Group has not been determined at the end of the accounting period. The unallocated surplus comprises these surplus assets and is deemed to be a liability until allocation to the appropriate party has been determined. In accordance with the requirements of FRS 27, the "best estimate" of the Group's share of future bonuses has been recognised as part of the unallocated surplus.

## Sensitivities

The table below indicates the stand alone impact of changes to certain key variables that have the greatest impact on the Group's with-profit fund. These are shown with reference to the unallocated surplus and the underlying with-profit liabilities:

	<i>2007</i>		
	<i>Change in variable</i>	<i>Increase/ (decrease) in liabilities £m</i>	<i>Impact on unallocated surplus</i>
Interest rates increase into perpetuity	25bps	(94)	29
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(652)	(257)
Lapse and surrender rates decrease across all policy types and cohorts (excluding paid-up policies)	(10)%	16	(16)
	<i>2006</i>		
	<i>Change in variable</i>	<i>Increase/ (decrease) in liabilities £m</i>	<i>Impact on unallocated surplus</i>
Interest rates increase into perpetuity	25bps	(142)	26
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(757)	(201)
Lapse and surrender rates decrease across all policy types and cohorts (excluding paid-up policies)	(10)%	16	(16)
	<i>2005</i>		
	<i>Change in variable</i>	<i>Increase/ (decrease) in liabilities £m</i>	<i>Impact on unallocated surplus</i>
Interest rates increase into perpetuity	100bps	(567)	105
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(757)	(201)
Lapse and surrender rates decrease across all policy types and cohorts (excluding paid-up policies)	(10)%	16	(16)
	<i>2005</i>		
	<i>Change in variable</i>	<i>Increase/ (decrease) in liabilities £m</i>	<i>Impact on unallocated surplus</i>
Interest rates increase into perpetuity	100bps	(640)	150
Equity/property market values fall and thereafter increase based on the long term view of the risk free rate	(10)%	(720)	(230)
Lapse and surrender rates decrease across all policy types and cohorts (excluding paid-up policies)	(10)%	20	(20)

Although the tables above demonstrate the impact of individual variable changes, in practice due to the correlation between certain variables a change in one variable would normally be expected to have an impact on other assumptions. It should also be noted that in some instances these sensitivities are non-linear.

## 29 Post Retirement Benefits

The Group operates defined benefit and defined contribution pension schemes, as well as defined benefit post retirement medical and concessionary mortgage plans. The charge for the year in respect of the pension schemes is £206m (2006 £208m, 2005 £228m) comprising £141m (2006 £161m, 2005 £205m) for defined benefit schemes, £60m (2006 £44m, 2005 £20m) for defined contribution schemes and £5m (2006 £3m, 2005 £3m) for other post retirement benefits.

### Defined contribution post employment benefit plans

The principal Group defined contribution plan is the HBOS Group Money Purchase Scheme. It is funded by contributions from colleagues and the Group. New colleagues are automatically enrolled in the scheme unless they opt out.

The level of Group contributions for the majority of members who contribute at the core rate of 4 per cent. is 6 per cent. In addition, if members wish to pay more, then the Group will also make further contributions in respect of the members' first 4 per cent. of additional contributions. For the majority of members, stepping their contribution rate to 8 per cent. will result in the Group stepping up its rate to 12 per cent. Higher levels of Group contributions are available to more senior colleagues. Alternatively, members may elect to pay a lower contribution of 2 per cent. and receive Group contributions at 3 per cent. These were the levels of contributions for colleagues and Group for the majority of the existing members at April 2006 and other colleagues who were automatically enrolled into the plan. The respective default rates for colleague and Group contributions have been increased to 3 per cent. and 4.5 per cent. in 2007 and will be increased to 4 per cent. and 6 per cent. in 2008.

The expense of all the Group defined contribution plans for the year ended 31 December 2007 was £60m (2006 £44m, 2005 £20m).

### **Defined benefit post employment benefit plans**

The Group provides several defined benefit plans. The main scheme is the HBOS Final Salary Pension Scheme ("HBOS FSPS") which is a closed funded scheme. It was formed in July 2006 through the merger of the Group's four main UK defined benefit schemes. Accordingly disclosures prior to the date of the merger have been re-analysed to show *pro forma* comparatives for the HBOS FSPS based on the comparative disclosures of the four legacy schemes.

Separate disclosures for all other defined benefit pension plans within the Group are made under the heading "Other Schemes". These contain a mixture of funded and unfunded schemes and arrangements.

Separate disclosures are also made on a combined basis for the unfunded post retirement medical plans and concessionary mortgage plans under the heading "Other Post Retirement Benefits".

The Company is the sponsor of the HBOS FSPS, the unfunded scheme which is included within the Other Schemes and the Other Post Retirement Benefits. The net liabilities of these schemes are £263m, £44m and £53m respectively totalling £360m (2006 £778m, £44m and £55m respectively totalling £877m, 2005 £1,700m, £42m and £49m respectively, totalling £1,791m). Accordingly the disclosures relating to the HBOS FSPS and Other Post Retirement Benefits are also those of the Company.

The unfunded scheme in the Company had a liability of £44m at the start of the year (2006 £42m) and £44m at the year end (2006 £44m). The pension expense relating to the unfunded scheme in the Company is £2m (2006 £3m) and is comprised of an interest cost and current service cost of £2m and £nil respectively (2006 £2m and £1m). In addition benefits paid by the Company in respect of the unfunded scheme during the year amounted to £2m (2006 £1m). The unfunded pension liabilities have been secured by assets held by the Group. These assets, comprising listed investment securities held at a value of £56m at 31 December 2007 (2006 £36m, 2005 £36m), are included in the Group's investment securities and would only be available to members in the event of certain contingencies, such as the failure to pay benefits.

The assets of the Group's funded schemes are held in separate trustee-administered funds, which are independent of the Group's own assets, to meet the long term pension liabilities of past and present employees. The trustees of the schemes are required to act with regard to the best interests of the schemes' beneficiaries and a number of trustees are nominated or elected by the members of the schemes. The trustees, in consultation with the Group, set the schemes' investment strategies and, with the agreement of the Group, set the level of contributions to be made to the schemes.

The liabilities of the defined benefit schemes are measured by discounting the estimated future cash flows to be paid out by the schemes using the projected unit method. This method is an accrued benefit valuation technique that makes allowances for projected earnings. The Group estimates the average duration of the liabilities of the defined benefit scheme to be 23 years.

Following its formation in 2006, the first funding valuation and the most recent published valuation of the HBOS FSPS was carried out as at 31 December 2006 by an independent actuary. The financial assumptions adopted within this valuation were based upon the economic conditions prevailing at the date of valuation. This resulted in the Group adjusting the rate of regular contributions to around 23 per cent. of pensionable salaries with effect from July 2007. In the light of the deficit of £95m under the assumptions agreed for the valuation, the Company also agreed to

make annual deficit contributions of £50m per annum for each of the years 2007 to 2010 inclusive. The Company has paid £100m in respect of the first two years contribution during the current financial year. The level of contributions payable to the scheme is expected to be reviewed again following completion of the next funding valuation, due as at 31 December 2009.

On 1 January 2008, the Clerical Medical International Pension Scheme, which is a funded defined benefit plan, included within Other Schemes is merging with the HBOS FSPS. In anticipation of this, the Company has paid a deficit reduction contribution of £5m during the year as part of the merger agreement.

The Group's net post retirement benefit liabilities in respect of its defined benefit plans are analysed as follows:

	2007				2006			
	HBOS FSPS	Other Schemes	Other Post Retirement Benefits	Total £m	HBOS FSPS	Other Schemes	Other Post Retirement Benefits	Total
Defined benefit obligations	(7,072)	(551)	(53)	(7,676)	(6,952)	(549)	(55)	(7,556)
Fair value of assets	6,809	520		7,329	6,174	470		6,644
<b>Net liabilities</b>	<b>(263)</b>	<b>(31)</b>	<b>(53)</b>	<b>(347)</b>	<b>(778)</b>	<b>(79)</b>	<b>(55)</b>	<b>(912)</b>
Movements in the net post retirement benefit liabilities were as follows:								
At 1 January	(778)	(79)	(55)	(912)	(1,701)	(91)	(49)	(1,841)
Pension expense	(131)	(10)	(5)	(146)	(148)	(13)	(3)	(164)
Group contributions	250	42		292	826	31		857
Benefits paid directly by the Group		1	2	3		1	2	3
Actuarial gains/(losses)	396	15	5	416	245	(7)	(5)	233
<b>At 31 December</b>	<b>(263)</b>	<b>(31)</b>	<b>(53)</b>	<b>(347)</b>	<b>(778)</b>	<b>(79)</b>	<b>(55)</b>	<b>(912)</b>
Movements in the defined benefit obligations were as follows:								
At 1 January	6,952	549	55	7,556	6,635	500	49	7,184
Current service cost	210	12	2	224	210	9	1	220
Plan participant contributions	23	1		24	21	3		24
Interest cost	358	28	3	389	319	25	2	346
Benefits paid	(165)	(19)		(184)	(144)	(11)		(155)
Benefits paid directly by the Group		(1)	(2)	(3)		1	(2)	(1)
Net actuarial (gains)/losses	(311)	(24)	(5)	(340)	(96)	32	5	(59)
Past service cost	5	1		6	7	1		8
Settlement/curtailment		(4)		(4)		(7)		(7)
Foreign exchange translation		8		8		(4)		(4)
<b>At 31 December</b>	<b>7,072</b>	<b>551</b>	<b>53</b>	<b>7,676</b>	<b>6,952</b>	<b>549</b>	<b>55</b>	<b>7,556</b>
Movements in the fair value of plan assets were as follows:								
At 1 January	6,174	470		6,644	4,934	409		5,343
Actual return on plan assets	527	24		551	537	47		584
Group contributions	250	42		292	826	31		857
Plan participant contributions	23	1		24	21	3		24
Benefits paid	(165)	(19)		(184)	(144)	(11)		(155)
Settlement/curtailment		(6)		(6)		(7)		(7)
Foreign exchange translation		8		8		(2)		(2)
<b>At 31 December</b>	<b>6,809</b>	<b>520</b>		<b>7,329</b>	<b>6,174</b>	<b>470</b>		<b>6,644</b>
The fair value of plan assets at 31 December comprise the following:								
Equity instruments	3,940	260		4,200	4,190	277		4,467
Bonds	2,478	129		2,607	1,636	58		1,694
With-profit investments		50		50		54		54
Property	298	8		306	270			270
Other assets	93	73		166	78	81		159
<b>Total value of assets</b>	<b>6,809</b>	<b>520</b>		<b>7,329</b>	<b>6,174</b>	<b>470</b>		<b>6,644</b>

The amount included in the balance sheet arising from the Group's net obligation in respect of its defined benefit plans is as follows:

	2005			
	<i>HBOS FSPS</i>	<i>Other Schemes</i>	<i>Other Post Retirement Benefits</i>	<i>Total</i>
	£m			
Defined benefit obligations	(6,635)	(500)	(49)	(7,184)
Fair value of assets	4,934	409		5,343
<b>Net post retirement benefit liabilities</b>	<b>(1,701)</b>	<b>(91)</b>	<b>(49)</b>	<b>(1,841)</b>
Movements in the net post retirement benefit liabilities were as follows:				
At 1 January	(1,616)	(100)	(46)	(1,762)
Pension expense	(190)	(15)	(3)	(208)
Group contributions	325	41		366
Benefits paid directly by the Group			2	2
Actuarial gains/(losses)	(220)	(17)	(2)	(239)
<b>At 31 December</b>	<b>(1,701)</b>	<b>(91)</b>	<b>(49)</b>	<b>(1,841)</b>
Movements in the defined benefit obligations were as follows:				
At 1 January	5,447	452	46	5,945
Current service cost	187	12	1	200
Plan participant contributions	23			23
Interest cost	294	23	2	319
Benefits paid	(122)	(11)		(133)
Benefits paid directly by the Group			(2)	(2)
Net actuarial losses/(gains)	801	27	2	830
Past service cost	5	3		8
Settlement/curtailment		(4)		(4)
Foreign exchange translation		(2)		(2)
<b>At 31 December</b>	<b>6,635</b>	<b>500</b>	<b>49</b>	<b>7,184</b>
Movements in the fair value of plan assets were as follows:				
At 1 January	3,831	352		4,183
Actual return on plan assets	877	34		911
Group contributions	325	41		366
Plan participant contributions	23			23
Benefits paid	(122)	(11)		(133)
Settlement/curtailment		(5)		(5)
Foreign exchange translation		(2)		(2)
<b>At 31 December</b>	<b>4,934</b>	<b>409</b>		<b>5,343</b>
The fair value of plan assets at 31 December comprise the following:				
Equity instruments	3,895	242		4,137
Bonds	706	31		737
With-profit investments		136		136
Property	254			254
Other assets	79			79
<b>Total value of assets</b>	<b>4,934</b>	<b>409</b>		<b>5,343</b>

The expense recognised in the income statement for the year ending 31 December comprises:

	2007			Total £m	2006			Total
	HBOS FSPS	Other Schemes	Other Post Retirement Benefits		HBOS FSPS	Other Schemes	Other Post Retirement Benefits	
Current service cost	210	12	2	224	210	9	1	220
Interest cost	358	28	3	389	319	25	2	346
Expected return on assets	(442)	(33)		(475)	(388)	(22)		(410)
Settlement/curtailment		2		2				
Past service cost	5	1		6	7	1		8
<b>Total expense</b>	<b>131</b>	<b>10</b>	<b>5</b>	<b>146</b>	<b>148</b>	<b>13</b>	<b>3</b>	<b>164</b>

	2005			Total £m
	HBOS FSPS	Other Schemes	Other Post Retirement Benefits	
Current service cost	187	12	1	200
Interest cost	294	23	2	319
Expected return on assets	(296)	(24)		(320)
Settlement/curtailment		1		1
Past service cost	5	3		8
<b>Total pension expense</b>	<b>190</b>	<b>15</b>	<b>3</b>	<b>208</b>

The actuarial gains/(losses) recognised in the statement of recognised income and expense for the year ending 31 December comprises:

	2007			Total £m	2006			Total
	HBOS FSPS	Other Schemes	Other Post Retirement Benefits		HBOS FSPS	Other Schemes	Other Post Retirement Benefits	
Actuarial gain/(loss) on plan assets	85	(9)		76	149	25		174
Experience (loss)/gain on plan liabilities	(91)	(4)	1	(94)	136	7	1	144
Gain/(loss) from change in assumptions	402	28	4	434	(40)	(39)	(6)	(85)
<b>Total actuarial gains/(losses)</b>	<b>396</b>	<b>15</b>	<b>5</b>	<b>416</b>	<b>245</b>	<b>(7)</b>	<b>(5)</b>	<b>233</b>

	2005			Total £m
	HBOS FSPS	Other Schemes	Other Post Retirement Benefits	
Actuarial gain on plan assets	581	10		591
Experience gain/(loss) on plan liabilities	(83)	(7)		(90)
Loss from change in assumptions	(718)	(20)	(2)	(740)
<b>Total actuarial gains/(losses)</b>	<b>(220)</b>	<b>(17)</b>	<b>(2)</b>	<b>(239)</b>

The Group's policy for recognising actuarial gains and losses is to take them directly to reserves in the period in which they arise. A gain of £312m (2006 gain of £163m, 2005 loss of £167m) (net of tax) was recognised in the consolidated statement of recognised income and expense in the year. Cumulative actuarial gains and losses recognised in the consolidated statement of recognised income and expense at 31 December 2007 amount to a gain of £176m (2006 loss £136m, 2005 loss £299m) (net of tax).



The expected and actual returns on plan assets for the HBOS FSPS and other schemes is as follows:

	<i>HBOS FSPS</i>	<i>2007 Other Schemes</i>	<i>Total £m</i>	<i>HBOS FSPS</i>	<i>2006 Other Schemes</i>	<i>Total</i>
Expected return on plan assets	442	33	475	388	22	410
Actuarial gain/(loss) on plan assets	85	(9)	76	149	25	174
<b>Actual return on plan assets</b>	<b>527</b>	<b>24</b>	<b>551</b>	<b>537</b>	<b>47</b>	<b>584</b>

	<i>HBOS FSPS</i>	<i>2005 Other Schemes £m</i>	<i>Total</i>
Expected return on plan assets	296	24	320
Actuarial gain on plan assets	581	10	591
<b>Actual return on plan assets</b>	<b>877</b>	<b>34</b>	<b>911</b>

The history of experience adjustments for the HBOS FSPS and other schemes is as follows:

	<i>HBOS FSPS</i>	<i>2007 Other Schemes</i>	<i>Total £m</i>	<i>HBOS FSPS</i>	<i>2006 Other Schemes</i>	<i>Total</i>
Defined benefit obligations	(7,072)	(551)	(7,623)	(6,952)	(549)	(7,501)
Fair value of plan assets	6,809	520	7,329	6,174	470	6,644
<b>Net liabilities</b>	<b>(263)</b>	<b>(31)</b>	<b>(294)</b>	<b>(778)</b>	<b>(79)</b>	<b>(857)</b>
Experience adjustments on plan liabilities: (Loss)/gain (£m)	(91)	(4)	(95)	136	7	143
Percentage of plan liabilities (%)	1	1	1	(2)	(1)	(2)
Experience adjustments on plan assets: Gain/(loss) (£m)	85	(9)	76	149	25	174
Percentage of plan assets (%)	1	(2)	1	2	5	3

	<i>HBOS FSPS</i>	<i>2005 Other Schemes £m</i>	<i>Total</i>
Defined benefit obligations	(6,635)	(500)	(7,135)
Fair value of plan assets	4,934	409	5,343
<b>Net liabilities</b>	<b>(1,701)</b>	<b>(91)</b>	<b>(1,792)</b>
Experience adjustments on plan liabilities Gain/(loss) (£m)	(83)	(7)	(90)
Percentage of plan liabilities (%)	1	1	1
Experience adjustments on plan assets Gain (£m)	581	10	591
Percentage of plan assets (%)	12	2	11

The mortality assumptions used in 2007 are unchanged from those adopted in 2006. For current and deferred pensioners table PNAOO projected to 2006 using the base level of improvements from the “92” series, with subsequent future improvements in line with the “92” series “medium cohort” projections have been used with a 10 per cent. loading to the female table reducing life expectancy. This is to align it with actual experience for the schemes’ pensioners. For active members table A92ULT multiplied by 70 per cent. has been used. The net actuarial gain on the defined benefit obligations of £59m in 2006 includes a loss of £348m in respect of changes in life expectancy arising from the use of these revised mortality tables, offset by gains arising from changes in the discount rate and other actuarial assumptions. The net actuarial losses of the defined benefit obligations of £830m in 2005 principally arose from the change in the discount rate assumption. The discount rate is based on an average yield from long-dated “AA” corporate bonds which fell significantly in 2005.

During 2006 Group contributions included additional contributions of £685m (2005 £120m) made specifically to reduce the funding deficits of the schemes.

On transfer of the schemes to the Company the defined benefit obligations transferred totalled £6,520m and the fair value of the plan assets amounted to £5,064m. At 31 December 2006, the net post retirement liabilities of the Company amounted to £877m (2005 £nil) and comprise the HBOS FSPS £778m (2005 £nil), the other post retirement benefits £55m (2005 £nil) and certain unfunded liabilities of £44m (2005 £nil) that are included within other schemes. Following the transfer of the schemes, the elements of the movements in the defined benefit obligation and fair value of the plan assets in the Company related to the pension expense have been fully recharged to subsidiary undertakings, which have also paid benefits and normal contributions on behalf of the Company.

### Summary of assumptions and membership data

The following assumptions and data have been used in respect of the defined benefit pension schemes:

	<i>2008</i>	<i>HBOS FSPS 2007</i>	<i>2006</i>	<i>2005</i>	<i>2008</i>	<i>Other Schemes 2007</i>	<i>2006</i>	<i>2005</i>
<b>Actuarial assumptions at beginning of the year</b>								
Discount rate (%)	5.70	5.15	4.85	5.45	5.70	5.15	4.85	5.45
RPI inflation rate (%)	3.4	3.0	2.8	2.8	3.4	3.0	2.8	2.8
Expected return on plan assets <sup>(1)</sup> (%)	6.78	7.18	7.15	7.71	6.66	6.86	6.29	6.20
Salary increases <sup>(2)</sup> (%)	3.9	3.5	3.3	3.8	3.9	3.5	3.3	3.8
Pension increases <sup>(3)</sup> (%)	3.3	3.0	2.8	2.8	3.3	3.0	2.8	2.8
<b>Life expectancy at age 60 (years)</b>								
Retired members								
Males	26	26	23	23	26	26	23	23
Females	27	27	26	26	27	27	26	26
Non-retired members								
Males	27	27	24	24	27	27	24	24
Females	29	29	27	27	29	29	27	27

#### Notes:

- (1) The expected return on plan assets is the weighted average of the expected returns of the main asset classes. These returns reflect a combination of historical performance, the forward looking views of financial markets, as suggested by the yields available, and the views of investment organisations. For 2008 the expected returns are 8.2 per cent. (2007 8.3 per cent.) on equities, 4.5 per cent. (2007 5.15 per cent. bonds) on government bonds, 5.6 per cent. on corporate bonds and 6.8 per cent. (6.75 per cent.) on property.

- (2) In addition to the general assumed rate of salary increases, there is a separate assumed salary scale of increases due to promotions and increasing seniority.
- (3) The pension increase is on the excess over the Guaranteed Minimum Pension. Pensions which are guaranteed to increase at a rate of at least 3 per cent. per annum have been assumed to increase at 3.6 per cent. per annum for the end of year calculations (3.40 per cent. per annum for 2006 and 3.25 per cent. per annum for previous calculations).

A summary of the membership data at the end of each year is as follows:

	<i>HBOS FSPS</i>			<i>Other Schemes</i>		
	<i>2007</i>	<i>2006</i>	<i>2005</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
<b>Active members</b>						
Number	27,893	30,044	32,504	2,581	2,113	2,289
Covered annual payroll (£m)	745	747	764	106	82	78
Average age	42	41	41	43	44	43
Average length of service	15	14	13	11	11	12
<b>Deferred members</b>						
Number	35,869	35,167	32,844	2,557	2,019	1,969
Average age	42	42	44	44	47	44
<b>Retired members</b>						
Number	14,460	13,866	12,932	675	677	644
Total annual pensions (£m)	129	120	112	18	10	9
Average age	64	63	64	63	64	65

The principal assumptions used in the calculation of the other post retirement benefits are the discount rate, which is the same as that used for the pension schemes and the medical cost trend rate which has been assumed to be the same as the discount rate.

Sensitivity analysis for each of the principal assumptions used to measure the scheme liabilities, showing the increase in defined benefit obligations at 31 December, is set out below:

<i>Factor</i>	<i>Change in assumption</i>	<i>HBOS FSPS</i>		<i>Other Schemes</i>	
		<i>Increase 2007</i>	<i>Increase 2006</i>	<i>Increase 2007</i>	<i>Increase 2006</i>
Discount rate	decrease 0.1%	2.3%	2.3%	2.2%	2.2%
Rate of inflation	increase 0.1%	2.3%	2.2%	2.2%	2.2%
Rate of salary growth	increase 0.1%	0.5%	0.4%	0.4%	0.5%
Life expectancy at age 60	increase by 1 year	2.7%	2.7%	2.5%	2.4%

### 30 Long Term Assurance Business Capital Position Statement

The Capital Position Statement sets out the total capital resources relating to the life assurance business of the Group. The statement shows the shareholders' funds in the long term assurance business together with the adjustments required to reconcile these amounts with the amounts determined in accordance with the regulatory reporting framework.

	<i>CMIGL UK with-profit fund</i>	<i>UK non- profit funds</i>	<i>2007 UK life shareholder funds £m</i>	<i>Overseas life business</i>	<i>Total life business</i>
<b>Total shareholders' funds</b>		4,004	40	736	4,780
<b>Adjustments onto regulatory basis:</b>					
Less value of in-force long term assurance business (Note 24)		(2,476)		(708)	(3,184)
Less purchased value of in-force investment business (Note 19)		(320)		(1)	(321)
Add unallocated surplus (Note 28) <sup>(1)</sup>	1,493				1,493
Less shareholders' share of realistic liabilities	(81)				(81)
Deferred taxation		1,102		135	1,237
Other adjustments		(651)	55	87	(509)
	<u>1,412</u>	<u>1,659</u>	<u>95</u>	<u>249</u>	<u>3,415</u>
Other qualifying capital:					
Loan capital			1,039		1,039
<b>Total capital available<sup>(3)</sup></b>	<u><u>1,412</u></u>	<u><u>1,659</u></u>	<u><u>1,134</u></u>	<u><u>249</u></u>	<u><u>4,454</u></u>
The Group's long term insurance and investment contract liabilities are allocated as follows:					
Insurance contract liabilities (Note 26)	5,640	17,764		2,510	25,914
Investment contract liabilities (Note 27) <sup>(2)</sup>	7,192	33,890		6,497	47,579
Unallocated surplus (Note 28)	1,493				1,493

Notes:

(1) The with-profit fund unallocated surplus is determined on an adjusted realistic basis.

(2) Excludes investment contract liabilities related to the collective investment schemes.

(3) Provisional available capital.

	<i>CMIGL UK with-profit fund</i>	<i>UK non- profit funds</i>	<i>2006 UK life shareholder funds £m</i>	<i>Overseas life business</i>	<i>Total life business</i>
Total shareholders' funds		4,119	(279)	710	4,550
Adjustments onto regulatory basis:					
Less value of in-force long term assurance business (Note 24)		(2,488)		(616)	(3,104)
Less purchased value of in-force investment business (Note 19)		(350)		(1)	(351)
Add unallocated surplus (Note 28) <sup>(1)</sup>	1,543				1,543
Less shareholders' share of realistic liabilities	(107)				(107)
Deferred taxation		1,102		152	1,254
Other adjustments		(728)	(5)	(12)	(745)
	<u>1,436</u>	<u>1,655</u>	<u>(284)</u>	<u>233</u>	<u>3,040</u>
Other qualifying capital:					
Loan capital			962		962
<b>Total capital available<sup>(3)</sup></b>	<u><u>1,436</u></u>	<u><u>1,655</u></u>	<u><u>678</u></u>	<u><u>233</u></u>	<u><u>4,002</u></u>
The Group's long term insurance and investment contract liabilities are allocated as follows:					
Insurance contract liabilities (Note 26)	5,934	15,982		2,197	24,113
Investment contract liabilities (Note 27) <sup>(2)</sup>	8,694	31,630		3,176	43,500
Unallocated surplus (Note 28)	1,543				1,543

Notes:

(1) The with-profit fund unallocated surplus is determined on an adjusted realistic basis.

(2) Excludes investment contract liabilities related to the collective investment schemes.

(3) Provisional available capital.

	<i>CMIGL UK with-profit fund</i>	<i>UK non- profit funds</i>	<i>2005 UK life shareholder funds £m</i>	<i>Overseas life business</i>	<i>Total life business</i>
Total shareholders' funds		3,870	(180)	739	4,429
Adjustments onto regulatory basis:					
Less value of in-force long term assurance business (Note 24)		(2,238)		(609)	(2,847)
Less purchased value of in-force investment business (Note 19)		(373)		(2)	(375)
Add unallocated surplus (Note 28) <sup>(1)</sup>	974				974
Less shareholders' share of realistic liabilities	(98)				(98)
Deferred taxation		952		136	1,088
Other adjustments		(566)	(4)	(41)	(611)
	<u>876</u>	<u>1,645</u>	<u>(184)</u>	<u>223</u>	<u>2,560</u>
Other qualifying capital:					
Loan capital			977		977
<b>Total capital available<sup>(3)</sup></b>	<u><u>876</u></u>	<u><u>1,645</u></u>	<u><u>793</u></u>	<u><u>223</u></u>	<u><u>3,537</u></u>

The Group's long term insurance and investment contract liabilities are allocated as follows:

Insurance contract liabilities (Note 26)	6,244	12,947		1,957	21,148
Investment contract liabilities (Note 27) <sup>(2)</sup>	10,691	22,709		3,737	37,137
Unallocated surplus (Note 28)	974				974

Notes:

(1) The with-profit fund unallocated surplus is determined on an adjusted realistic basis.

(2) Excludes investment contract liabilities related to the collective investment schemes.

(3) Total capital available has been restated to include the with-profit fund's total available capital on a "realistic peak" basis in line with emerging industry practice. Previously the with-profit fund's total available capital was included on a "regulatory peak" basis with the difference included as an additional capital requirement.

The Group has one UK with-profit fund, the Clerical Medical Investment Group Limited ("CMIGL") with-profit fund, which is shown separately in the Capital Position Statement. The Group's UK non-profit businesses are aggregated as well as the Group's overseas life businesses for the purpose of this statement.

For the Group's UK with-profit fund, available capital and capital requirements are determined under the "twin peaks" assessment as prescribed by the regulations of the Financial Services Authority ("FSA"). Under this assessment the available capital is determined by comparing admissible assets with the mathematical reserves determined on the "regulatory peak" basis. This is adjusted by the with-profit insurance capital component ("WPICC") to arrive at the available capital position for the purpose of this disclosure. The capital requirement, adjusting for the WPICC, consists of the long term insurance capital requirement ("LTICR").

The WPICC is determined under the twin peaks test by comparing the regulatory peak with the realistic peak. If the latter is more onerous then this gives rise to a WPICC. At 31 December 2007, 2006 and 2005, the realistic peak was more onerous. Accordingly, the available capital of the with-profit fund is adjusted by the WPICC and presented on a "realistic" basis. As more fully described in Note 28, the unallocated surplus is determined on an adjusted realistic basis in accordance with FRS 27.

UK shareholders' funds, UK non-profit funds and overseas businesses are shown separately in the Capital Position Statement. There are no formal arrangements, other than those relating to the CMIGL with-profit fund described below, for shareholders' funds or the surplus within the individual life funds to be used to support other businesses or life funds within the Group. However, as described below, subject to certain conditions being met, the available capital within the individual funds is potentially transferable to other parts of the Group. However, the capital within each fund is generally subject to restrictions as to its availability to meet requirements that arise elsewhere in the Group, including other long term businesses. In particular, for sections in the Capital Position Statement where aggregate capital amounts have been shown, such as for UK non-profit funds and overseas business, there are no prior arrangements in place to allow the capital to move freely between entities within these sections.

### **Restrictions to the application of capital**

Restrictions apply to the transfer of assets from any long term fund. In particular, at all times, each long term fund must maintain an excess of assets over liabilities. Transfers of assets from a long term fund can only be made once management are satisfied that they have met the relevant requirements of the fund. The principal restrictions are:

#### **(a) CMIGL with-profit fund**

The unallocated surplus held in the fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses. Such distributions would also be subject to a tax charge. The use of capital within the fund is also subject to the terms of the scheme of demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. Capital within the Clerical Medical non-profit fund is available to meet the with-profit fund's capital requirements. There are no other arrangements that provide capital support to the fund.

#### **(b) UK non-profit funds**

Except as above, the capital held in the fund is attributable to the shareholders and, subject to meeting the regulatory requirements of these businesses, this capital is potentially available to meet capital requirements elsewhere in the Group. Any transfer of the surplus would give rise to a tax charge.

#### **(c) Overseas life business**

These include several smaller life companies outside the UK. In all cases the available capital resources are subject to local regulatory requirements including Germany, Ireland and Australia. The available capital held in each company is potentially available to meet the capital requirements in other parts of the Group, subject to additional complexity surrounding the transfer of capital from one country to another.

### **Target capital**

For the UK with-profit fund, the Group is required to hold sufficient capital to meet FSA requirements, based on the risk capital margin ("RCM") determined in accordance with the FSA's regulatory rules under its realistic capital regime. The determination of the RCM is based on the impact of specified changes in market prices of the fund assets as well as policyholder behaviour, taking into account the actions management would have taken in the event of the particular adverse changes.

For UK non-profit business, the relevant capital requirement is the LTICR and resilience capital requirement determined in accordance with FSA regulations.

Under the FSA's Individual Capital Adequacy Standards framework, each company is required to carry out its own assessment of the capital required to meet its liabilities in all reasonably foreseeable circumstances known as the individual capital assessment ("ICA"). The ICA takes into account certain business risks not reflected in the FSA's other capital requirements.

Management intends to maintain surplus capital in excess of the various regulatory requirements, including the ICA, in order to absorb changes in both the underlying businesses and the capital

requirements over the short term. At 31 December 2007 the provisional available capital, excluding the with-profit fund, was 468 per cent. (2006 462 per cent., 2005 473 per cent.) of the provisional LTICR and resilience capital requirements of £650m (2006 £555m, 2005 £562m). At 31 December 2007, the total provisional available capital including the with-profit fund on a realistic basis was 399 per cent. (2006 354 per cent., 2005 270 per cent.) of the provisional LTICR and resilience capital requirements of £1,116m (2006 £1,131m, 2005 £1,312m).

### Changes in capital

The principal factors that resulted in changes to the total provisional available capital are set out in the table below:

	<i>CMIGL UK with-profit fund</i>	<i>UK non- profit funds</i>	<i>UK life shareholder funds £m</i>	<i>Overseas life business</i>	<i>Total life business</i>
At 1 January 2006	876	1,645	793	223	3,537
Changes in non-investment assumptions <sup>(1)</sup>	(10)	5		(5)	(10)
Investment markets and changes in investment assumptions <sup>(2)</sup>	83	44	(11)	3	119
New business <sup>(3)</sup>		(331)		(27)	(358)
Other experience <sup>(4)</sup>	487	192	(4)	81	756
Transfers of capital and dividends <sup>(5)</sup>		100	(100)	(42)	(42)
<b>At 31 December 2006</b>	<b>1,436</b>	<b>1,655</b>	<b>678</b>	<b>233</b>	<b>4,002</b>
Impact of adopting PS06/14		279			279
Changes in non-investment assumptions <sup>(1)</sup>	(15)	42	59	(1)	85
Investment markets and changes in investment assumptions <sup>(2)</sup>	(112)	128		10	26
New business <sup>(3)</sup>		(423)		(138)	(561)
Other experience <sup>(4)</sup>	103	548	31	206	888
Transfers of capital and dividends <sup>(5)</sup>		(570)	366	(61)	(265)
<b>At 31 December 2007</b>	<b>1,412</b>	<b>1,659</b>	<b>1,134</b>	<b>249</b>	<b>4,454</b>

Notes:

- (1) There were no significant changes to the non-investment assumptions during the year.
- (2) Net positive market conditions led to an increase in the value of securities resulting in an increase to the total capital available.
- (3) The amount of capital has been reduced by the increase in liabilities and new business strain (excess of acquisition costs over margins due to significant volumes of new long term assurance business written since the last balance sheet date).
- (4) This is the effect of current year experience on in-force blocks of business.
- (5) This represents the dividends paid by, or transfers of capital to and from, the funds during the year.

### 31 Deferred Tax

	<i>2007</i>	<i>2006</i>	<i>2005</i>
	<i>£m</i>		
Deferred tax liabilities	2,945	3,349	2,759
Deferred tax assets	(415)	(758)	(1,008)
<b>Net position</b>	<b>2,530</b>	<b>2,591</b>	<b>1,751</b>

At 31 December 2007 a deferred tax liability of £251m (2006 £214m, 2005 £115m) relating to investments in subsidiaries has not been recognised because the Company controls whether or not the liability will be incurred and it is satisfied that it will not be incurred in the foreseeable future.



As a result of the Finance Act 2007, the main UK corporation tax rate will reduce from 30 per cent. to 28 per cent. in April 2008. UK deferred tax balances that are not expected to have been realised by April 2008 have been restated at the rate of 28 per cent. In addition, the German corporation tax rate reduced from 25 per cent. to 15 per cent. in January 2008.

The movement in the net position is as follows:

	2007	2006	2005
		£m	
At 1 January	2,591	1,751	1,222
Charge to income for the year (Note 9)	199	661	545
(Credit)/charge to equity for the year (Note 9)	(86)	139	(58)
Changes in rates of corporation tax recognised in income (Note 9)	(178)		
Changes in rates of corporation tax recognised in equity (Note 9)	1		
Transfer to current tax		37	
Acquisitions		60	107
Disposals			(55)
Other movements	3	(57)	(10)
<b>At 31 December</b>	<b>2,530</b>	<b>2,591</b>	<b>1,751</b>

Analysed as follows:

<i>Deferred tax liabilities</i>	<i>Capital allowances</i>	<i>Available for sale investments</i>	<i>Cash flow hedges</i>	<i>2007 Long term assurance business £m</i>	<i>Effective interest rate</i>	<i>Other</i>	<i>Total</i>
At 1 January 2007	1,112	96	182	1,738	131	90	3,349
Charge/(credit) to income for the year	31	(9)		(44)	(29)	88	37
(Credit)/charge to equity for the year		(65)	(182)	5		(1)	(243)
Changes in rates of corporation tax recognised in income	(76)			(101)	(7)	(12)	(196)
Changes in rates of corporation tax recognised in equity		(7)					(7)
Other movements	(7)			12	3	(3)	5
<b>At 31 December 2007</b>	<b>1,060</b>	<b>15</b>		<b>1,610</b>	<b>98</b>	<b>162</b>	<b>2,945</b>

<i>Deferred tax assets</i>	<i>Cash flow hedges</i>	<i>Employee benefits</i>	<i>2007 Provisions £m</i>	<i>Other</i>	<i>Total</i>
At 1 January 2007		(284)	(213)	(261)	(758)
Charge to income for the year		46	36	80	162
(Credit)/charge to equity for the year	(37)	130		64	157
Changes in rates of corporation tax recognised in income		1	9	8	18
Changes in rates of corporation tax recognised in equity	3	5			8
Other movements		4		(6)	(2)
<b>At 31 December 2007</b>	<b>(34)</b>	<b>(98)</b>	<b>(168)</b>	<b>(115)</b>	<b>(415)</b>

<i>Deferred tax liabilities</i>	<i>Capital allowances</i>	<i>Available for sale investments</i>	<i>Cash flow hedges</i>	<i>2006 Long term assurance business £m</i>	<i>Effective interest rate</i>	<i>Other</i>	<i>Total</i>
At 1 January 2006	928	65	57	1,416	122	171	2,759
Charge to income for the year	112	7		294	9	(75)	347
Charge/(credit) to equity for the year		20	125				145
Transfers to current tax		4				33	37
Acquisitions	85						85
Other movements	(13)			28		(39)	(24)
<b>At 31 December 2006</b>	<b>1,112</b>	<b>96</b>	<b>182</b>	<b>1,738</b>	<b>131</b>	<b>90</b>	<b>3,349</b>

<i>Deferred tax assets</i>	<i>Employee benefits</i>	<i>Provisions</i>	<i>Other</i>	<i>Total</i>
	<i>2006 £m</i>			
At 1 January 2006	(541)	(294)	(173)	(1,008)
Charge to income for the year	189	84	41	314
Charge/(credit) to equity for the year	56		(62)	(6)
Acquisitions			(25)	(25)
Other movements	12	(3)	(42)	(33)
<b>At 31 December 2006</b>	<b>(284)</b>	<b>(213)</b>	<b>(261)</b>	<b>(758)</b>

<i>Deferred tax liabilities</i>	<i>Capital allowances</i>	<i>Available for sale investments</i>	<i>Cash flow hedges</i>	<i>2005 Long term assurance business £m</i>	<i>Effective interest rate</i>	<i>Other</i>	<i>Total</i>
At 1 January 2005	944	68	40	987	122	56	2,217
Charge to income for the year	39			322		125	486
(Credit)/charge to equity for the year		(3)	17				14
Acquisitions				107			107
Disposals	(55)						(55)
Other movements						(10)	(10)
<b>At 31 December 2005</b>	<b>928</b>	<b>65</b>	<b>57</b>	<b>1,416</b>	<b>122</b>	<b>171</b>	<b>2,759</b>

<i>Deferred tax assets</i>	<i>Employee benefits</i>	<i>Provisions</i>	<i>Other</i>	<i>Total</i>
	<i>2005 £m</i>			
At 1 January 2005	(507)	(293)	(195)	(995)
Charge to income for the year	38	(1)	22	59
Credit to equity for the year	(72)			(72)
<b>At 31 December 2005</b>	<b>(541)</b>	<b>(294)</b>	<b>(173)</b>	<b>(1,008)</b>

Deferred tax assets in respect of employee benefits primarily relate to retirement benefit plans. Deferred tax assets relating to share based compensation are included in other.

In the Company there is a deferred tax asset of £85m (2006 £254m, 2005 £nil). The asset arose during 2006 and is primarily in respect of employee benefits following the creation of the HBOS FSPS and the transfer of the net post retirement liabilities to the Company.

### 32 Other Liabilities

	<i>Group</i>			<i>Company</i>		
	<i>2007</i>	<i>2006</i>	<i>2005</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
	<i>£m</i>					
Unclaimed shares	151	152	165	151	152	165
Other liabilities	4,921	7,019	4,847	53	61	60
	<u>5,072</u>	<u>7,171</u>	<u>5,012</u>	<u>204</u>	<u>213</u>	<u>225</u>

Unclaimed shares comprise the net sale proceeds of certain Halifax Group Limited (formerly Halifax Group plc) ordinary shares which, following the Halifax Group restructuring which took effect on 1 June 1999, represented Halifax plc ordinary shares. These shares were issued to meet claims for Halifax plc ordinary shares from qualifying members of Halifax Building Society and others following the transfer of business from Halifax Building Society to Halifax plc in 1997. This liability also includes the related unclaimed dividends up to the date of sale and the unclaimed capital payments arising from the Halifax Group restructuring in 1999. These amounts are being held on behalf of the persons who would have been entitled to claim the shares before they were sold. Amounts representing the sale proceeds, together with the unclaimed capital payments, can be claimed during a period of nine years from the date of sale (30 August 2001) after which time they will be forfeited. Amounts representing the related unclaimed dividends can be claimed during the period of twelve years from the date of the resolution for payment of each dividend, after which time they will be forfeited. Following an internal reorganisation on 1 July 2002, responsibility for these balances was assumed by the Company.

### 33 Provisions

	<i>Regulatory provisions</i>	<i>Other provisions</i>	<i>Total</i>
	<i>£m</i>		
<b>At 1 January 2007</b>	131	70	201
Exchange translation		3	3
Charge to administrative expenses	122	17	139
Utilised in year	(147)	(21)	(168)
<b>At 31 December 2007</b>	<u>106</u>	<u>69</u>	<u>175</u>

  

	<i>Mortgage endowment compensation</i>	<i>Other</i>	<i>Total</i>
	<i>£m</i>		
At 1 January 2006	188	90	278
Exchange translation		(2)	(2)
Additional provision in the year	95	14	109
Utilised in year	(152)	(32)	(184)
<b>At 31 December 2006</b>	<u>131</u>	<u>70</u>	<u>201</u>

Regulatory provisions are established when a legal or constructive obligation exists and represent the estimated cost of making redress payments to customers in respect of past product sales where sales processes have been deficient or where fees and premiums have been overcharged. Other provisions include property-related costs in respect of surplus leased space that amounted to £27m (2006 £27m) at the year end, provisions for long term and annual leave, provisions in respect of legal liabilities and for obligations under reward programmes. The timing of cash outflows for customer driven flows can be uncertain and depend on the rate at which claims are received and processed. It is estimated that £35m (2006 £95m) of the outstanding provisions will be settled within the next year.

### 34 Debt Securities in Issue

	2007			2006			2005
	<i>At fair value through the income statement</i>	<i>At amortised cost</i>	<i>Total</i>	<i>At fair value through the income statement £m</i>	<i>At amortised cost</i>	<i>Total</i>	<i>Total</i>
Bonds and medium term notes	1,842	71,976	73,818	3,260	57,383	60,643	53,203
Other debt securities		132,702	132,702		123,007	123,007	104,758
	<u>1,842</u>	<u>204,678</u>	<u>206,520</u>	<u>3,260</u>	<u>180,390</u>	<u>183,650</u>	<u>157,961</u>

The Group issues debt securities that are secured against loans and advances, debt securities and certain other assets of the Group principally from special purpose entities. At 31 December 2007 such debt securities in issue amount to £57,716m (2006 £63,905m, 2005 £55,727m) of which £11,954m (2006 £19,010m) is issued by the Grampian conduit and £137m (2006 £835m) by the Landale conduit. In addition the Group has issued £24,780m (2006 £16,826m) of covered bonds. Debt securities in issue measured at amortised cost include £38,036m (2006 £39,181m) of securities subject to fair value hedge designation, such as debt securities relating to securitisation and covered bonds, the carrying value of which has been adjusted to reflect the fair value of the risk being hedged. Debt securities in issue in 2005 comprise £1,243m designated at fair value through the income statement and £156,718m measured at amortised cost.

### 35 Other Borrowed Funds

	<i>Group</i>			<i>Company</i>		
	<i>2007</i>	<i>2006</i>	<i>2005</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
			<i>£m</i>			
Preferred securities	4,973	3,191	2,524			
Preference shares	1,571	1,128	1,313	1,571	1,128	1,289
Subordinated liabilities:						
Dated	10,964	8,656	9,218	7,253	4,683	4,257
Undated	6,745	6,717	7,199	6,679	6,515	6,272
	<u>24,253</u>	<u>19,692</u>	<u>20,254</u>	<u>15,503</u>	<u>12,326</u>	<u>11,818</u>

	2007	Group 2006 £m	2005
<b>Preferred securities</b>			
U.S.\$750m 6.071% Non-cumulative Perpetual Preferred Securities of U.S.\$1,000 each	374	381	435
U.S.\$1,000m 6.85% Non-cumulative Perpetual Preferred Securities of U.S.\$1,000 each	499	509	580
£600m 6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A of £1,000 each	600	600	600
£250m 8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class A)	250	250	250
£150m 7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B)	150	150	150
£245m 7.881% Guaranteed Non-voting Non-cumulative Preferred Securities	245	245	245
€415m Fixed-to-Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities	305	278	285
€750m 4.939% Non-voting Non-cumulative Perpetual Preferred Securities	551	503	
£285m Junior Perpetual Preferred Securities		285	
£2bn 6.0064/6.0895% Fixed Rate Perpetual Securities	2,000		
Other Preferred Securities	4	12	4
U.S.\$45m Preferred Securities		23	
Unamortised issue costs	(24)	(25)	(24)
Accrued interest	36	33	10
Fair value hedge adjustments	(17)	(53)	(11)
	<u>4,973</u>	<u>3,191</u>	<u>2,524</u>

On 21 June 2007 Fortrose Investments Ltd, a subsidiary, issued £2,000m of 6.0064/6.0895 per cent. Fixed Rate Perpetual Securities. Interest is payable two monthly in arrears, and the step up in rate occurs in March 2008.

During 2006 Castlemill Investments Ltd, a subsidiary, issued £285m of Junior Perpetual Preferred Securities and other subsidiaries issued Preferred Securities totalling £8m and U.S.\$45m, all of which were redeemed during 2007.

On 16 May 2006 HBOS Capital Funding No.3 L.P., a subsidiary, issued €750m 4.939 per cent. Non-voting Non-cumulative Perpetual Preferred Securities. The securities pay interest annually in arrears until 23 May 2016 at which time the interest rate will become three month EURIBOR plus 1.37 per cent. per annum payable quarterly in arrears. The Group has the option to redeem these securities on 23 May 2016 and quarterly thereafter.

	2007	Group 2006	2005 £m	2007	Company 2006	2005
<b>Preference shares</b>						
£300m 9 <sup>1</sup> / <sub>4</sub> % Non-cumulative Irredeemable £1 preference shares	300	300	300	300	300	300
£100m 9 <sup>3</sup> / <sub>4</sub> % Non-cumulative Irredeemable £1 preference shares	100	100	100	100	100	100
U.S.\$750m 6.413% Fixed-to- Floating Rate U.S.\$1 Series A preference shares	374	382	435	374	382	435
U.S.\$750m 5.92% Fixed-to- Floating Rate U.S.\$1 Series B preference shares	374	382	435	374	382	435
U.S.\$750m 6.657% Fixed-to- Floating rate U.S.\$1 preference shares	374			374		
Unamortised issue costs	(9)	(8)	(8)	(9)	(8)	(8)
Accrued interest	27	24	27	27	24	27
Fair value hedge adjustments	31	(52)	24	31	(52)	
	<u>1,571</u>	<u>1,128</u>	<u>1,313</u>	<u>1,571</u>	<u>1,128</u>	<u>1,289</u>

One thousand 6.413 per cent. fixed to floating rate preference shares series "A" of U.S.\$1 each represents one non-cumulative callable American Depository Receipt and one thousand 5.92 per cent. fixed to floating rate preference shares series "B" of U.S.\$1 each represents one non-cumulative American Depository Receipt.

The U.S.\$750m 6.413 per cent. Fixed-to-Floating Rate Series A preference shares, the U.S.\$750m 5.92 per cent. Fixed-to-Floating Rate Series B preference shares and the U.S.\$750m 6.657 per cent. Fixed-to-Floating Rate preference shares have been issued in the form of American Depository Receipts.

On 21 May 2007 HBOS plc issued 7,500 American Depository Receipts representing U.S.\$750m 6.657 per cent. Fixed-to-Floating Rate U.S.\$1 preference shares. These are Tier I non-innovative non-equity preference shares that were issued at \$1,000 per share. Dividends are payable semi-annually in arrears until 21 May 2037 at which date the Company has the option to redeem them. Thereafter, dividends are payable at a rate of three month LIBOR plus 1.27 per cent. per annum payable quarterly in arrears and can be redeemed by the Company on any dividend payment date.

	2007	Group 2006	2005 £m	2007	Company 2006	2005
<b>Dated subordinated liabilities</b>						
£400m 8.75% Subordinated Notes 2006			400			
U.S.\$150m 8.85% Notes 2006			87			
£75m 9.125% Subordinated Notes 2006			75			
£60m 9.00% Instruments 2006			60			
€650m 4.75% Subordinated Bonds 2009	477	436	446			
€500m 5.50% Instruments 2009	367	335	343			
U.S.\$500m Notes 2010	249	254	290			
U.S.\$150m Notes 2011	75	76	87			
€7m Floating Rate Notes 2011			5			
€750m Subordinated Fixed Rate Notes 2012	551	503	515			
U.S.\$450m Subordinated Floating Rate Notes 2012		229	262			
£200m Floating Rate Step-up Callable Subordinated Notes 2012		200	200			
€12.8m 6.25% Instruments 2012	9	9	9			
Aus\$75m Callable Notes 2012		30	32			
€1,000m Subordinated Callable Fixed/Floating Rate Instruments 2013	734	671	686			
€325m 6.125% Notes 2013	239	218	223			
U.S.\$1,000m 4.25% Subordinated Guaranteed Notes 2013	499	509	580	499	509	580
¥60bn 0.55% Subordinated Callable Notes 2013	267	257	296	267	257	296
U.S.\$500m Subordinated Callable Notes 2014	249	254	290	249	254	290
£250m 11% Subordinated Bonds 2014	250	250	250			
€1,000m 4.875% Subordinated Notes 2015	734	671	686	734	671	686
€500m Callable Floating Rate Subordinated Notes 2016	367	335	343	367	335	343
€500m Subordinated Notes 2016	367	335		367	335	
U.S.\$750m Notes 2016	374	382		374	382	
€1,000m Subordinated Lower Tier II Notes 2017	734			734		
U.S.\$1,000m Subordinated Callable Notes 2017	499			499		
Aus\$400m Subordinated Callable Floating Rate Instruments 2017	175			175		

	2007	Group 2006	2005 £m	2007	Company 2006	2005
Aus\$200m Subordinated Callable Fixed/Floating Rate Instruments 2017	88			88		
Can\$500m Callable Fixed-to- Floating Rate Notes 2017	254			254		
£500m Lower Tier II Subordinated Notes 2017	500			500		
£150m 10.5% Subordinated Bonds 2018	150	150	150			
£250m 6.375% Instruments 2019	250	250	250			
€750m Callable Fixed-to- Floating Rate Subordinated Notes 2019	551	503	515	551	503	515
£500m 9.375% Subordinated Bonds 2021	500	500	500			
€160m Subordinated Fixed Rate Notes 2021	117			117		
€400m 6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023	294	268	275			
€750m Fixed Rate Step-up Subordinated Notes due 2030	551	503	515	551	503	515
U.S.\$750m 6.00% Subordinated Notes 2033	374	382	435	374	382	435
£245m 7.881% Subordinated Extendable Maturity Notes 2048				245	245	245
€415m Fixed-to-Floating Rate Subordinated Extendable Maturity Notes 2048				305	278	285
Unamortised premiums, discounts and issue costs	(32)	(28)	(32)	(25)	(24)	(26)
Accrued interest	221	203	227	79	61	59
Fair value hedge adjustments	(70)	(29)	218	(51)	(8)	34
	<u>10,964</u>	<u>8,656</u>	<u>9,218</u>	<u>7,253</u>	<u>4,683</u>	<u>4,257</u>

During the year the following dated subordinated liabilities have been issued:

On 20 March 2007 HBOS plc issued €1bn Subordinated Lower Tier II Notes at an issue price of 99.954 per cent. of the principal amount. The notes pay interest at a rate of three month EURIBOR plus 0.2 per cent. per annum payable quarterly in arrears until 21 March 2012 at which time the interest rate will become three month EURIBOR plus 0.7 per cent. per annum payable quarterly in arrears until maturity in March 2017. The Company has the option to redeem these notes on 21 March 2012 and quarterly thereafter.

On 27 April 2007 HBOS plc issued Aus\$400m Subordinated Callable Floating Rate and Aus\$200m Subordinated Callable Fixed/Floating Rate Australian Domestic Instruments at issue prices of 100 per cent. and 99.423 per cent. of the principal amount respectively. The fixed rate notes pay interest at a rate of 6.75 per cent. and the floating rate notes at three month AUD-BBR-BSW plus 0.26 per cent. per annum payable quarterly in arrears until 1 May 2012 at which time both interest rates will become three month AUD-BBR-BSW plus 0.76 per cent. per annum payable quarterly in arrears until maturity in May 2017. The Company has the option to redeem these notes on 1 May 2012 and quarterly thereafter.



On 6 June 2007 HBOS plc issued U.S.\$1bn Subordinated Callable Notes at par. The notes pay interest at a rate of three month U.S.\$ LIBOR plus 0.2 per cent. per annum payable quarterly in arrears until 6 September 2012 at which time the interest rate will become three month U.S.\$ LIBOR plus 0.7 per cent. per annum payable quarterly in arrears until maturity in September 2017. The Company has the option to redeem these notes on 6 September 2012 and quarterly thereafter.

On 20 June 2007 HBOS plc issued Can\$500m Callable Fixed-to-Floating Rate Notes at par. The notes are subordinated and pay interest at a rate of 5.109 per cent. per annum payable quarterly in arrears until 20 June 2012 at which time the interest rate will become three month CAD-BA-CDOR plus 0.65 per cent. per annum payable quarterly in arrears until maturity in June 2017. The Company has the option to redeem these notes on 20 June 2012 and quarterly thereafter.

On 15 October 2007 HBOS plc issued €160m Subordinated Fixed Rate Notes at par. The notes pay interest at a rate of 5.374 per cent. per annum payable annually and mature on 30 June 2021.

On 17 October 2007 HBOS plc issued £500m Lower Tier II Subordinated Notes at an issue price of 99.9 per cent. of the principal amount. The notes pay interest at a rate of 6.305 per cent. per annum payable semi-annually until 18 October 2012 at which time the interest rate will become three month LIBOR plus 1.2 per cent. per annum payable quarterly in arrears until maturity in October 2017. The Company has the option to redeem these notes on 18 October 2012 and quarterly thereafter.

During 2006 the following dated subordinated liabilities were issued:

On 28 March 2006 HBOS plc issued €500m Subordinated Notes at an issue price of 99.735 per cent. of the principal amount. The notes pay interest at a rate of three month EURIBOR plus 0.175 per cent. per annum payable quarterly in arrears until 29 March 2011 at which time the interest rate will become three month EURIBOR plus 0.675 per cent. per annum payable quarterly in arrears until maturity in March 2016. The Company has the option to redeem these notes on 29 March 2011 and quarterly thereafter.

On 29 September 2006 HBOS plc issued U.S.\$750m Notes at an issue price of 99.868 per cent. of the principal amount. The notes pay interest at a rate of three month U.S.\$ LIBOR plus 0.2 per cent. per annum payable quarterly in arrears until 30 September 2011 at which time the interest rate will become three month LIBOR plus 0.7 per cent. per annum payable quarterly in arrears until maturity in September 2016. The Company has the option to redeem these notes on 30 September 2011 and quarterly thereafter.

No repayment, for whatever reason, of dated subordinated liabilities prior to its stated maturity and no purchase by the relevant entity of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary, the claims of the holders of dated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Company or subsidiary undertaking, other than creditors whose claims are expressed to rank *pari passu* with, or junior to, the claims of the holders of the dated loan capital.

	2007	Group 2006	2005	2007	Company 2006	2005
	<i>£m</i>					
<b>Undated subordinated liabilities</b>						
£500m Cumulative Callable Fixed-to-Floating Rate Undated Subordinated Notes	500	500	500	500	500	500
U.S.\$750m 6.071% Undated Subordinated Fixed-to-Floating Rate Instruments				374	382	435
€750m 4.875% Undated Fixed-to-Floating Rate Subordinated Notes	551	503	515	551	503	515
€500m Floating Rate Undated Subordinated	367	335	343	367	335	343

	2007	Group 2006	2005 £m	2007	Company 2006	2005
Notes						
U.S.\$1,000m 5.375% Undated Fixed-to-Floating Rate Subordinated Notes	499	509	580	499	509	580
€750m Undated Subordinated Fixed-to- Floating Notes	551	503	515	551	503	515
£600m 5.75% Undated Subordinated Step-up Notes	600	600	600	600	600	600
U.S.\$1,000m 6.85% Undated Subordinated Notes				499	509	580
£600m Fixed-to-Floating Rate Undated Subordinated Notes				600	600	600
€500m Fixed-to-Floating Rate Undated Subordinated Notes	367	335	343	367	335	343
£300m Perpetual Regulatory Tier One Securities	300	300	300			
£300m 7.5% Undated Subordinated Step-up Notes	300	300	300	300	300	300
JPY 42.5bn 3.50% Undated Subordinated Yen Step-up Notes	189	182	210	189	182	210
U.S.\$300m Reset Notes		153	174			
£200m Perpetual Notes	200	200	200			
£200m 7.375% Undated Subordinated Guaranteed Bonds	200	200	200			
€300m Floating Rate Undated Subordinated Step-up Notes	220	201	206	220	201	206
U.S.\$250m Floating Rate Primary Capital Notes	125	127	145			
£150m Instruments			150			
£150m Instruments	150	150	150			
JPY 17bn Instruments	76	73	84			
£100m Instruments	100	100	100			
£100m 12% Perpetual Subordinated Bonds	100	100	100			
£100m 8.75% Perpetual Subordinated Bonds	100	100	100			
£75m 13.625% Perpetual Subordinated Bonds	75	75	75			
JPY 9bn Instruments	40	38	44			
£50m 9.375% Perpetual Subordinated Bonds	50	50	50			
£500m 5.75% Undated Subordinated Step-up Notes	500	500	500	500	500	500
€750m 4.25% Perpetual Fixed/Floating Rate Reset Subordinated Guaranteed Notes	551	503	515			

	2007	Group 2006	2005	2007	Company 2006	2005
	£m					
€750m 4.939% Undated Fixed-to-Floating Rate Subordinated Notes				551	503	
Unamortised premiums, discounts and issue costs	(71)	(44)	(53)	(48)	(33)	(36)
Accrued interest	146	124	128	104	87	81
Fair value hedge adjustments	(41)		125	(45)	(1)	
	<u>6,745</u>	<u>6,717</u>	<u>7,199</u>	<u>6,679</u>	<u>6,515</u>	<u>6,272</u>

On 16 May 2006 HBOS plc issued €750m Undated Fixed-to-Floating Rate Subordinated Notes at par to HBOS Capital Funding No. 3 L.P., a subsidiary undertaking. The notes pay interest at a rate of 4.939 per cent. annually in arrears until 23 May 2016 at which time the interest rate will become three month EURIBOR plus 1.37 per cent. per annum payable quarterly in arrears. The Company has the option to redeem these notes on 23 May 2016 and quarterly thereafter.

No exercise of any redemption option or purchase by the relevant entity of any of its undated subordinated liabilities may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary, the claims of the holders of undated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Company or subsidiary other than creditors whose claims are expressed to rank *pari passu* with, or junior to the claims of the holders of the undated loan capital. The undated loan capital is junior in point of subordination to the dated loan capital referred to above.

### 36 Share Capital

	Ordinary shares	Preference shares £m	Total
<b>Allotted, called up and fully paid</b>			
At 1 January 2005	981		981
Issued preference shares <sup>(1)</sup>		198	198
Issued under employee share schemes	5		5
Ordinary share buyback	(27)		(27)
At 1 January 2006	959	198	1,157
Issued under employee share schemes	8		8
Ordinary share buyback	(26)		(26)
<b>At 31 December 2006 and 1 January 2007</b>	941	198	1,139
Issued under employee share schemes	5		5
Ordinary share buyback	(13)		(13)
<b>At 31 December 2007</b>	<u>933</u>	<u>198</u>	<u>1,131</u>

Note:

(1) Issued preference share capital has been reduced by £727m and share premium increased following a reclassification of the issue of new shares in 2005.

### Issued Share Capital

At 31 December 2007 the Company's issued ordinary share capital, excluding shares held in treasury, amounted to 3,730,415,166 shares (2006 3,761,157,260). In December 2006 HBOS plc announced a further share buyback programme for 2007 in addition to the previous programmes. During the year HBOS plc has bought 50 million (2006 97 million, 2005 116 million) shares at a total consideration (including costs) of £500m (2006 £982m, 2005 £994m). At 31 December 2007

2,589,000 (2006 3,032,000, 2005 6,000,000) shares bought back remain in treasury to be cancelled.

The Group operates a number of share option plans and saving related option plans for colleagues. Details of these are given in Note 37.

On 16 June 2006 HBOS plc issued 350,000 6.3673 per cent. fixed-to-floating non-cumulative preference shares of £1 each at an issue price of £1,000.

### **Authorised Share Capital**

At 31 December 2007 the authorised share capital comprised:

#### **Ordinary shares**

4,740 million ordinary shares of 25 pence each (2006 4,740 million, 2005 4,740 million).

#### **Preference shares**

2,596,834,400 million preference shares of £1 each (2006 2,597 million, 2005 2,597 million);

200 million  $6\frac{1}{8}$  per cent. non-cumulative redeemable preference shares of £1 each (2006 200 million, 2005 200 million);

375 million  $9\frac{1}{4}$  per cent. non-cumulative irredeemable preference shares of £1 each (2006 375 million);

125 million  $9\frac{3}{4}$  per cent. non-cumulative irredeemable preference shares of £1 each (2006 125 million);

250,000 8.117 per cent. non-cumulative perpetual preference shares class "A" of £10 each (2006 250,000, 2005 250,000);

150,000 7.754 per cent. non-cumulative perpetual preference shares class "B" of £10 each (2006 150,000, 2005 150,000);

750,000 6.0884 per cent. non-cumulative preference shares of £1 each (2006 750,000, 2005 750,000);

198,065,600 6.475 per cent. non-cumulative preference shares of £1 each (2006 198,065,600, 2005 198,065,600);

3,000 million preference shares of €1 each (2006 3,000 million, 2005 3,000 million);

4,997,750,000 million preference shares of U.S.\$1 each (2006 4,998 million, 2005 4,998 million);

750,000 6.413 per cent. non-cumulative callable fixed-to-floating rate preference shares series "A" of U.S.\$1 each (2006 750,000, 2005 750,000);

750,000 5.92 per cent. non-cumulative callable fixed-to-floating rate preference shares series "B" of U.S.\$1 each (2006 750,000, 2005 750,000);

750,000 6.657 per cent. non-cumulative callable preference shares of U.S.\$1 each (2006 nil);

350,000 6.3673 per cent. fixed-to-floating non-cumulative preference shares of £1 each (2006 350,000, 2005 nil);

1,000 million preference shares of Aus\$1 each (2006 1,000 million, 2005 nil); and

1,000 million preference shares of Can\$1 each (2006 1,000 million, 2005 nil).

The terms of some of the preference shares when issued are such that these shares are classified as other borrowed funds rather than as issued share capital.

In 2006 and 2005 only:

300 million  $9\frac{1}{4}$  per cent. non-cumulative irredeemable £1 preference shares (2005 300 million); and

100 million  $9\frac{3}{4}$  per cent. non-cumulative irredeemable £1 preference shares (2005 100 million).

### 37 Share-based Payments

The Group believes that share ownership by colleagues throughout the Group enhances their alignment with shareholders' interests. Therefore, colleagues in the Group are able to own HBOS shares through various share-based payment arrangements. During the year ended 31 December 2007, the Group operated the following share-based payment arrangements, which are predominantly equity-settled:

Sharesave plan	This is a standard tax-approved scheme that is available to all colleagues.
Share option plans	The final award under the HBOS plan was made in 2004. Under this plan options over shares at market value, with a face value equal to 20 per cent. of salary, were awarded to all colleagues with the exception of those of level 8 and above. A separate option plan exists for St. James's Place, which awards options in respect of HBOS shares, and which continues to operate.
Free shares	This was introduced in 2005 under the share incentive plan legislation as a replacement for the share option plan (not including the St. James's Place plan). In broad terms, it covers all colleagues and free shares up to a limit of £3,000 annually, are awarded to each colleague.
Sharekicker plan	This provides colleagues with the opportunity to purchase shares with a proportion of their annual net bonus. For every two shares purchased a matching share is awarded after three years.
EPS Sharekicker plan	This replaces Sharekicker from 2007 for colleagues of level 7 and above (in relation to annual net bonuses) and colleagues of level 8 and above (in relation to net bonuses payable under the two year incentive scheme). Matching shares awarded under this plan depends on EPS performance over the three year vesting period, the range being between 0 per cent. and 200 per cent.
Long term incentive plan	This is offered to some of the Group's most senior colleagues.
Executive stock option plan	The final award under this plan was in 2000. Under this plan, options were granted at market value to certain colleagues. The options vested upon satisfaction of a performance measure over a three year period. Options are exercisable from the date the measure is satisfied until the tenth anniversary of the date of grant.
St. James's Place plans	Various St. James's Place plc option and share plans are offered to some of its colleagues.
Insight Investment plan	In 2007 Insight Investment Management Ltd converted an existing incentive scheme into a share-based payment arrangement, offering options and/or shares to some of its colleagues.
Invista Real Estate plans	Various share-based plans are offered to certain colleagues in Invista Real Estate Investment Management Holdings plc.

Modifications during the year to awards in the Long term incentive, Sharekicker and EPS Sharekicker plans are explained below. The table below summarises the share-based payment awards granted in 2007, 2006 and 2005:

	<i>Sharesave plan</i>	<i>Share option plan<sup>(3)</sup></i>	<i>Free shares</i>	<i>Sharekicker plan</i>	<i>EPS Sharekicker plan</i>	<i>Long term incentive plan</i>
<b>Awards in 2007</b>						
Date of grant	30 March	1 March	7 August	23 March	23 March	15 March
Number granted	4,614,933	620,957	8,372,685	4,535,816 <sup>(4)</sup>	722,340 <sup>(4)</sup>	2,163,888 <sup>(5)</sup>
<b>Awards in 2006</b>						
Date of grant	21 September	2 March	8 August	23 March	16 March	30 March
Number granted	9,669,771	495,885	7,370,115	4,707,159 <sup>(4)</sup>		1,915,822 <sup>(5)</sup>
Transfer on 16 March 2007 <sup>(1)</sup>				(527,155)	527,155 <sup>(4)</sup>	
<b>Awards in 2005</b>						
Date of grant	23 September	3 March	10 August	23 March		30 March
Number granted	10,381,241	476,401	7,352,056	4,989,559 <sup>(4)</sup>		1,892,966 <sup>(5)</sup>
Contractual life	3.5, 5.5 and 7.5 years	5 years	3 years	3 years	3 years	3 years
Vesting conditions	5.25 and 7.25 years vesting period <sup>(2)</sup>	3 years service	3 years service	3 years service	3 years service and achievement of EPS target	3 years service and achievement of TSR target

Notes:

- (1) Modifications arising as a result of the introduction of the new EPS Sharekicker plan.
- (2) Although the savings periods are three, five and seven years the vesting periods are slightly longer since savings commence after the grant date.
- (3) The awards relate to the St. James's Place plan.
- (4) These are the number of deferred shares purchased.
- (5) The 2007 award includes 79,200 shares that were not awarded until 23 August 2007. The 2006 award includes 217,248 shares that were not awarded until 25 August 2006. The 2005 award includes 89,696 shares that were not awarded until 2 September 2005. Numbers of awards granted are based on 100 per cent. of share grants.

## Movements in options

Movements in options granted under the various equity participation plans mentioned above are as follows:

	2007		2006		2005	
	<i>Number of options</i>	<i>Weighted average exercise price</i>	<i>Number of options</i>	<i>Weighted average exercise price</i>	<i>Number of options</i>	<i>Weighted average exercise price</i>
<i>Sharesave plan</i>	(£)		(£)		(£)	
<b>Outstanding at 1 January</b>	48,560,991	6.29	46,576,267	5.86	50,305,553	5.44
Granted during the year	4,614,933	8.44	9,669,771	7.93	10,381,241	6.91
Exercised during the year	(9,626,924)	5.52	(4,877,672)	5.62	(10,648,034)	4.93
Forfeited during the year	(2,949,595)	7.11	(2,536,970)	6.13	(3,308,241)	5.46
Expired during the year	(305,778)	6.08	(270,405)	5.79	(154,252)	5.65
<b>Outstanding at 31 December</b>	40,293,627	6.65	48,560,991	6.29	46,576,267	5.86
<b>Exercisable at 31 December</b>	2,644,399	4.52	2,067,132	5.70	1,883,551	5.11
	2007		2006		2005	
	<i>Number of options</i>	<i>Weighted average exercise price</i>	<i>Number of options</i>	<i>Weighted average exercise price</i>	<i>Number of options</i>	<i>Weighted average exercise price</i>
<i>Share option plans</i>	(£)		(£)		(£)	
<b>Outstanding at 1 January</b>	35,860,579	7.13	63,355,372	6.92	87,725,000	7.02
Granted during the year	620,957	10.71	495,885	9.99	476,401	8.32
Exercised during the year	(15,123,252)	7.10	(25,667,956)	6.68	(19,653,591)	7.38
Forfeited during the year	(576,251)	7.20	(2,322,722)	7.05	(5,192,438)	6.94
<b>Outstanding at 31 December</b>	20,782,033	6.94	35,860,579	7.13	63,355,372	6.92
<b>Exercisable at 31 December</b>	19,211,979	7.05	6,888,530	6.85	5,570,779	7.48

	2007		2006		2005	
	Number of options (£)	Weighted average exercise price	Number of options (£)	Weighted average exercise price	Number of options (£)	Weighted average exercise price
<b>Executive stock option plan</b>						
<b>Outstanding at 1 January</b>	1,251,907	6.11	2,042,488	5.78	3,797,079	5.58
Exercised during the year	(395,980)	5.79	(790,581)	5.24	(1,754,591)	5.36
Forfeited during the year	(42,000)	5.87				
<b>Outstanding and exercisable at 31 December</b>	<b>813,927</b>	<b>6.28</b>	<b>1,251,907</b>	<b>6.11</b>	<b>2,042,488</b>	<b>5.78</b>

For the sharesave plan, the weighted average share price at the date of exercise for share options exercised during the year was £10.85 (2006 £9.91, 2005 £8.71). The options outstanding at 31 December 2007 had exercise prices in the range of £4.10 to £8.44 (2006 £4.10 to £7.93, 2005 £4.10 to £6.91) and a weighted average remaining contractual life of 3 years (2006 3 years, 2005 3.2 years).

For the share option plans, the weighted average share price at the date of exercise for share options exercised during the year was £10.34 (2006 £9.89, 2005 £8.59). The options outstanding at 31 December 2007 had exercise prices in the range of £6.54 to £10.71 (2006 £6.54 to £9.99, 2005 £6.54 to £8.32) and a weighted average remaining contractual life of 3 years (2006 2.9 years, 2005 3.7 years).

For the executive stock option plan, the weighted average share price at the date of exercise for share options exercised in the year was £10.03 (2006 £9.91, 2005 £8.62). The options outstanding at 31 December 2007 had exercise prices in the range of £5.38 to £7.13 (2006 £5.35 to £7.12, 2005 £2.73 to £7.12) and a weighted average remaining contractual life of 2 years (2006 2.9 years, 2005 3.5 years).

#### Financial assumptions underlying the calculation of fair value

The fair value expense has been based on the fair value of the instruments granted, as calculated using appropriate pricing models. The table below shows the assumptions and models used to calculate the grant date fair value of awards in 2006 and 2007:

	Sharesave plan	Share option plan <sup>(2)</sup>	Free shares	Sharekicker plan	EPS sharekicker plan <sup>(6)</sup>	Long term incentive plan
<b>Awards in 2007</b>						
Fair value (pence)	260	182	945	474 <sup>(4)</sup>	947	756
Share price (pence)	1,047	1,071	945	1,062	1,062	1,017
Exercise price (pence)	844	1,071				
Expected volatility (% p.a.) <sup>(1)</sup>	20	20	N/A	N/A	N/A	N/A
Expected dividends (% p.a.)	4.0	3.5	N/A	3.9 <sup>(5)</sup>	3.9 <sup>(5)</sup>	N/A <sup>(7)</sup>
Risk-free interest rate	5.3	5.3	N/A	N/A	N/A	N/A
<b>Awards in 2006</b>						
Fair value (pence)	299	167	974	451 <sup>(4)</sup>	947	554
Share price (pence)	1,057	999	974	1,001	1,024	959
Exercise price (pence)	793	999				
Expected volatility (% p.a.) <sup>(1)</sup>	20	15	N/A	N/A	N/A	15
Expected dividends (% p.a.)	3.6	3.4	N/A	3.6 <sup>(5)</sup>	4.0 <sup>(5)</sup>	N/A <sup>(7)</sup>

	<i>Sharesave plan</i>	<i>Share option plan<sup>(2)</sup></i>	<i>Free shares</i>	<i>Sharekicker plan</i>	<i>EPS sharekicker plan<sup>(6)</sup></i>	<i>Long term incentive plan</i>
Risk-free interest rate	4.9	4.4	N/A	N/A	N/A	N/A
<b>Awards in 2005</b>						
Fair value (pence)	189	138	910	362 <sup>(4)</sup>		729
Share price (pence)	847.5	832.0	910.0	815.0		834.5
Exercise price (pence)	691.2	832.0	0.0	0.0		0.0
Expected volatility (% p.a.) <sup>(1)</sup>	20	20	N/A	N/A		20
Expected dividends (% p.a.)	4.0	3.8	N/A	4.0 <sup>(5)</sup>		N/A <sup>(7)</sup>
Risk-free interest rate	4.2	4.9	N/A	N/A		N/A
<b>Pricing model</b>	Black-Scholes	Binomial Lattice		Black-Scholes <sup>(3)</sup>	Black-Scholes	Monte Carlo Simulation

Notes:

- (1) Expected volatility is based on an analysis of both the Group's historical volatility over the twelve months preceding the date of each award and the volatility implied by the price of traded options as at the date of each award.
- (2) The awards relate to the St. James's Place plan.
- (3) As no performance conditions attach to these awards and dividends are reinvested, the fair value is the same as the face value of the awards.
- (4) The fair value of Sharekicker awards reflects that a share is automatically awarded for every two held after three years.
- (5) Dividends payable on the matching shares during the vesting period are not awarded to the recipient.
- (6) The 2006 award arises from the modifications made on 16 March 2007.
- (7) Dividends payable on the shares during the vesting period are reinvested and so no dividend yield assumption is required.

### Early exercise assumptions

The following allowance has been made for the impact of early exercise once options have vested:

#### Sharesave plan

As the length of the exercise window is only six months all option holders are assumed to exercise halfway through the exercise window.

#### St. James's Place plan

It is assumed that half of the option holders will exercise their options each year if the share price is at least 15 per cent. above the exercise price.

### Allowance for performance conditions

The long term incentive plan includes a market based performance condition based on the Group's total shareholder return relative to an index of comparator companies. The impact of this performance condition has been modelled using Monte Carlo Simulation techniques, which involves running several thousands of simulations of future share price movements for both the Group and the comparator index. For the purpose of these simulations it is assumed that the share price of the Group and the comparator index are 60 per cent. correlated (2006 award 60 per cent., 2005 Award 70 per cent.) and that the comparator index has volatility of 20 per cent. p.a. for the 2007 award (2006 award 15 per cent. p.a., 2005 award 20 per cent. p.a.).

The performance condition is based on the Group's performance relative to the comparator index over a three year period commencing on 1 January each year. The fair value calculations for the awards that were made in 2007, 2006 and 2005 therefore include an allowance for the actual performance of the Group's share price relative to the index over the period between 1 January and the award date.

In 2007 the weightings attached to certain comparators were amended with effect from 1 January 2007 and apply, from that date to 2005, 2006 and 2007 awards. The modifications do not alter the fair values of any of the awards, nor make additional changes necessary.



### Modifications in relation to Sharekicker and EPS Sharekicker

In addition to the introduction of the EPS Sharekicker plan from 2007, eligible colleagues were also provided with the option of moving the outstanding elements of their 2005 and 2006 Sharekicker awards into the new EPS Sharekicker plan with effect from 1 January 2007. Elections to this effect were finalised on 16 March 2007.

These amendments to the 2005 and 2006 Sharekicker awards are being accounted for as a modification under IFRS 2. As such, any additional matching shares expected to vest to colleagues as a result of the switch to EPS Sharekicker are being charged using the fair value of the 2005 and 2006 awards at 16 March 2007. The assumptions applied to measure the fair values at 16 March 2007 are as follows:

	<i>2006</i> <i>awards</i>	<i>2005</i> <i>awards</i>
Number of awards moved to EPS Sharekicker	527,155	637,687
Fair value (pence)	947	985

The share price, expected dividends and pricing model are the same as those used for the 2006 awards for the EPS Sharekicker plan in the table above. In 2007 £2.2m has been charged as a result of the modification of the 2005 and 2006 awards.

### Charge to the income statement

	<i>2007</i>	<i>2006</i> <i>£m</i>	<i>2005</i>
Expense arising from share-based payment transactions (Note 5)			
Equity-settled	138	95	82
Cash-settled	1	6	1
	<u>139</u>	<u>101</u>	<u>83</u>

Included within the charge for the year is £13m (2006 £8m, 2005 £3m) in respect of share-based arrangements within St. James's Place, £4m in respect of the new Insight Investment plan (2006 £nil) and £3m in respect of Invista Real Estate plans (2006 £nil). In relation to the Group's share schemes, National Insurance and income tax costs of £14m (2006 £36m, 2005 £22m) are borne by the Group and are not included in the above table.

The establishment of the Insight Investment plan during the year required awards made under its previous incentive scheme to be converted into this equity-settled arrangement. As a result £18m was transferred to the share-based compensation scheme reserve which is not included in the charge to the income statement above. If all options and shares outstanding under the new Insight Investment plan at 31 December 2007 vested on that date, 4.8 million HBOS shares would be required to meet this. These shares would be sourced from the market, in accordance with the terms of the plan.

The liability for cash-settled share-based payment plans at 31 December 2007 is £5m (2006 £5m, 2005 £1m) and is included in accruals and deferred income.

The Group uses trusts to purchase and hold its own shares as part of the share-based payment arrangements. Details of these trusts and the shares held are given below.

### No.1 and No.2 Employee Share Ownership Trusts

The No.1 Employee Share Ownership Trust ("ESOT 1") administers shares conditionally granted to Executive Directors and other executives under the HBOS Long Term Executive Bonus Plan. The Trust also administers shares which have been conditionally granted to Executive Directors, other executives and employees under the HBOS plc Annual Bonus Plan and overseas operations of the HBOS plc Share Incentive Plan ("Free Shares"). The No.2 Employee Share Ownership Trust ("ESOT 2") administers shares to be awarded to Executive Directors, other executives and employees under the Group's Sharesave and share option plans, where options are not satisfied by the new issue of shares or from shares held by the HBOS QUEST. Interest free loans have been provided by the Company to the Trusts to allow shares to be purchased in the market to satisfy these share grants.

At 31 December 2007 0.5 million HBOS plc ordinary shares (2006 0.7 million, 2005 0.2 million) with a market value of £4m (2006 £8m, 2005 £2m) were held in ESOT 1 and 7.5 million HBOS plc ordinary shares (2006 3.6 million, 2005 0.1 million) with a market value of £55m (2006 £41m, 2005 £1m) were held in ESOT 2. The shares in the Trusts are included in the balance sheet of the Group at a net book value of £nil (2006 £nil). Under the terms of the Trusts, dividends on these shares require to be waived.

### HBOS plc Qualifying Employee Share Ownership Trust (“the HBOS QUEST”)

The HBOS QUEST operates in conjunction with the HBOS Sharesave scheme and the former savings-related share schemes operated by Bank of Scotland and Halifax Group plc.

At 31 December 2007, the HBOS QUEST held 0.1 million HBOS plc ordinary shares (2006 1.7 million, 2005 3.2 million) with a market value of £1m (2006 £19m, 2005 £31m). These shares are included in the balance sheet at nil value for 2007, 2006 and 2005. Under the terms of the Trust Deed, dividends on these shares require to be waived.

A number of trusts operate in conjunction with the Free Shares Plan which commenced in 2005.

- (a) The Share Incentive Plan trust operates in conjunction with free share awards made to employees throughout the Group, except to the extent noted below. At 31 December 2007 this trust held 19.6 million HBOS plc ordinary shares (2006 12.7 million, 2005 6.5 million), with a market value of £144m (2006 £144m, 2005 £64m). These shares are included in the balance sheet at nil value.
- (b) The Irish Profit Share Trust holds free shares awarded to colleagues employed in Ireland. At 31 December 2007 this trust held 0.5 million HBOS plc ordinary shares (2006 0.3 million, 2005 0.1 million), with a market value of £3m (2006 £3m, 2005 £1m). These shares are included in the balance sheet at nil value.
- (c) The HBOS Australia Employee Share Trust holds free shares awarded to colleagues employed in Australia. At 31 December 2007 this trust held 1.7 million shares (2006 1.0 million, 2005 0.5 million) with a market value of £13m (2006 £12m, 2005 £5m). These ordinary shares are included in the balance sheet at nil value.
- (d) ESOT 1 administers free shares awarded to colleagues based overseas.

## 38 Shareholders' Equity

	Share capital <sup>(1)</sup>	Share premium <sup>(1)</sup>	Cash flow hedge reserve	Other reserves Available for sale reserve <sup>(2)</sup>	Other reserves <sup>(3)</sup>	Retained earnings	Minority interests	Total
	£m							
<b>Group</b>								
At 1 January 2005	981	1,441	88	169	509	13,334	159	16,681
<b>Changes in equity</b>								
Foreign exchange translation					(4)			(4)
Net actuarial losses from defined benefit plans						(167)		(167)
Available for sale investments								
Net change in fair value				133				133
Net gains transferred to income statement				(118)				(118)
<b>Cash flow hedges</b>								
Effective portion of changes in fair value taken to equity			6					6
Net losses transferred to income statement			34					34
<b>Profit after tax</b>						3,230	32	3,262
Total recognised income and expense			40	15	(4)	3,063	32	3,146
Dividends paid						(1,363)		(1,363)
Issue of new shares	203	875						1,078
Ordinary share buyback	(27)				27	(994)		(994)
Net movement in own shares						(174)		(174)
Movement in share-based compensation scheme reserve						82		82
<b>At 31 December 2005</b>	1,157	2,316	128	184	532	13,948	191	18,456
At 1 January 2006	1,157	2,316	128	184	532	13,948	191	18,456
Foreign exchange translation					(23)			(23)
Revaluation of existing net assets upon acquisition of a jointly controlled entity						(15)		(15)

	Share capital <sup>(1)</sup>	Share premium <sup>(1)</sup>	Cash flow hedge reserve	Other reserves Available for sale reserve <sup>(2)</sup>	Other reserves <sup>(3)</sup>	Retained earnings	Minority interests	Total
	£m							
Net actuarial gains from defined benefit plans (net of tax)						163		163
<b>Available for sale investments</b>								
Net change in fair value				190				190
Net gains transferred to income statement				(171)				(171)
<b>Cash flow hedges</b>								
Effective portion of changes in fair value taken to equity			209					209
Net losses transferred to income statement			86					86
<b>Profit for the year</b>						3,879	60	3,939
Total recognised income and expense			295	19	(23)	4,027	60	4,378
Dividends paid (Note 40)						(1,501)	(22)	(1,523)
Issue of new shares (Note 36)	8	540						548
Ordinary share buyback	(26)				26	(982)		(982)
Dilution of shareholdings in subsidiaries							162	162
Acquisition of disposal group							125	125
Disposal of subsidiaries							(30)	(30)
Movement in own shares						(47)		(47)
Movement in share-based compensation reserve						84		84
<b>At 31 December 2006 and 1 January 2007</b>	<b>1,139</b>	<b>2,856</b>	<b>423</b>	<b>203</b>	<b>535</b>	<b>15,529</b>	<b>486</b>	<b>21,171</b>
Foreign exchange translation				1	1			2
Net actuarial gains from defined benefit plans (net of tax)						312		312
<b>Available for sale investments</b>								
Net change in fair value				(333)				(333)
Net gains transferred to income statement				(184)				(184)
<b>Cash flow hedges</b>								
Effective portion of changes in fair value taken to equity			(216)					(216)
Net gains transferred to income statement			(292)					(292)
<b>Profit for the year</b>						4,045	68	4,113
Total recognised income and expense			(508)	(516)	1	4,357	68	3,402
Dividends paid (Note 40)						(1,747)	(39)	(1,786)
Issue of new shares (Note 36)	5	141						146
Ordinary share buyback	(13)				13	(500)		(500)
Sale of disposal group							(130)	(130)
Other movements					3	(15)		(12)
Movement in own shares						(177)		(177)
Tax on share-based compensation schemes						(36)		(36)
Movements in share-based compensation reserve						156		156
<b>At 31 December 2007</b>	<b>1,131</b>	<b>2,997</b>	<b>(85)</b>	<b>(313)</b>	<b>552</b>	<b>17,567</b>	<b>385</b>	<b>22,234</b>

Notes:

- (1) Share capital at 31 December 2005 has been reduced by £727m and share premium increased following a reclassification of the issue of new shares in 2005.
- (2) The available for sale reserve is comprised of £(450)m (2006 £33m) in respect of treasury assets and £137m (2006 £170m) in respect of corporate and other investments.
- (3) Other reserves principally include the merger reserve of £494m arising from the combination of Halifax and Bank of Scotland in 2001. The cumulative balance for exchange translation at 31 December 2007 is £(28)m (2006 £(32)m), 2005 £(9)m.

	<i>Share capital<sup>(1)</sup></i>	<i>Share premium<sup>(1)</sup></i>	<i>Other reserves £m</i>	<i>Retained earnings</i>	<i>Total</i>
<b>Company</b>					
At 1 January 2005	981	1,441		4,859	7,281
Changes in equity					
<b>Profit after tax</b>				1,894	1,894
Total recognised income and expense				1,894	1,894
Dividends paid				(1,363)	(1,363)
Issue of new shares	203	875			1,078
Ordinary share buyback	(27)		27	(994)	(994)
Net movement in own shares				(58)	(58)
Movement in share-based compensation scheme reserve				79	79
<b>At 31 December 2005</b>	<b>1,157</b>	<b>2,316</b>	<b>27</b>	<b>4,417</b>	<b>7,917</b>

Note:

(1) Share capital at 31 December 2005 has been reduced by £727m and share premium increased following a reclassification of the issue of new shares in 2005.

	<i>Share capital</i>	<i>Share premium</i>	<i>Other reserves £m</i>	<i>Retained earnings</i>	<i>Total</i>
<b>Company</b>					
At 1 January 2006	1,157	2,316	27	4,417	7,917
Net actuarial loss from defined benefit plans (net of tax)				(93)	(93)
<b>Profit after tax</b>				2,700	2,700
Total recognised income and expense				2,607	2,607
Dividends paid				(1,501)	(1,501)
Issue of new shares	8	540			548
Ordinary share buyback	(26)		26	(982)	(982)
Acquisition of own shares				(59)	(59)
Movement in respect of share-based compensation				(2)	(2)
Movements in respect of tax on employee benefits				57	57
<b>At 31 December 2006 and 1 January 2007</b>	<b>1,139</b>	<b>2,856</b>	<b>53</b>	<b>4,537</b>	<b>8,585</b>
Net actuarial gain from defined benefit plans (net of tax)				261	261
<b>Profit after tax</b>				1,731	1,731
Total recognised income and expense				1,992	1,992
Dividends paid				(1,747)	(1,747)
Issue of new shares	5	141			146
Ordinary share buyback	(13)		13	(500)	(500)
Acquisition of own shares				(62)	(62)
Movements in respect of share-based compensation			3	134	137
<b>At 31 December 2007</b>	<b>1,131</b>	<b>2,997</b>	<b>69</b>	<b>4,354</b>	<b>8,551</b>

Movements in own shares are included within retained earnings. These shares are held for the purposes of satisfying obligations arising from certain share-based compensation schemes as detailed in Note 37.

### **39 Capital Management**

The Group's approach to managing capital is set out below.

#### **Capital Management**

**It is HBOS's policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times.**

HBOS recognises the impact on shareholder returns of the level of equity capital employed and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on equity possible with greater leverage.

The Group's capital is managed via the Board through the Group Business Plan, with the objective of maintaining both the optimal amount of capital and the most appropriate mix between the different components of capital. The day-to-day management of the Group's capital is delegated to the Group Capital Committee.

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

The principal forms of capital are included in the following balances on the consolidated balance sheet: called up share capital, share premium account, other reserves, retained earnings and other borrowed funds. Capital also includes collective impairment allowances held in respect of loans and advances.

#### **Capital Requirements**

The FSA supervises HBOS on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, HBOS as a whole. Individual banking and insurance subsidiaries are directly regulated by either the FSA or their local supervisors, who set their capital adequacy requirements.

In implementing the EU's Banking Consolidation Directive (Basel I), the FSA requires each bank and banking group to maintain an individually prescribed ratio of total capital to risk weighted assets, taking into account both balance sheet assets and off-balance sheet transactions.

The Group must at all times monitor and demonstrate compliance with the relevant regulatory capital requirements of the FSA. The Group has in place processes and controls to monitor the Group's capital adequacy and no breaches were reported to the FSA during the year. HBOS's capital is divided into two tiers:

- Tier 1 capital comprises shareholders' funds, innovative Tier 1 securities and minority interests, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at Tier 1 capital.
- Tier 2 capital comprises qualifying subordinated loan capital, collective impairment allowances, and unrealised gains arising on the fair valuation of equities held as available for sale.

Various limits are applied to elements of the capital base. The amount of innovative Tier 1 securities cannot exceed 15 per cent. of overall Tier 1 capital, qualifying Tier 2 capital cannot exceed Tier 1 capital, and qualifying dated subordinated loan capital may not exceed 50 per cent. of Tier 1 capital. There are also limitations on the amount of collective impairment allowances which may be included as part of Tier 2 capital. From the total of Tier 1 and Tier 2 capital the carrying amounts of unconsolidated investments (e.g., insurance company investments), investments in the capital of banks, and certain regulatory items are deducted.

Movements in Tier 1 capital and the Capital structure of the Group are given below.

## Capital

The movement in Tier 1 capital in the year is shown below:

<b>Movement in Tier 1 capital</b>	2007	2006
	£m	
<b>As at 1 January</b>	22,429	20,667
Profit for the year after preference dividends paid	4,033	3,880
Ordinary dividends paid	(1,667)	(1,442)
Shares bought back	(500)	(982)
Decrease/(increase) in goodwill and intangible assets <sup>(1)</sup>	815	(745)
Preference shares and preferred securities issued	374	842
(Decrease)/increase in minority interests <sup>(1)</sup>	(935)	252
Other, including exchange differences	(161)	(43)
<b>As at 31 December</b>	<u>24,388</u>	<u>22,429</u>

Note:

(1) The decrease in goodwill and intangible assets and minority interests in 2007 is primarily due to the new prudential rules on the consolidation of participations. As part of Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU), rules on the consolidation of participations have been implemented from 1 January 2007. The change principally requires "proportional" consolidation of jointly controlled entities and associates and results in a reduction of risk weighted assets and minority interests and goodwill balances relating to these participations.

	<i>As at</i> 31 December 2007	<i>As at</i> 31 December 2006
	£m	
<b>Capital Resources Basel I</b>		
<b>Core Tier 1</b>		
Ordinary share capital	933	941
Eligible reserves	20,166	18,496
Minority interests (equity)	123	1,058
<b>Perpetual non-cumulative preference shares</b>		
Preference share capital	2,781	2,422
<b>Innovative Tier 1</b>		
Preferred securities	3,247	3,189
<b>Deductions from Tier 1</b>		
Goodwill and other intangible assets	(2,862)	(3,677)
<b>Total Tier 1 capital</b>	<u>24,388</u>	<u>22,429</u>
<b>Upper Tier 2</b>		
Available for sale reserve	187	168
Undated subordinated debt	5,591	5,598
Collectively assessed impairment provisions	2,671	2,711
<b>Lower Tier 2</b>		
Dated subordinated debt	9,900	7,914
<b>Total Tier 2 capital</b>	<u>18,349</u>	<u>16,391</u>
<b>Supervisory deductions</b>		
Unconsolidated investments – life	(4,596)	(4,260)
Unconsolidated investments – other	(506)	(510)
Investments in other banks and other deductions	(983)	(896)
<b>Total supervisory deductions</b>	<u>(6,085)</u>	<u>(5,666)</u>
<b>Total Capital Resources</b>	<u>36,652</u>	<u>33,154</u>

The Group's practice is to use the Company to issue capital instruments and the Group's dividend policy requires surplus reserves to be remitted to the Company, except where they are required to be retained by the subsidiary for regulatory or financial reasons.

#### 40 Dividends

After the balance sheet date a dividend of 32.3 pence per ordinary share was proposed by the Directors. This ordinary dividend has not been provided for but the impact on retained earnings, based on the number of shares in issue at 31 December 2007, is £1,205m. Ordinary dividends are charged direct to reserves only when the Company has a contractual obligation to pay.

The following dividends have been charged to retained earnings during the year:

	2007	2006	2005
		£m	
<b>Ordinary share dividends</b>			
2005 final dividend of 24.35p per share		930	868
2006 interim dividend of 13.5p per share		512	459
2006 final dividend of 27.9p per share	1,048		
2007 interim dividend of 16.6p per share	619		
	<u>1,667</u>	<u>1,442</u>	<u>1,327</u>
<b>Preference share dividends</b>			
Equity dividends paid	80	59	36
	<u>1,747</u>	<u>1,501</u>	<u>1,363</u>

#### 41 Contingent Liabilities and Commitments

Group	2007	2006	2005
		£m	
<b>Contingent liabilities</b>			
Acceptances and endorsements	43	62	23
Guarantees and irrevocable letters of credit	6,891	5,068	5,093
	<u>6,934</u>	<u>5,130</u>	<u>5,116</u>
<b>Commitments</b>			
Short term trade related transactions	115	120	117
Undrawn formal standby facilities, credit lines and other commitments to lend with a maturity:			
Up to and including one year	68,253	61,645	59,315
Over one year	31,416	24,049	20,381
	<u>99,784</u>	<u>85,814</u>	<u>79,813</u>
<b>Company</b>	2007	2006	2005
		£m	
<b>Contingent liabilities</b>			
Guarantees provided to subsidiaries	2,608	2,552	2,180
	<u>2,608</u>	<u>2,552</u>	<u>2,180</u>

The contractual amounts above indicate the volume of business outstanding at the year end and do not reflect the underlying credit and other risks, which are significantly lower as some facilities will not be drawn down and some facilities that are drawn will be supported by collateral. Further details of assets pledged as collateral security are given in Note 16 for investment securities and Note 14 for loans and advances to customers. It should be noted that the Group's liquidity lines to the Group's Grampian and Landale conduits do not appear in the table above as these are internal to the Group and are eliminated on consolidation.

Where the Group is a lessee the future minimum lease payments under non-cancellable operating leases are due to be paid in the following periods:

<b>Group</b>	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
Not later than one year	185	154	142
Later than one year and not later than five years	674	567	494
Later than five years	1,320	1,061	994
	<u>2,179</u>	<u>1,782</u>	<u>1,630</u>

Where the Group is a lessee the future obligations payable under finance leases are as follows:

<b>Group</b>	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£m</i>	
Not later than one year	1	1	1
Later than one year and not later than five years		1	1
	<u>1</u>	<u>2</u>	<u>2</u>

Commitments in respect of capital expenditure on property and equipment that is authorised but not provided for in the accounts, for contracts which have been entered into amount to £21m (2006 £21m, 2005 £16m). Commitments for contracts which have been placed in relation to operating lease assets amount to £11m (2006 £9m, 2005 £10m).

On 27 July 2007 it was announced that the Company, along with seven other major UK current account providers, had reached agreement with the Office of Fair Trading to start legal proceedings in the High Court of England and Wales for a declaration (or declarations) to resolve legal uncertainties concerning the fairness and lawfulness of unarranged overdraft charges (the "test case"). It was also announced that the Company and those other providers will seek a stay of all current and potential future Court proceedings which are brought against them in the UK concerning these charges and have obtained the consent of the Financial Services Ombudsman not to proceed with consideration of the merits of any complaints concerning these charges that are referred to him prior to the resolution of the test case. By virtue of a waiver granted by the Financial Services Authority of its complaints handling rules, the Company (and other banks, including the banks party to the test case) will not be dealing with or resolving customer complaints on unarranged overdraft charges while the test case is running. A definitive outcome of the test case is unlikely to be known for at least 12 months. Given the very early stage of these proceedings and the uncertainty as to their outcome, it is not practicable at this time to estimate any potential financial effect.

Prior to the announcement above, the Group refunded certain unarranged overdraft charges on an ex-gratia basis as shown in Note 4. The Group's consideration of the current position is outlined in the critical accounting judgement in respect of regulatory provisions.

HBOS is engaged in various other litigation in the UK and overseas arising out of its normal business activities. HBOS considers that none of these actions is material and has not disclosed any contingent liability in respect of these actions because it is not practicable to do so.



## 42 Fair Value of Financial Instruments

The designation of financial instruments adopted by the Group for measurement purposes is set out in the critical accounting judgements and the valuation methodologies for financial instruments are set out in the appropriate accounting policies.

	<i>Policyholder funds Carrying amount and fair value</i>	<i>At fair value through the income statement Carrying amount and fair value</i>	<i>2007</i>		
			<i>Available for sale Carrying amount and fair value £m</i>	<i>Loans and receivables</i>	
			<i>Carrying amount</i>	<i>Fair value</i>	
<b>Financial assets</b>					
Cash and balances with central banks				2,572	2,572
Items in course of collection				945	945
Financial assets held for trading		54,681			
Derivative assets	416	13,725			
Loans and advances to banks	2,437	681		4,938	4,948
Loans and advances to customers				430,007	431,639
Investment securities	67,683	9,463	49,986	1,266	1,266
Other financial assets	426	461		893	893
	<u>70,962</u>	<u>79,011</u>	<u>49,986</u>	<u>440,621</u>	<u>442,263</u>

	<i>Policyholder funds Carrying amount and fair value</i>	<i>At fair value through the income statement Carrying amount and fair value</i>	<i>2007</i>		
			<i>At amortised cost</i>		
			<i>Carrying amount</i>	<i>Fair value</i>	
<b>Financial liabilities</b>					
Deposits by banks				41,513	41,528
Customer accounts				243,221	244,072
Financial liabilities held for trading			22,705		
Derivative liabilities		313	11,998		
Investment contract liabilities		43,772	1,864		
Debt securities in issue			1,842	204,678	203,579
Other borrowed funds			50	24,203	23,981
Other financial liabilities		253	249	665	665
	<u>44,338</u>	<u>38,708</u>	<u>38,708</u>	<u>514,280</u>	<u>513,825</u>

In the table above investment contract liabilities exclude £7,192m of investment contracts classified as investment contracts with DPF. An analysis of this is given in Note 27.

The valuation methodologies for calculating the fair value of financial instruments carried as loans and receivables and at amortised cost are set out below.

Loans and advances to banks, loans and advances to customers, deposits by banks and customer accounts are not regularly traded and so market prices are not available. Fair value is estimated by discounting anticipated contractual cash flows at a current market rate of interest. Current market rates are estimated by discounting anticipated contractual cashflows at a current market rate of interest and certain portfolios of loans are also impacted by a significant change in credit spread. Current market rates are estimated by reference to the rates at which similar products are advanced by the Group and market. For loans and deposits with variable interest rates or fixed rates which are re-priced within a short period, the carrying value represents fair value. For debt securities in issue and other borrowed funds carried at amortised cost, the fair values have been derived using quoted prices where available, broker valuations and where these are not available, cash flow models, adjusted for credit spreads where appropriate.

These calculations do not necessarily represent the fair value that could be obtained for the portfolios if they were sold at 31 December 2007. The exit price for such portfolios in a wholesale market would be subject to negotiation with a buyer and, for the financial assets, would take account of factors including credit risk, loan to collateral ratios, liquidity, contractual terms, historic default rates and age of the portfolio. These factors and others would in combination be the basis of valuation of the portfolios. All such drivers of valuation interact and there is no certainty that any single factor would have a greater impact on the portfolio valuation than others.

The fair values of financial assets classified as loans and receivables or financial liabilities held at amortised cost are based on market prices where available, or are estimated using other valuation techniques. Where they are short term in nature or reprice frequently, fair value approximates to carrying value. The fair value information presented does not represent the fair value of the Group as a going concern. The classification adopted by the Group is shown in the following table:

	2006				
	<i>Policyholder funds</i>	<i>At fair value through the income statement</i>	<i>Available for sale</i>	<i>Loans and receivables</i>	
	<i>Carrying amount and fair value</i>	<i>Carrying amount and fair value</i>	<i>Carrying amount and fair value</i>	<i>Carrying amount</i>	<i>Fair value</i>
			<i>£m</i>		
<b>Financial assets</b>					
Cash and balances with central banks				1,966	1,966
Items in course of collection				880	880
Financial assets held for trading		49,139			
Derivative assets	330	8,282			
Loans and advances to banks	2,168	590		8,835	9,426
Loans and advances to customers				376,808	377,158
Investment securities	65,385	6,299	44,854	493	493
Other financial assets	424	293		1,444	1,431
	<u>68,307</u>	<u>64,603</u>	<u>44,854</u>	<u>390,426</u>	<u>391,354</u>

	2006			
	<i>Policyholder funds Carrying amount and fair value</i>	<i>At fair value through the income statement Carrying amount and fair value</i>	<i>At amortised cost</i>	
			<i>Carrying amount</i>	<i>Fair value</i>
<b>Financial liabilities</b>				
Deposits by banks			30,557	30,460
Customer accounts			211,857	212,077
Financial liabilities held for trading		22,334		
Derivative liabilities	280	10,475		
Investment contract liabilities	39,250	1,542		
Debt securities in issue		3,260	180,390	180,078
Other borrowed funds		48	19,644	20,203
Other financial liabilities	503		2,151	2,052
	<u>40,033</u>	<u>37,659</u>	<u>444,599</u>	<u>444,870</u>

In the table above investment contract liabilities exclude £8,694m of investment contracts classified as investment contracts with DPF. An analysis of this is given in Note 27.

For the Company, derivatives and debt securities are measured at fair value. Fair values for other borrowed funds have been obtained from market prices where available, broker quotes or where neither are available a discounted cash flow model using current market rates adjusted for credit spreads. At 31 December 2007 the carrying value of other borrowed funds is £15,503m (2006 £12,326m, 2005 £11,818m) and the fair value is £15,253m (2006 £13,053m). The fair value of amounts owed by and to Group entities is deemed to be the carrying value except where they have fixed interest rates or where they are directly linked to other borrowed funds. In these circumstances the fair value is adjusted to reflect the impact of current interest rates or the fair value adjustments of the linked other borrowed funds. At 31 December 2007 the carrying value of net amounts owed by Group entities is £9,618m (2006 £9,468m) and the fair value £9,201m (2006 £9,391m).

	2005					
	<i>Derivatives and at fair value through the income statement</i>		<i>Available for sale</i>		<i>Loans and receivables</i>	
	<i>Carrying amount</i>	<i>Fair value</i>	<i>Carrying amount</i>	<i>Fair value</i>	<i>Carrying amount</i>	<i>Fair value</i>
						<i>£m</i>
<b>Assets</b>						
Cash and balances with central banks					1,678	1,678
Items in course of collection					753	753
Financial assets held for trading	41,766	41,766				
Derivative assets	10,499	10,499				
Loans and advances to banks	3,056	3,056			14,300	14,377
Loans and advances to customers					343,768	345,728
Investment securities	61,619	61,619	41,927	41,927	788	1,212
Other financial assets	758	731			1,039	1,009
	<u>117,698</u>	<u>117,671</u>	<u>41,927</u>	<u>41,927</u>	<u>362,326</u>	<u>364,757</u>

	2005			
	<i>Derivatives and at fair value through the income statement</i>		<i>At amortised cost</i>	
	<i>Carrying amount</i>	<i>Fair value</i>	<i>Carrying amount</i>	<i>Fair value</i>
				<i>£m</i>
<b>Liabilities</b>				
Deposits by banks	2	2	32,039	32,031
Customer accounts			200,948	201,598
Financial liabilities held for trading	25,007	25,007		
Derivative liabilities	8,576	8,576		
Investment contract liabilities <sup>(1)</sup>	31,466	31,466		
Debt securities in issue	1,243	1,243	156,718	156,939
Other borrowed funds	120	120	20,134	22,392
Other financial liabilities	397	397	841	785
	<u>66,811</u>	<u>66,811</u>	<u>410,680</u>	<u>413,745</u>

Note:

(1) Investment contracts exclude investment contracts classified as investment contracts with DPF.

### 43 Credit Risk

The Group's approach to managing credit risk is set out in the Risk Management note. The table below sets out the Group's exposure to credit risk relating to financial instruments before taking account of collateral and other security. Policyholder assets are excluded from the Group's exposure in the table as the underlying credit risks are for the account of policyholders and have no direct impact on the Group's results.

	2007			2006		
	Total	Policyholder funds	Group exposure £m	Total	Policyholder funds	Group exposure
<b>Assets</b>						
Cash and balances at central banks	2,572		2,572	1,966		1,966
Items in the course of collection	945		945	880		880
Financial assets held for trading	54,681		54,681	49,139		49,139
Derivative assets	14,141	416	13,725	8,612	330	8,282
Loans and advances to banks	8,056	2,437	5,619	11,593	2,168	9,425
Loans and advances to customers	430,007		430,007	376,808		376,808
Debt securities	77,553	20,714	56,839	68,826	18,925	49,901
Other financial assets (excluding equity shares)	1,780	426	1,354	2,161	424	1,737
	589,735	23,993	565,742	519,985	21,847	498,138
Contingent liabilities and commitments	106,718		106,718	90,944		90,944
	696,453	23,993	672,460	610,929	21,847	589,082

The table below sets out the Company's exposure to credit risk relating to financial instruments before taking account of collateral and other security.

	2007 £m	2006
Derivative assets	162	1
Amounts owed to Group entities	38,885	27,765
Debt securities	1	40
	39,048	27,806
Contingent liabilities and commitments	2,608	2,552
	41,656	30,358

The internal credit ratings of the Group are assessed on a comparable basis to those given by external credit rating agencies. Where external credit ratings are available, these have been used in the analyses below.

#### Financial assets held for trading

Financial assets held for trading are almost exclusively investment grade investments with 99 per cent. (2006 99 per cent.) of inter-bank and structured investment portfolios rated "A" or above based on internal credit ratings. An analysis of financial instruments held for trading is given in Note 11 and in the Risk Management note.

## Derivative assets

Derivative assets are primarily traded with investment grade counterparties with 83 per cent. (2006 90 per cent.) of derivatives rated "A" or above based on internal credit ratings. The Company's derivatives are wholly traded with Bank of Scotland plc which has a credit rating of "AA". An analysis of derivatives is given in Note 13.

## Loans and advances to banks

Loans and advances to banks are primarily invested with investment grade banks of which 80 per cent. (2006 90 per cent.) have a credit rating of "A" or above based on internal credit ratings.

## Loans and advances to customers

Loans and advances to customers are managed on a divisional basis. A divisional analysis of advances to customers is set out in Note 8 and an analysis of loans and advances is given in Note 14. Additional disclosures in respect of the credit quality of loans and advances on a divisional basis is given below:

### Retail

#### (i) Exposure

Asset Quality Information	As at	As at
	31 December 2007	31 December 2006
	<i>£bn</i>	
<b>Loans and advances to customers</b>	253.4	237.7
Impairment provisions on advances	2.3	2.1
Loans and advances to customers before impairment provisions	255.7	239.8
	As at	As at
	31 December 2007	31 December 2006
	%	
<b>Classification of advances<sup>(1)</sup></b>		
Residential mortgages	92.6	92.1
Other personal lending:		
Secured Personal Loans	0.4	0.6
Unsecured Personal Loans	3.7	3.7
Credit Cards	2.7	3.0
Banking	0.6	0.6
<b>Total</b>	<b>100.0</b>	<b>100.0</b>
		%
<b>Analysis of residential mortgages</b>		
Mainstream balances	73.2	74.0
Specialist balances <sup>(2)</sup>	26.8	26.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>
		%
<b>New business profile of residential mortgages</b>		
Mainstream balances	69.7	69.3
Specialist balances	30.3	30.7
<b>Total</b>	<b>100.0</b>	<b>100.0</b>

Notes:

(1) Before impairment provisions.

(2) Comprising predominantly buy to let and self-certificated mortgages.

**(ii) Credit Quality and Collateral**

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	£bn	
<b>Loans and advances to customers are analysed as follows<sup>(1)</sup></b>		
Neither past due nor impaired <sup>(2)</sup>	241.8	226.5
Past due up to three months but not impaired <sup>(3)</sup>	7.3	6.8
Impaired	6.6	6.5
<b>Total</b>	<u>255.7</u>	<u>239.8</u>

**Loan to value analysis of residential mortgage book**

	%	
Less than 60% (averaging 28%., 2006 28%)	46.7	45.7
60% to 70%	18.2	16.5
70% to 80%	18.3	18.8
80% to 90%	13.3	15.3
Greater than 90%	3.5	3.7
<b>Total</b>	<u>100.0</u>	<u>100.0</u>

**Average loan to value**

	%	
Stock of residential mortgages	44	44
New residential lending	65	64
Impaired mortgages	57	57

Note:

(1) LTV analysis is based on indexed valuation for stock and valuation at inception for new loans.

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	£m	
<b>Impaired loans<sup>(1)</sup></b>		
Secured	4,234	4,047
Unsecured	2,322	2,411
<b>Total</b>	<u>6,556</u>	<u>6,458</u>

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	£m	
<b>Impaired loans<sup>(1)</sup></b>		
Past due 0 to 3 months	165	253
Past due 3 to 6 months	2,302	2,166
Past due 6 to 12 months	1,383	1,311
Past due over 12 months	534	597
Recoveries	1,840	1,814
Possession	332	317
<b>Total</b>	<u>6,556</u>	<u>6,458</u>

	%	
<b>Impaired loans as a % of closing advances</b>		
Secured	1.80	1.84
Unsecured	13.04	13.17
<b>Total</b>	<u>2.59</u>	<u>2.72</u>

	£m	
<b>Impairment provisions on advances</b>		
Secured	330	408
Unsecured	1,919	1,700
<b>Total</b>	<u>2,249</u>	<u>2,108</u>

	%	
<b>Impairment provisions as a % of closing advances</b>		
Secured	0.14	0.19
Unsecured	10.78	9.29
<b>Total</b>	<u>0.89</u>	<u>0.89</u>

	As at 31 December 2007	As at 31 December 2006
	%	
<b>Impairment provisions as a % of impaired loans</b>		
Secured	8	10
Unsecured	83	71
<b>Total</b>	<u>34</u>	<u>33</u>

Notes:

- (1) Before impairment provisions.
- (2) Included in loans and advances that are neither past due nor impaired are £227m (2006 £291m) that would have been past due or impaired had their terms not been renegotiated.
- (3) Secured £6.7bn (2006 £6.1bn) and unsecured £0.6bn (2006 £0.7bn).

**Corporate**

**(i) Exposure**

	As at 31 December 2007	As at 31 December 2006
	£bn	
<b>Asset Quality Information</b>		
<b>Loans and advances to customers</b>	109.3	89.6
Impairment provisions on advances	0.8	0.7
Loans and advances to customers before impairment provisions	<u>110.1</u>	<u>90.3</u>



	As at 31 December 2007	As at 31 December 2006
	%	
<b>Classification of advances<sup>(4)</sup></b>		
Agriculture, forestry and fishing	1	1
Energy	2	2
Manufacturing industry	4	5
Construction and property:		
– Property investment	19	17
– Property development	6	6
– Housing associations	3	3
– Housebuilders	3	2
– Other property	6	6
Hotels, restaurants and wholesale and retail trade	11	11
Transport, storage and communication	6	7
Financial	5	5
Other services	13	15
Individuals	2	3
Non-UK residents	19	17
	<u>100</u>	<u>100</u>

#### (ii) Credit Quality and Collateral

Corporate's loans are predominantly secured by fixed and floating charges. These charges allow Corporate a first ranking claim on the borrower's assets in the event a default situation occurs.

	As at 31 December 2007	As at 31 December 2006
	£bn	
<b>Loans and advances to customers<sup>(4)</sup></b>		
Neither past due nor impaired <sup>(4)</sup>	104.2	83.5
Past due but not impaired	2.7	5.1
Impaired	3.2	1.7
<b>Total</b>	<u>110.1</u>	<u>90.3</u>

	%	
<b>Loans neither past due nor impaired<sup>(4)</sup></b>		
Internal rating:		
Better than satisfactory risk	34	26
Satisfactory risk	52	52
Viable but monitoring	12	19
High Risk	2	3
<b>Total</b>	<u>100</u>	<u>100</u>

	As at 31 December 2007	As at 31 December 2006
	£m	
<b>Loans past due but not impaired<sup>(4)</sup></b>		
Past due 0 to 3 months	2,690	3,417
Past due 3 to 6 months	7	536
Past due more than 6 months	23	1,158
<b>Total</b>	<u>2,720</u>	<u>5,111</u>

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£m</i>	
<b>Impaired loans<sup>(4) (2)</sup></b>		
Past due 0 to 3 months	1,033	227
Past due 3 to 6 months	521	171
Past due 6 to 12 months	645	572
Past due over 12 months	966	750
<b>Total</b>	<u>3,165</u>	<u>1,720</u>
	<i>£m</i>	
<b>Impaired loans<sup>(4)</sup></b>		
Impaired loans no loss <sup>(3)</sup>	1,648	557
Impaired loans with loss	1,517	1,163
<b>Total</b>	<u>3,165</u>	<u>1,720</u>
<b>Impaired loans with loss as a % of closing advances</b>	1.39%	1.30%
<b>Impairment provisions</b>	£802m	£735m
<b>Impairment provisions as a % of closing advances</b>	0.73%	0.82%
<b>Impairment provisions as a % of impaired loans with loss</b>	53%	63%

Notes:

- (1) Included in loans and advances that are neither past due nor impaired are £2m (2006 £89m) of troubled debt restructured loans that would have been past due or impaired had their terms not been renegotiated.
- (2) Period relates to when account entered impaired status.
- (3) Loans categorised as impaired no loss represent loans that have been individually assessed as having impairment characteristics but where we expect, after taking into consideration collateral and other credit enhancements, full recovery of both interest and capital. As we have progressed our Basel II project, we have refined the categorisation of assets reflected in the year on year increase.
- (4) Before impairment provisions.

**International**

**(i) Exposure**

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£bn</i>	
<b>Asset Quality Information</b>		
<b>Loans and advances to customers</b>	67.1	48.7
Impairment provisions on advances	0.3	0.2
Loans and advances to customers before impairment provisions	<u>67.4</u>	<u>48.9</u>
	<i>%</i>	
<b>Classification of advances<sup>(1)</sup></b>		
Agriculture, forestry and fishing	2	2
Energy	2	2
Manufacturing industry	3	3
Construction and property	27	26
Hotels, restaurants and wholesale and retail trade	9	10
Transport, storage and communication	2	2
Financial	3	3
Other services	8	7
<b>Individuals</b>		
Home mortgages	40	40
Other personal lending	4	5
	<u>100</u>	<u>100</u>

**(ii) Credit Quality**

<b>Asset Quality Information</b>	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£bn</i>	
<b>Loans and advances to customers<sup>(1)</sup></b>		
Neither past due nor impaired	65.9	47.6
Past due but not impaired	0.7	0.7
Impaired	0.8	0.6
	67.4	48.9
	67.4	48.9
	%	
<b>Loans neither past due nor impaired<sup>(1)</sup></b>		
Internal rating:		
Better than satisfactory risk	30	29
Satisfactory risk	60	62
Viable but monitoring	9	8
High Risk	1	1
	100	100
	100	100
	<i>£m</i>	
<b>Loans past due but not impaired<sup>(1)</sup></b>		
Past due 0 to 3 months	714	642
Past due 3 to 6 months	2	10
Past due more than 6 months	8	
	724	652
	724	652
	<i>£m</i>	
<b>Impaired loans<sup>(1)</sup></b>		
Past due 0 to 3 months	354	299
Past due 3 to 6 months	170	88
Past due 6 to 12 months	122	74
Past due over 12 months	113	63
Possession cases	67	57
	826	581
	826	581
<b>Impaired loans as a % of closing advances</b>	1.23%	1.19%
<b>Impairment provisions</b>	£322m	£246m
<b>Impairment provisions as a % of closing advances</b>	0.48%	0.51%
<b>Impairment provisions as a % of impaired loans</b>	39%	42%

Note:

(1) Before impairment provisions.

## Australia

### (i) Exposure

#### Asset Quality Information

#### Loans and advances to customers

Impairment provisions on advances

Loans and advances to customers before impairment provisions

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
--	---------------------------------------	---------------------------------------

*£bn*

	33.2	24.5
--	------	------

	0.1	0.1
--	-----	-----

	33.3	24.6
--	------	------

%

#### Classification of advances<sup>(1)</sup>

Agriculture, forestry and fishing

Energy

Manufacturing industry

Construction and property

Hotels, restaurants and wholesale and retail trade

Transport, storage and communication

Financial

Other services etc.

Individuals:

– Home mortgages

– Other personal lending

Non-Australian residents

	3	3
--	---	---

	2	3
--	---	---

	3	3
--	---	---

	26	24
--	----	----

	8	9
--	---	---

	3	2
--	---	---

	2	3
--	---	---

	8	7
--	---	---

	39	38
--	----	----

	4	6
--	---	---

	2	2
--	---	---

	100	100
--	-----	-----

### (ii) Credit Quality

#### Loans and advances to customers<sup>(1)</sup>

Neither past due nor impaired

Past due up to 3 months but not impaired

Impaired

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
--	---------------------------------------	---------------------------------------

*£bn*

	32.6	23.9
--	------	------

	0.4	0.4
--	-----	-----

	0.3	0.3
--	-----	-----

	33.3	24.6
--	------	------

%

#### Loans neither past due nor impaired<sup>(1)</sup>

Internal rating:

Better than satisfactory risk

Satisfactory risk

Viable but monitoring

High risk

	48	43
--	----	----

	41	46
--	----	----

	10	10
--	----	----

	1	1
--	---	---

	100	100
--	-----	-----

*£m*

#### Loans past due but not impaired<sup>(1)</sup>

Past due 0 to 3 months

	399	432
--	-----	-----

	399	432
--	-----	-----

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£m</i>	
<b>Impaired loans<sup>(1)</sup></b>		
Past due 0 to 3 months	135	89
Past due 3 to 6 months	76	46
Past due 6 to 12 months	22	40
Past due over 12 months	42	13
Possession cases	58	57
	<u>333</u>	<u>245</u>
	<u><u>333</u></u>	<u><u>245</u></u>
<b>Impaired loans as a % of closing advances</b>	1.00%	1.00%
<b>Impairment provisions</b>	£147m	£113m
<b>Impairment provisions as a % of closing advances</b>	0.44%	0.46%
<b>Impairment provisions as a % of impaired loans</b>	<u>44%</u>	<u>46%</u>

Note:

(1) Before impairment provisions.

## Ireland

### (i) Exposure

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£bn</i>	
<b>Asset Quality Information</b>		
<b>Loans and advances to customers</b>	21.9	15.9
Impairment provisions on advances	0.1	0.1
	<u>22.0</u>	<u>16.0</u>
	<u><u>22.0</u></u>	<u><u>16.0</u></u>
	%	
<b>Classification of advances<sup>(1)</sup></b>		
Agriculture, forestry and fishing	1	1
Energy	1	
Manufacturing industry	3	4
Construction and property	28	27
Hotels, restaurants and wholesale and retail trade	12	13
Transport, storage and communication	2	2
Financial	2	2
Other services	6	6
Individuals:		
– Home mortgages	28	28
– Other personal lending	6	6
Non-Ireland residents	11	11
	<u>100</u>	<u>100</u>
	<u><u>100</u></u>	<u><u>100</u></u>

**(ii) Credit Quality**

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	£bn	
<b>Loans and advances to customers<sup>(1)</sup></b>		
Neither past due nor impaired	21.6	15.7
Past due but not impaired		
Impaired	0.4	0.3
	<u>22.0</u>	<u>16.0</u>
	%	
<b>Loans neither past due nor impaired<sup>(1)</sup></b>		
Internal rating:		
Satisfactory risk	99	99
Viable but monitoring	1	1
	<u>100</u>	<u>100</u>
	£m	
<b>Impaired loans<sup>(1)</sup></b>		
Past due 0 to 3 months	219	171
Past due 3 to 6 months	65	42
Past due 6 to 12 months	68	34
Past due over 12 months	70	50
	<u>422</u>	<u>297</u>
<b>Impaired loans as a % of closing advances</b>	1.93%	1.87%
<b>Impairment provisions</b>	£141m	£113m
<b>Impairment provisions as a % of closing advances</b>	0.64%	0.71%
<b>Impairment provisions as a % of impaired loans</b>	<u>33%</u>	<u>38%</u>

Note:

(1) Before impairment provisions.

## Europe and North America (ENA)

### (i) Exposure

<b>Asset Quality Information</b>	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£bn</i>	
<b>Loans and advances to customers</b>	12.0	8.3
Impairment provisions on advances		
Loans and advances to customers before impairment provisions	<u>12.0</u>	<u>8.3</u>

	%	
<b>Classification of advances<sup>(1)</sup></b>		
Energy	7	6
Manufacturing industry	2	1
Construction and property	7	7
Hotels, restaurants and wholesale and retail trade	2	2
Transport, storage and communication	1	1
Financial	7	4
Other services etc.	10	10
Individuals:		
Home mortgages	64	69
	<u>100</u>	<u>100</u>

### (ii) Credit Quality

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£bn</i>	
<b>Loans and advances to customers<sup>(1)</sup></b>		
Neither past due nor impaired	11.6	8.0
Past due but not impaired	0.3	0.2
Impaired	0.1	0.1
	<u>12.0</u>	<u>8.3</u>

	%	
<b>Loans neither past due nor impaired<sup>(1)</sup></b>		
Internal rating:		
Better than satisfactory risk	37	43
Satisfactory risk	40	37
Viable but monitoring	21	15
High risk	2	5
	<u>100</u>	<u>100</u>

	<i>£m</i>	
<b>Loans past due but not impaired<sup>(1)</sup></b>		
Past due 0 to 3 months	315	210
Past due 3 to 6 months	2	10
Past due more than six months	8	
	<u>325</u>	<u>220</u>

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£m</i>	
<b>Impaired loans<sup>(1)</sup></b>		
Past due 0 to 3 months		39
Past due 3 to 6 months	29	
Past due 6 to 12 months	32	
Past due over 12 months	1	
Possession cases	9	
	<u>71</u>	<u>39</u>
	<u><u>71</u></u>	<u><u>39</u></u>
<b>Impaired loans as a % of closing advances</b>	0.59%	0.47%
<b>Impairment provisions</b>	£34m	£20m
<b>Impairment provisions as a % of closing advances</b>	0.28%	0.24%
<b>Impairment provisions as a % of impaired loans</b>	<u>48%</u>	<u>51%</u>

Note:

(1) Before impairment provisions.

The Group's Corporate, International and Treasury neither past due nor impaired lending exposures are analysed by internal credit rating below:

	<i>2007</i>	<i>2006</i>
	<i>%</i>	
Better than satisfactory risk	33	27
Satisfactory risk	54	55
Viable but monitoring	11	16
High risk	2	2
	<u>100</u>	<u>100</u>
	<u><u>100</u></u>	<u><u>100</u></u>

The loan to value of the Group's Retail home mortgage lending exposure is analysed below:

	<i>2007</i>	<i>2006</i>
	<i>%</i>	
Less than 70%	65	62
70% to 80%	18	19
80% to 90%	13	15
Greater than 90%	4	4
	<u>100</u>	<u>100</u>
	<u><u>100</u></u>	<u><u>100</u></u>

The ageing of the Group's lending exposure that is past due but not impaired is analysed below:

	<i>2007</i>	<i>2006</i>
	<i>£m</i>	
Up to 3 months	10,746	10,898
3 to 6 months	9	546
Greater than 6 months	31	1,158
	<u>10,786</u>	<u>12,602</u>
	<u><u>10,786</u></u>	<u><u>12,602</u></u>



The Group's impaired gross lending exposure is analysed below:

	2007	2006
	<i>£m</i>	
Retail secured lending	4,234	4,047
Retail unsecured lending	2,322	2,411
Corporate – no loss	1,648	557
Corporate – with loss	1,517	1,163
International	826	581
	<u>10,547</u>	<u>8,759</u>

Loans categorised as impaired with no loss represent loans that have been individually assessed as having impairment characteristics but where we expect, after taking into consideration collateral and other credit enhancements, full recovery of both interest and capital.

The ageing of the Group's lending exposure that is impaired is analysed below:

	2007	2006
	<i>£m</i>	
Up to 3 months	1,552	779
3 to 6 months	2,993	2,425
6 months to one year	2,150	1,957
Greater than one year	1,613	1,410
Possession	399	374
Recoveries	1,840	1,814
	<u>10,547</u>	<u>8,759</u>

The Group holds collateral valued at £292m (2006 £332m) in respect of the £399m (2006 £317m) of possession exposures.

#### **Collateral**

The value of collateral held by the Group as described above includes the value of the homes secured against the mortgage lending without limitation to the actual loan amounts. The average loan to value of UK Retail home mortgages that are impaired is 57 per cent. (2006 57 per cent.). The Group's Corporate lending is generally secured by fixed and floating charges.

#### **Amounts owed by Group entities**

The Company's inter-company assets are primarily transacted with companies in the Group that have credit ratings of "AA".

#### **Debt securities**

Debt securities are primarily held within the Treasury & Asset Management, Corporate and Insurance & Investment divisions and are almost exclusively issued by investment grade counterparties with 96 per cent. (2006 94 per cent.) of debt securities rated "A" or above based on internal credit ratings. The Company's investment securities comprise UK government gilts with an external "AAA" credit rating. An analysis of debt securities is given in Note 34 and in the Risk Management note.

#### **Contingent liabilities and commitments**

Contingent liabilities and commitments are analysed in Note 41. This amount reflects the outstanding business at the year end and reflects the maximum credit exposure that could be drawn down. Some facilities will not be drawn down or may be only partially utilised.

#### **44 Market Risk**

The Group's approach to managing market risk is set out in the Risk Management note. The Company's approach to managing market risk is to transfer interest rate and foreign exchange risk to its subsidiary Bank of Scotland plc through a combination of inter-company loans, deposits and

derivative instruments. The following table shows, split by currency, the Company's sensitivity as at 31 December 2007 to an immediate interest rate shift of 25 basis points to all interest rates.

<i>Impact of interest rate shift on income statement (expense)/income</i>	2007		2006	
	+25 bps	- 25 bps	+25 bps	- 25 bps
	<i>£m</i>			
<b>Currency</b>				
Sterling	(34)	34	(23)	23
Australian Dollar	1	(1)	1	(1)
	<u>(33)</u>	<u>33</u>	<u>(22)</u>	<u>22</u>

### Non-Trading Currency Exposure

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

<i>Functional currency of the operation</i>	2007			2006			2005		
	<i>Net investments in overseas operations</i>	<i>Borrowing taken out to hedge net investments</i>	<i>Remaining structural currency exposure</i>	<i>Net investments in overseas operations</i>	<i>Borrowing taken out to hedge net investments</i>	<i>Remaining structural currency exposure</i>	<i>Net investments in overseas operations</i>	<i>Borrowing taken out to hedge net investments</i>	<i>Remaining structural currency exposure</i>
Australian Dollar	2,023	2,023		1,560	1,560		1,345	1,341	4
Euro	1,888	1,613	275	1,464	1,224	240	1,088	892	196
US Dollar	97	97		106	99	7	161	161	
Other	4		4	13		13	10		10
	<u>4,012</u>	<u>3,733</u>	<u>279</u>	<u>3,143</u>	<u>2,883</u>	<u>260</u>	<u>2,604</u>	<u>2,394</u>	<u>210</u>

At 31 December 2007, 31 December 2006 and 31 December 2005 there are no material net currency exposures in the non-trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses. Additional information on the Group's foreign exchange risk is set out in the Risk Management note.

### 45 Liquidity Risk

The Group's approach to managing liquidity risk is set out in the Risk Management note.

The tables below set out the contractual cash flows attaching to the Group's financial liabilities (excluding those related to policyholder funds) and the Company's financial liabilities. Except for the insurance contract liabilities these cash flows are not discounted and include both the contractual cash flows pertaining to the balance sheet liabilities and future contractual cash flows that they will generate. Certain long dated financial liabilities allow for early termination at the option of the Group. Where the terms of these instruments have been designed to economically compel the Group to early settle, the earlier settlement date has been applied. For undated instruments the earlier of 20 years or expected date of maturity has been applied. The analysis of insurance contract liabilities is based on the expected timing of discounted amounts recognised at the balance sheet date. Policyholder funds have been excluded from the analysis as the underlying risks are for the account of policyholders and have no direct impact on the Group's results. In addition to the cash flows detailed below, the Group is exposed to potential cash outflows in the form of commitments and contingencies as set out in Note 41.

Group	2007				
	Up to 1 month	1 to 3 months	3 to 12 months £m	1 to 5 years	Over 5 years
<b>Liabilities</b>					
Deposits by banks	23,563	12,413	4,369	629	673
Customer accounts	193,031	19,276	25,220	7,934	1,642
Financial liabilities held for trading	9,119	5,556	6,540	242	
<b>Derivative liabilities</b>					
Gross settled derivatives – outflows	20,580	21,966	15,575	39,030	15,700
Gross settled derivatives – inflows	(20,558)	(22,084)	(15,298)	(38,324)	(14,998)
Gross settled derivatives – net flows	22	(118)	277	706	702
Net settled derivative liabilities	332	516	1,347	4,133	(400)
	354	398	1,624	4,839	302
Insurance contract liabilities	99	61	495	1,185	1,821
Investment contract liabilities	1	2	1,907	13	98
Debt securities in issue	26,990	48,086	42,900	75,693	36,843
Other borrowed funds	48	246	2,145	11,776	23,911
Other financial liabilities	914				
	254,119	86,038	85,200	102,311	65,290
	<u>254,119</u>	<u>86,038</u>	<u>85,200</u>	<u>102,311</u>	<u>65,290</u>
			<b>2006</b>		
Group	Up to 1 month	1 to 3 months	3 to 12 months £m	1 to 5 years	Over 5 years
<b>Liabilities</b>					
Deposits by banks	11,911	11,751	3,250	1,448	2,670
Customer accounts	181,029	16,454	10,761	6,187	1,704
Financial liabilities held for trading	8,037	5,630	7,699	249	
<b>Derivative liabilities</b>					
Gross settled derivatives – outflows	16,213	33,366	24,234	41,070	33,552
Gross settled derivatives – inflows	(15,881)	(33,049)	(23,615)	(39,415)	(33,419)
Gross settled derivatives – net flows	332	317	619	1,655	133
Net settled derivative liabilities	1,396	680	1,786	3,500	4,395
	1,728	997	2,405	5,155	4,528
Insurance contract liabilities	1,107	20	163	436	2,080
Investment contract liabilities	365	3	915	46	450
Debt securities in issue	15,289	53,616	31,700	48,466	55,077
Other borrowed funds	28	219	1,507	8,773	21,505
Other financial liabilities	2,151				
	221,645	88,690	58,400	70,760	88,014
	<u>221,645</u>	<u>88,690</u>	<u>58,400</u>	<u>70,760</u>	<u>88,014</u>

Company	2007				
	Up to 1 month	1 to 3 months	3 to 12 months £m	1 to 5 years	Over 5 years
<b>Liabilities</b>					
<b>Derivative liabilities</b>					
Gross settled derivatives – outflows	12	77	564	4,539	6,356
Gross settled derivatives – inflows		(58)	(486)	(4,412)	(6,002)
Gross settled derivatives – net flows	12	19	78	127	354
Amounts owed to Group entities	16,597	1,050	2,814	10,208	11,568
Other borrowed funds		128	445	4,935	10,691
	<u>16,609</u>	<u>1,197</u>	<u>3,337</u>	<u>15,270</u>	<u>22,613</u>

Company	2006				
	Up to 1 month	1 to 3 months	3 to 12 months £m	1 to 5 years	Over 5 years
<b>Liabilities</b>					
<b>Derivative liabilities</b>					
Gross settled derivatives – outflows	3	35	114	1,945	5,035
Gross settled derivatives – inflows		(36)	(91)	(1,791)	(4,721)
Gross settled derivatives – net flows	3	(1)	23	154	314
Amounts owed to Group entities	10,431	1,302	1,704	4,072	12,786
Other borrowed funds		124	362	4,148	10,402
	<u>10,434</u>	<u>1,425</u>	<u>2,089</u>	<u>8,374</u>	<u>23,502</u>

#### 46 Special Purpose Entities

The Group sponsors special purpose entities (“SPEs”) that are used in its securitisation and funding programmes. The principal securitisation programmes are listed in Note 14. In addition, the Group sponsors two conduit programmes, Grampian and Landale, which invest in asset-backed securities funded by commercial paper or through banking facilities. Details of the assets secured under these conduit programmes are given in Note 16.

Two of the Landale SPEs are not consolidated by the Group. One is the central funding company for the conduit that obtains external funding and lends it to the purchasing companies. The second is a purchasing company that has acquired floating rate notes issued under the Group’s mortgage securitisation programmes and which is supported by liquidity lines that are provided by third party banks. These entities are not consolidated as there are insufficient indicators of control, in particular as the credit risk relating to the assets held by the entities and the liquidity risks are not borne by the Group. If these two entities were consolidated by the Group the financial impact would be minimal with the principal effects increasing deposits by banks by £1,756m (2006 £nil) and customer accounts by £100m (2006 £nil) and decreasing debt securities in issue by £1,856m (2006 £nil). Group profit before tax and retained earnings would both be increased by £0.5m (2006 £nil).

#### 47 Related Party Transactions

HBOS plc is the ultimate parent company of the Group. Banking transactions are entered into by the Company with its subsidiaries in the normal course of business and are at normal commercial terms. These include loans, deposits and foreign currency transactions. Balances between HBOS plc and its subsidiaries are shown on the Company balance sheet. Interest income and expense are £1,909m (2006 £1,469m, 2005 £1,336m) and £1,718m (2006 £966m, 2005 £998m) respectively. HBOS plc is the principal employer of the Group and staff and other costs in the year of £2,457m (2006 £2,277m, 2005 £2,015m) were recharged to subsidiaries.

In the year ended 31 December 2007, the Group provided both administration and processing services to Sainsbury's Bank plc. The amounts payable to the Group during the year are £42m (2006 £36m, 2005 £41m), of which £18m is outstanding at the year end (2006 £15m, 2005 £24m). At 31 December 2007, Sainsbury's Bank plc also has balances with the Group that are included in loans and advances to banks of £726m (2006 £766m, 2005 £1,011m) and deposits by banks of £3,430m (2006 £943m, 2005 £830m).

At 31 December 2007, there are loans and advances to customers of £11,373m (2006 £10,115m, 2005 £9,310m) outstanding and balances within customer accounts of £575m (2006 £304m, 2005 £185m) relating to jointly controlled entities and associated undertakings.

At 31 December 2007, there are customer accounts of £20m (2006 £3m, 2005 £16m) and investment and insurance contract liabilities of £425m (2006 £489m, 2005 £401m) related to the Group's pension arrangements. Additionally, the Group's pension funds hold HBOS plc ordinary shares with a value of £19m (2006 £28m, 2005 £28m) and HBOS plc bonds with a value of £2m (2006 £nil).

#### **48 Transactions with Key Management Personnel**

For the purposes of IAS 24 "Related Party Disclosures", key management personnel comprise the members of the Board of HBOS plc and, as the senior executive committee of the Group, the members of the HBOS Executive Committee.

#### **Remuneration and other compensation**

	<i>2007</i>	<i>2006</i>	<i>2005</i>
		<i>£'000</i>	
Emoluments	13,276	10,436	9,199
Termination benefits	1,475		
Post retirement benefits	63	222	577
Equity compensation benefits	6,257	7,715	9,813

#### **Product transactions**

Key management personnel and other colleagues, as well as receiving salary, incentives, shares, pensions and other benefits are entitled to enter into product transactions with HBOS plc and its subsidiaries. These transactions are generally in the form of banking, savings, mortgage, loan, insurance, assurance and investment products. Any product offerings that are received on beneficial terms compared to the terms received by customers and which give rise to taxable benefits in kind are declared to HM Revenue & Customs and taxed accordingly.

Key management personnel and members of their related parties have undertaken transactions with HBOS plc and its subsidiaries, jointly controlled entities and associated undertakings in the normal course of business, details of which have been disclosed to the Group are given below:

## Mortgages, credit cards and term loans

	<i>Number of key management personnel</i>	<i>£'000</i>
<b>At 1 January 2005</b>	12	5,486
Amounts advanced during the year	4	1,154
Interest charged	9	281
Amounts repaid during the year	11	(2,310)
Upon resignation	2	(85)
	<hr/>	<hr/>
<b>At 31 December 2005</b>	10	4,526
Amounts advanced during the year	5	1,589
Interest charged	7	245
Amounts repaid during the year	11	(1,324)
Upon resignation	1	13
	<hr/>	<hr/>
<b>At 31 December 2006</b>	10	5,049
<b>Upon appointment</b>	1	3
<b>Interest charged</b>	8	271
<b>Amounts repaid during the year</b>	11	(2,036)
<b>Upon resignation</b>	3	(1,460)
	<hr/>	<hr/>
<b>At 31 December 2007</b>	<u>7</u>	<u>1,827</u>

## Bank, cheque or current accounts

	<i>Number of key management personnel</i>	<i>Credit balances</i>	<i>Debit balances</i>	<i>Net balances</i>
		<i>£'000</i>		
<b>At 1 January 2005</b>	9	1,515	(60)	1,455
Upon appointment	2	27		27
Net movement during the year	11	(202)	(17)	(219)
Upon resignation	2	(118)		(118)
	<hr/>	<hr/>	<hr/>	<hr/>
<b>At 31 December 2005</b>	10	1,222	(77)	1,145
Net movement during the year	12	6,316	(940)	5,376
Upon resignation	1	(51)		(51)
	<hr/>	<hr/>	<hr/>	<hr/>
<b>At 31 December 2006</b>	11	7,487	(1,017)	6,470
<b>Upon appointment</b>	3	413		413
<b>Net movement during the year</b>	15	(1,129)	(419)	(1,548)
<b>Upon resignation</b>	3	(130)	1,236	1,106
	<hr/>	<hr/>	<hr/>	<hr/>
<b>At 31 December 2007</b>	<u>12</u>	<u>6,641</u>	<u>(200)</u>	<u>6,441</u>

## Savings and deposit accounts

	<i>Number of key management personnel</i>	<i>£'000</i>
<b>At 1 January 2005</b>	6	1,859
Upon appointment	2	197
Amounts deposited during the year	9	2,058
Interest credited	9	58
Amounts withdrawn during the year	9	(1,234)
Upon resignation	2	(571)
	<hr/>	<hr/>
<b>At 31 December 2005</b>	7	2,367
Upon appointment	1	94
Amounts deposited during the year	8	5,611
Interest credited	9	51
Amounts withdrawn during the year	7	(1,813)
Upon resignation	1	(3,010)
	<hr/>	<hr/>
<b>At 31 December 2006</b>	8	3,300
<b>Upon appointment</b>	2	1,550
<b>Amounts deposited during the year</b>	9	3,123
<b>Interest credited</b>	7	114
<b>Amounts withdrawn during the year</b>	7	(2,393)
<b>Upon resignation</b>	1	(32)
	<hr/>	<hr/>
<b>At 31 December 2007</b>	10	5,662
	<hr/> <hr/>	<hr/> <hr/>

## Life assurance and investment contracts

	<i>Number of key management personnel</i>	<i>£'000</i>
<b>At 1 January 2005</b>	6	2,392
Upon appointment	2	134
Premiums paid/amounts invested during the year	4	1,373
Other movements including investment returns	8	613
	<hr/>	<hr/>
<b>Total sum insured/value of investment at 31 December 2005</b>	7	4,512
Upon appointment	1	48
Premiums paid/amounts invested during the year	8	307
Other movements including investment returns	8	2,127
Upon resignation	1	(5)
	<hr/>	<hr/>
<b>Total sum insured/value of investment at 31 December 2006</b>	8	6,989
<b>Upon appointment</b>	2	173
<b>Premiums paid/amounts invested during the year</b>	9	3,191
<b>Other movements including investment returns</b>	10	(1,995)
<b>Upon resignation</b>	2	(1,331)
	<hr/>	<hr/>
<b>Total sum insured/value of investment at 31 December 2007</b>	8	7,027
	<hr/> <hr/>	<hr/> <hr/>

The following disclosures are presented in accordance with the Companies Act 1985 as amended by the Companies Act 2006.

The number of Directors together with their connected persons who had transactions and balances with banking entities in the Group were as follows:

	2007		2006	
	Number of Directors	£'000	Number of Directors	£'000
Loans	6	1,440	7	4,420
Quasi-loans and credit cards	6	14	7	27
	<u>6</u>	<u>1,454</u>	<u>7</u>	<u>4,447</u>

#### 49 Effective Interest Rates

	2006 Yield %	2005 Yield
<b>Assets</b>		
Loans and advances to banks	5.25	4.50
Loans and advances to customers	6.31	6.25
Investment securities	4.53	3.40
<b>Liabilities</b>		
Deposits by banks	4.53	4.50
Customer accounts	3.70	3.90
Debt securities in issue	4.57	3.95
Other borrowed funds	5.35	5.40

The above figures do not take account of derivative interest rate hedging and therefore do not reflect economic margins earned.

#### 50 Interest Rate Sensitivity Gap

In the tables below the carrying amounts of derivative financial instruments, financial assets and liabilities held for trading and the assets and liabilities of the disposal group are included as internal funding of the trading book. The notional principal amounts associated with those derivatives which are used to reduce the Group's exposure to interest rate movements are shown as part of net hedging derivatives. This includes derivatives held for economic hedging purposes which do not meet the hedge accounting requirements of IAS39. The estimated potential loss arising from the Group's exposure to interest rate risk from the Group's trading activities is shown in Note 55 for 2007 and in Note 51 Trading Value at Risk' for 2006. Additional information on the Group's management of interest rate risk is given in the Risk Management note.



The tables summarise the repricing profiles of the Group's assets and liabilities as follows:

	2006								Non- interest bearing items
	Up to 1 month	1 to 3 months	3 to 12 months	1 to 2 years	2 to 3 years £m	3 to 4 years	4 to 5 years	Over 5 years	
<b>Assets</b>									
Loans and advances to banks	5,914	1,962	856	246	150	7	9	186	95
Loans and advances to customers	229,117	29,235	32,114	48,395	12,937	7,870	8,530	8,392	218
Investment securities	23,539	15,650	1,370	537	563	494	787	6,707	4,148
Other assets, prepayments and accrued income									20,937
	<u>258,570</u>	<u>46,847</u>	<u>34,340</u>	<u>49,178</u>	<u>13,650</u>	<u>8,371</u>	<u>9,326</u>	<u>15,285</u>	<u>25,398</u>
<b>Liabilities</b>									
Deposits by banks	16,181	10,822	2,880	276	56	35	40	68	198
Customer accounts	169,644	10,423	19,183	4,055	1,985	509	355	1,435	4,268
Insurance contract liabilities <sup>(1)</sup>									3,806
Investment contract liabilities <sup>(1)</sup>									1,542
Debt securities in issue	29,031	102,921	26,039	3,905	4,017	4,120	2,020	12,004	(407)
Other borrowed funds	174	3,054	566	928	335	504	697	11,823	1,611
Other liabilities, accruals and deferred income									13,595
Shareholders' equity									21,171
Internal funding of trading book	(25,003)	(1,878)	(247)	(74)	33	(5)	(4)	45	2,042
	<u>190,027</u>	<u>125,342</u>	<u>48,421</u>	<u>9,090</u>	<u>6,426</u>	<u>5,163</u>	<u>3,108</u>	<u>25,375</u>	<u>47,826</u>
Policyholder liabilities less assets <sup>(2)</sup>									187
	<u>68,543</u>	<u>(78,495)</u>	<u>(14,081)</u>	<u>40,088</u>	<u>7,224</u>	<u>3,208</u>	<u>6,218</u>	<u>(10,090)</u>	<u>(22,615)</u>
Net hedging derivatives	(38,949)	48,580	8,676	(30,974)	(6,638)	241	(645)	19,709	
Total interest rate sensitivity gap	<u>29,594</u>	<u>(29,915)</u>	<u>(5,405)</u>	<u>9,114</u>	<u>586</u>	<u>3,449</u>	<u>5,573</u>	<u>9,619</u>	<u>(22,615)</u>
Cumulative interest rate sensitivity gap	<u>29,594</u>	<u>(321)</u>	<u>(5,726)</u>	<u>3,388</u>	<u>3,974</u>	<u>7,423</u>	<u>12,996</u>	<u>22,615</u>	

Notes:

- (1) Long term insurance, investment contract liabilities, related reinsurance and value of in-force long term assurance business assets are measured taking into account discount rates. However, the expected cash flows underlying the valuations are not directly subject to interest rate risks. Accordingly, these balances have been included in non-interest bearing items in the table above. The sensitivity of the Group to changes in interest rates related to long term insurance and investment contracts is set out in Note 24.
- (2) Assets and liabilities associated with policyholder funds and collective investment schemes shown in Note 53 have been excluded from the repricing profile in the above table. This is on the basis that the underlying interest rate risks inherent in the net assets of the funds are matched by the policyholder liabilities, limiting the impact of these risks on the Group results.

	2005								Non-interest bearing items
	Up to 1 month	1 to 3 months	3 to 12 months	1 to 2 years	2 to 3 years £m	3 to 4 years	4 to 5 years	Over 5 years	
<b>Assets</b>									
Loans and advances to banks	7,542	5,155	2,161	310	191	83	31	11	422
Loans and advances to customers	220,777	20,654	27,506	33,228	18,820	5,691	5,616	9,564	1,912
Investment securities	21,649	14,281	1,062	225	129	319	241	4,573	9,082
Other assets, prepayments and accrued income									18,274
	<u>249,968</u>	<u>40,090</u>	<u>30,729</u>	<u>33,763</u>	<u>19,140</u>	<u>6,093</u>	<u>5,888</u>	<u>14,148</u>	<u>29,690</u>
<b>Liabilities</b>									
Deposits by banks	19,032	8,549	3,669		174		35	446	134
Customer accounts	161,414	15,728	16,516	2,337	1,617	708	365	97	2,166
Insurance contract liabilities <sup>(1)</sup>									4,019
Investment contract liabilities <sup>(1)</sup>									2,800
Debt securities in issue	28,522	86,988	18,488	3,482	4,061	4,429	4,522	6,393	1,076
Other borrowed funds	188	1,488	786	236	688	1,093	866	14,340	569
Other liabilities, accruals and deferred income									11,406
Shareholders' equity									18,456
Internal funding of trading book	(14,634)	(2,686)	(1,237)		(41)				
	<u>194,522</u>	<u>110,067</u>	<u>38,222</u>	<u>6,055</u>	<u>6,499</u>	<u>6,230</u>	<u>5,788</u>	<u>21,276</u>	<u>40,626</u>
Policyholder liabilities less assets <sup>(2)</sup>									224
	<u>55,446</u>	<u>(69,977)</u>	<u>(7,493)</u>	<u>27,708</u>	<u>12,641</u>	<u>(137)</u>	<u>100</u>	<u>(7,128)</u>	<u>(11,160)</u>
Net hedging derivatives	1,283	8,136	9,044	(24,002)	(12,166)	2,187	1,362	14,156	
Total interest rate sensitivity gap	<u>56,729</u>	<u>(61,841)</u>	<u>1,551</u>	<u>3,706</u>	<u>475</u>	<u>2,050</u>	<u>1,462</u>	<u>7,028</u>	<u>(11,160)</u>
Cumulative interest rate sensitivity gap	<u>56,729</u>	<u>(5,112)</u>	<u>(3,561)</u>	<u>145</u>	<u>620</u>	<u>2,670</u>	<u>4,132</u>	<u>11,160</u>	

Notes:

(1) Long term insurance, investment contract liabilities, related reinsurance and value of in-force long term assurance business assets are measured taking into account discount rates. However, the expected cash flows underlying the valuations are not directly subject to interest rate risks. Accordingly, these balances have been included in non-interest bearing items in the table above. The sensitivity of the Group to changes in interest rates related to long term insurance and investment contracts is set out in Note 24.

(2) Assets and liabilities associated with policyholder funds and collective investment schemes shown in Note 53 have been excluded from the repricing profile in the above table. This is on the basis that the underlying interest rate risks inherent in the net assets of the funds are matched by the policyholder liabilities, limiting the impact of these risks on the Group results.

## 51 Trading Value at Risk

The Group's Value at Risk ("VaR") methodology of estimating potential losses arising from the Group's exposure to market risk is explained in the Risk Management note. The Group's trading market risk exposure for the year ended 31 December 2006 is analysed below.

Exposure	As at 31 December 2006	As at 31 December 2005	Average 2006	2005	Highest 2006	2005	Lowest 2006	2005
<b>Total value at risk</b>	4.5	5.7	4.2	6.1	6.5	8.8	2.9	3.7
Included in the above								
Value at risk relating to:								
Interest rates	2.2	1.4	2.4	1.9	4.0	3.7	1.4	0.6
Credit spread	2.0	3.9	1.4	3.1	3.9	4.6	0.9	1.7
Foreign exchange	0.2	0.3	0.3	0.6	0.8	2.5	0.1	0.1
Equity risk factor	0.1	0.1	0.1	0.5	0.4	1.2		

For all significant exposures VaR is calculated on a daily basis. Interest rate risk relating to the trading book is principally managed using a sensitivity methodology to measure exposure and set

limits. This methodology calculates the present value impact of a one basis point movement in interest rates on the outstanding positions. Credit spread risk is managed using a credit spread VaR and position limits based on credit spread sensitivity. Foreign exchange risk is principally managed by the use of position limits. Equity risk is managed through an Equity Index VaR and position limits.

## 52 Assets and Liabilities in Foreign Currencies

	2006	2005
	£m	
The aggregate amounts of assets and liabilities denominated in currencies other than Sterling were:		
Assets	133,697	195,599
Liabilities	169,828	218,502

The above figures do not reflect the Group's exposure to foreign exchange, which is significantly lower as it is hedged by currency derivatives.

## 53 Maturity Analysis of Assets and Liabilities

The tables below break down the Group's financial assets and liabilities excluding policyholder funds by remaining contractual maturity. Policyholder funds are excluded from the maturity profile in the table as the underlying liquidity risks are for the account of the policyholders and have no direct impact on the Group's results.

	Up to 1 month	1 to 3 months	3 to 12 months	2006 1 year to 5 years £m	Over 5 years	Policyholder funds	Total
<b>Assets</b>							
Cash and balances at central banks	1,956		10				1,966
Items in course of collection	880						880
Financial assets held for trading	14,177	13,619	7,628	8,686	5,029		49,139
Derivative assets	157	688	1,053	2,417	3,967	330	8,612
Loans and advances to banks	1,218	6,640	1,037	528	2	2,168	11,593
Loans and advances to customers	45,169	54,797	13,123	39,827	223,892		376,808
Investment securities	3,257	1,700	1,578	12,404	34,856	63,236	117,031
Other financial assets	1,737					424	2,161
<b>Total</b>	<b>68,551</b>	<b>77,444</b>	<b>24,429</b>	<b>63,862</b>	<b>267,746</b>	<b>66,158</b>	<b>568,190</b>
<b>Liabilities</b>							
Deposits by banks	11,866	11,817	3,145	1,215	2,513	1	30,557
Customer accounts	177,826	16,979	10,067	5,361	1,624		211,857
Financial liabilities held for trading	8,923	5,572	7,598	241			22,334
Derivative liabilities	327	1,087	1,106	2,846	5,109	280	10,755
Insurance contract liabilities	1,107	20	163	436	2,080	21,171	24,977
Investment contract liabilities	365	3	914	42	218	47,944	49,486
Unallocated surplus						1,543	1,543
Debt securities in issue	17,030	52,970	27,906	34,381	51,363		183,650
Other borrowed funds	141	1,809	420	2,223	15,099		19,692
Other financial liabilities	2,151					503	2,654
<b>Total</b>	<b>219,736</b>	<b>90,257</b>	<b>51,319</b>	<b>46,745</b>	<b>78,006</b>	<b>71,442</b>	<b>557,505</b>

	<i>Up to 1 month</i>	<i>1 to 3 months</i>	<i>3 to 12 months</i>	<i>2005 1 year to 5 years £m</i>	<i>Over 5 years</i>	<i>Policyholder funds</i>	<i>Total</i>
<b>Assets</b>							
Cash and balances at central banks	1,670		8				1,678
Items in course of collection	753						753
Financial assets held for trading	14,992	10,251	6,504	1,826	8,193		41,766
Derivative assets	444	580	816	2,336	6,239	84	10,499
Loans and advances to banks	8,161	5,225	1,868	272	380	1,450	17,356
Loans and advances to customers	27,566	50,604	14,885	47,363	203,350		343,768
Investment securities	3,370	302	2,209	8,438	37,242	52,773	104,334
Other financial assets	909					888	1,797
<b>Total</b>	<b>57,865</b>	<b>66,962</b>	<b>26,290</b>	<b>60,235</b>	<b>255,404</b>	<b>55,195</b>	<b>521,951</b>
<b>Liabilities</b>							
Deposits by banks	16,904	11,072	3,810	187	66	2	32,041
Customer accounts	174,659	11,037	9,052	3,198	3,002		200,948
Financial liabilities held for trading	13,727	5,106	6,021	153			25,007
Derivative liabilities	323	821	735	2,319	4,378		8,576
Insurance contract liabilities	84	166	805	892	2,072	17,951	21,970
Investment contract liabilities	6	22	2,310	462		39,357	42,157
Unallocated surplus						974	974
Debt securities in issue	19,265	38,851	23,200	37,909	38,736		157,961
Other borrowed funds	93	49	587	1,195	18,330		20,254
Other financial liabilities	115					1,123	1,238
<b>Total</b>	<b>225,176</b>	<b>67,124</b>	<b>46,520</b>	<b>46,315</b>	<b>66,584</b>	<b>59,407</b>	<b>511,126</b>

The tables below set out the assets and liabilities of the policyholder funds comprising the unit-linked and with-profit funds as well as the consolidated collective investment schemes. The insurance and investment contract liabilities have been analysed between due within one year and due in one year or more based on net expected cash flows. Investment securities and derivative assets have been categorised as current assets on the basis that they stand ready to be traded either as part of the normal portfolio management process or to meet policyholder withdrawals. The remaining assets and liabilities have been categorised as due within one year and due in one year or more based on their expected maturities.

	<i>Due within 1 year</i>	<i>2006 Due in 1 year or more £m</i>	<i>Total</i>
<b>Assets</b>			
Derivative assets	330		330
Loans and advances to banks	2,168		2,168
Investment securities	63,236		63,236
Investment properties		4,911	4,911
Property and equipment		186	186
Other assets	424		424
<b>Total Assets<sup>(1)</sup></b>	<b>66,158</b>	<b>5,097</b>	<b>71,255</b>
<b>Liabilities</b>			
Deposits by banks	1		1
Derivative liabilities	280		280
Insurance contract liabilities	2,058	19,113	21,171
Investment contract liabilities	4,419	43,525	47,944
Unallocated surplus		1,543	1,543
Other liabilities	503		503
<b>Total Liabilities</b>	<b>7,261</b>	<b>64,181</b>	<b>71,442</b>

Note:

(1) Policyholder assets have been reduced by £187m in respect of holdings of the Company's shares that are held within the funds.

	<i>Due within 1 year</i>	<i>2005 Due in 1 year or more £m</i>	<i>Total</i>
<b>Assets</b>			
Derivative assets	84		84
Loans and advances to banks	1,450		1,450
Investment securities	52,773		52,773
Investment properties		3,824	3,824
Property and equipment		164	164
Other assets	888		888
<b>Total Assets<sup>(1)</sup></b>	<b>55,195</b>	<b>3,988</b>	<b>59,183</b>
<b>Liabilities</b>			
Deposits by banks	2		2
Insurance contract liabilities	2,399	15,552	17,951
Investment contract liabilities	4,189	35,168	39,357
Unallocated surplus		974	974
Other liabilities	1,123		1,123
<b>Total Liabilities</b>	<b>7,713</b>	<b>51,694</b>	<b>59,407</b>

Note:

(1) Policyholder assets have been reduced by £224m in respect of holdings in the Company's shares that are held within the funds.

## 54 Acquisitions

On 31 May 2006 the Group acquired control of the 50 per cent. of the ordinary share capital of Lex Vehicle Leasing (Holdings) Limited (“Lex”) previously owned by its fellow joint venturer, the RAC, making Lex a wholly owned subsidiary. The consideration payable in cash including costs of acquisition totalled £235m of which £232m has been paid with £3m payable in annual instalments over the next six years.

The fair value of the identifiable assets, liabilities and contingent liabilities acquired totalled £84m. The principal fair value adjustments relating to the balance sheet of Lex comprise a payment to the RAC pension scheme, representing the statutory debt due to that scheme of £53m and an upward revaluation of the car fleet of £17m. A net charge of £15m reflecting the post-tax difference between the book value and fair value of the net assets already owned by the Group has been booked directly to retained earnings. Goodwill of £151m arose on acquisition, attributable to obtaining a market leading position and the expectation of cost synergies. The post-acquisition profit before tax attributable to the 50 per cent. acquired for the seven months to 31 December 2006 included in the Group’s consolidated income statement for the year ended 31 December 2006 is £14m.

On 16 July 2006, the Group acquired a 58.3 per cent. equity interest in Mother Topco Limited for £175m. Subsequently, on 31 October 2006, the Mother Topco Limited group of companies acquired 100 per cent. of the equity of McCarthy & Stone, a UK provider of retirement homes. The cost of this acquisition was £1,128m. The assets and liabilities of the sub-group headed by Mother Topco Limited are classified as a disposal group (Note 12). The post-acquisition profit after tax of this group of companies was £5m.

On 1 August 2006 the Group acquired Mourants Equity Compensation Solutions Ltd, a share scheme administration business. The cost of consideration, paid in cash including costs of acquisition, totalled £29m. The fair value of the identifiable assets, liabilities and contingent liabilities acquired totalled £12m. Goodwill of £17m arose on acquisition, representing access to new markets, an assembled workforce and cost synergies.

## 55 Risk Management

### Management of Key Risks

The Group is committed to developing its risk management techniques and methodologies, both to maintain high standards of risk management practice and to fulfil the requirements of UK and international regulators.

### Credit Risk

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

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

Group Credit, a specialist support function within Group Risk, provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance of each divisional portfolio to the Group Credit Risk Committee, Group Credit exercises independent oversight over the effectiveness of credit risk management arrangements and adherence to approved policies, standards and limits.

Day-to-day management of credit risk is undertaken by specialist credit teams working within each Division in compliance with policies approved by the Board. Typically functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts and credit risk model build and governance.

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

- for retail portfolios use is made of credit scoring software for new applications. In addition, behavioural scoring is used to provide an assessment of the conduct of a customer's accounts in granting extensions to, and setting limits for, existing facilities. Affordability is a vitally important measure and is reviewed in combination with either application and/or behavioural scores. Small business customers may be rated using scorecards in a similar manner to retail customers.
- for corporate portfolios a full independent credit assessment of the financial strength of each potential transaction and/or customer is undertaken, awarding an internal risk rating which is reviewed regularly. The same approach is also used for larger SME (small to medium enterprise) customers; and
- within Treasury Division (Treasury), which handles the Group's banking and sovereign related exposures, as well as the Group's structured credit bond (ABS) portfolio held for liquidity and proprietary purposes, focused credit risk policies are established and reviewed by Group Wholesale Credit Committee ("GWCC"), a sub-committee of the Group Credit Risk Committee. Basel II Advanced IRB compliant models are used to rate banking and sovereign counterparties. Structured credit bonds are reviewed individually by an independent credit function prior to purchase and an internal rating is applied to all exposures. The rating assessment is commensurate with, and often more stringent than, those of the external credit rating agencies. Additional thresholds and limits are applied by rating and asset class and, as part of an ongoing portfolio review process, thorough surveillance is performed covering each bond holding, supplemented by stress analyses conducted on a periodic basis.

An additional measure within the credit risk framework is the establishment of product, industrial sector and country limits to avoid excessive concentrations of risk. Material portfolios, such as mortgages, have approved sub-sector limits to ensure that they remain within plan and tolerance for risk. All such limits are set and monitored by the Group Credit Risk Committee. Standards have been established across the Group for the management of credit risk. All Divisions are committed to continuously improving credit risk management. There continues to be investment in the development of credit risk rating tools, including enhancements to the portfolio risk measurement systems and in governance arrangements to support operations within the terms of the Basel II Accord. These include principles for development, validation and performance monitoring of credit risk models. The approval process for credit models is dependant upon materiality, with all models impacting the regulatory capital calculation requiring approval by the Group Credit Risk Committee and those deemed material to the Group being approved by the Group Capital Committee.

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

#### **Financial instruments subject to credit risk**

The table below sets out the Group's exposure to credit risk relating to financial instruments before taking account of collateral and other security. Policyholder assets are excluded from the analysis in the table as the underlying credit risks are for the account of the policyholders and have no direct impact on the Group's results. A full reconciliation between the Group's consolidated balance sheet and financial instruments subject to credit risk is set out in Note 43 to the Financial Statements.

	<i>Financial instruments subject to credit risk</i>	
	<i>As at</i>	<i>As at</i>
	<i>31 December</i>	<i>31 December</i>
	<i>2007</i>	<i>2006</i>
	<i>£m</i>	
Loans and advances to customers	430,007	376,808
Financial assets held for trading	54,681	49,139
Debt securities	56,839	49,901
Other financial assets	24,215	22,290
	<hr/>	<hr/>
Contingent liabilities and commitments	565,742	498,138
	106,718	90,944
	<hr/>	<hr/>
<b>Total</b>	<b>672,460</b>	<b>589,082</b>
	<hr/> <hr/>	<hr/> <hr/>

### **Loans and advances to customers**

Loans and advances to customers are managed on a divisional basis. Information about the credit quality of loans and advances to customers is set out in Note 43 to the Financial Statements.

### **Financial assets held for trading**

Management of credit risk within Treasury portfolios relies on obtaining detailed knowledge and understanding of the assets and issuers it deals with. As described above, a full credit analysis is undertaken and, based upon that, an internal rating is derived which helps to establish a credit appetite for the issuer or asset intended to be acquired.

As Treasury manages the liquidity of the HBOS Group, its mandate is to maintain a high quality credit portfolio and, in addition to the credit process mentioned above, it also actively uses portfolio techniques to manage and monitor the quality of its portfolios, and to avoid concentration risk.

This includes the use of rating based thresholds, established portfolio level thresholds, asset class limits and sub-limits. There are also rules governing the types of assets that can be held within Treasury's Liquidity portfolios, Trading and Banking books and for individual (ABS) tranche sizes. There are also limits controlling the maximum weighted average life of assets.

Financial assets held for trading are almost exclusively investment grade investments with 99.6 per cent. (2006 99.5 per cent.) of inter-bank and structured investment portfolios rated "A" or above based on an internal credit ratings scale that is, in general, aligned with the ratings scales of the major credit ratings agencies (Moody's, S&P and Fitch).

	<i>As at</i>	<i>As at</i>
	<i>31 December</i>	<i>31 December</i>
	<i>2007</i>	<i>2006</i>
	<i>%</i>	
AAA	51.5	51.9
AA	34.4	30.6
A	13.7	17.0
Below A	0.4	0.5



## Debt securities

Debt securities are primarily held within the Treasury or Insurance & Investment Divisions and are almost exclusively invested in investment grade counterparties with 96.5 per cent. (2006 94.0 per cent.) of debt securities rated "A" or above, again based on our internal rating scale.

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	%	
AAA	57.8	67.6
AA	25.8	18.2
A	12.9	8.2
Below A	3.5	6.0

The AAA proportion of the portfolio fell during 2007 due to two factors: (i) a reduction in Sovereign assets and (ii) an increase in the size of the portfolio comprising mainly AA and A assets, thereby reducing the AAA proportion.

## Other financial assets

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

## Market Risk

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

- changes in external market factors such as interest rates (interest rate risk), foreign exchange rates (foreign exchange risk), commodities and equities; and
- the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions.

The objectives of the Group's market risk framework are to ensure that:

- market risk is taken only in accordance with the Board's appetite for such risk;
- such risk is within the Group's financial capability, management understanding and staff competence;
- the Group complies with all regulatory requirements relating to the taking of market risk; and
- the quality of the Group's profits is appropriately managed and its reputation safeguarded.

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

The Group devotes resources to ensuring that market risk is comprehensively captured, accurately modelled and reported, and effectively managed. Trading and non-trading portfolios are managed at various organisational levels, from the HBOS Group overall, down to specific business areas. Market risk measurement and management methods are designed to meet or exceed industry standards, and the tools used facilitate internal market risk management and reporting.

Market risk is controlled across the Group by setting limits using a range of measurement methodologies. The principal methodologies are Net Interest Income ("Nil") sensitivity and Market Value ("MV") sensitivity for banking books and Value at Risk ("VaR") for trading books. All are supplemented by scenario analysis which is performed in order to estimate the potential economic loss that could arise from extreme, but plausible stress events.

Detailed market risk framework documents and limit structures have been developed for each Division. These are tailored to the specific market risk characteristics and business objectives of each Division. Each divisional policy requires appropriate divisional sanction, and is then forwarded to the Group Market Risk Committee for approval on at least an annual basis.

Market risk within the insurance and investment businesses arises in a number of ways and depending upon the product: some risks are borne directly by the customer and some by the insurance and investment companies. Risk to customers is controlled by adherence to and regular monitoring of investment mandates and, if appropriate, unit pricing systems and controls. In the

case of risk to the companies, individual Boards approve overall risk appetites and policies against which exposure is monitored.

Market risk – principally interest rate, inflation and equity – also arises from the Group’s defined benefit pensions obligations. These sensitivities are regularly measured and are reported to the Group Market Risk Committee every month.

### Interest Rate Risk (Non-Trading)

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

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

- Net Interest Income sensitivity – This methodology comprises an analysis of the Group’s current interest rate risk position overlaid with behavioural assessment and re-pricing assumptions of planned future activity. The change to forecast Nil is calculated with reference to a set of defined parallel interest rate shocks which measure how much current projections would alter over a 12 month period.
- Market Value sensitivity – This methodology considers all re-pricing mismatches in the current balance sheet including those beyond the time horizon of the Nil measure. It is also calculated with reference to a set of defined parallel interest rate shocks.

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

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

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

### Net Interest Income Sensitivity

The following table shows, split by major currency, the Group’s sensitivities as at 31 December 2007 to an immediate up and down 25 basis points change to all interest rates.

<i>Impact of interest rate shift</i>	<i>As at 31 December 2007</i>	
	<i>+ 25bps</i>	<i>- 25bps</i>
	<i>£m</i>	
<b>Currency</b>		
Sterling	(21.2)	21.6
US Dollar	(0.6)	0.5
Euro	(4.3)	4.3
AU Dollar	0.1	(0.1)
Other	0.1	(0.1)
<b>Total</b>	<b>(25.9)</b>	<b>26.2</b>

<i>Impact of interest rate shift</i>	<i>As at 31 December 2006</i>	
	<i>+ 25bps</i>	<i>- 25bps</i>
	<i>£m</i>	
<b>Currency</b>		
Sterling	(14.1)	16.0
US Dollar	(1.2)	1.2
Euro	(4.4)	4.4
AU Dollar	1.0	(1.2)
Other	(0.2)	0.2
<b>Total</b>	<b>(18.9)</b>	<b>20.6</b>

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

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

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

### Reserve Sensitivity

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

<b>Impact of interest rate shift</b>	<i>As at 31 December 2007</i>	
	<i>+ 25bps</i>	<i>- 25bps</i>
	<i>£m</i>	
Available for sale reserve	(15.7)	15.7
Cash flow hedge reserve	101.5	(101.5)
<b>Total</b>	<b>85.8</b>	<b>(85.8)</b>

<b>Impact of interest rate shift</b>	<i>As at 31 December 2006</i>	
	<i>+ 25bps</i>	<i>- 25bps</i>
	<i>£m</i>	
Available for sale reserve	(21.9)	21.9
Cash flow hedge reserve	76.4	(76.4)
<b>Total</b>	<b>54.5</b>	<b>(54.5)</b>

### Foreign Exchange Risk (Non-Trading)

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

structural currency risk. The actual risk position is monitored monthly by the Group Market Risk Committee.

Transaction exposures arise primarily from profits generated in the overseas operations, which will be remitted back to the UK and then converted into sterling.

Translation exposures arise due to earnings that are retained within the overseas operations and reinvested within their own balance sheet.

Structural currency exposures arise from the Group's investments in overseas subsidiaries, branches and other investments and are given in Note 44.

As at 31 December 2007 and 31 December 2006 there are no material net currency exposures in the non-trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses.

## **Trading**

The Group's market risk trading activities are conducted by Treasury. This Group activity is subject to a Trading Book Policy Statement, which is approved by the Board, and limits set by the Group Market Risk Committee.

Treasury trading primarily centres around two activities: proprietary trading and trading on the back of business flows. Both activities incur market risk, the majority being interest rate and foreign exchange rate exposure. In addition, a number of marketable assets held as part of our liquidity risk management framework are also held in trading books. Such activity gives rise to market risk as a result of movements in credit spread.

The framework for managing the market risk in these activities requires detailed and tailored modelling techniques, which are the responsibility of the Treasury Market Risk team.

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

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

The underlying assumption of VaR is that future price volatility and correlation will not differ significantly from that previously observed. It also implicitly assumes that all positions are sufficiently liquid to be realisable within the chosen one day holding period. Also, VaR gives no indication of the size of any loss that could occur from extreme adverse price changes (i.e., outside the chosen confidence level). For these reasons, stress testing is employed to simulate the effect of selected adverse market movements. Such measures are particularly relevant when market conditions are abnormal and daily price movements are difficult to source, as has been the case in a number of financial markets since August 2007.

The large increase in VaR, relative to 31 December 2006, is due principally to higher price volatility in wholesale markets – the size of underlying trading positions has not changed materially.

The regulatory capital charge for market risk trading exposures represents only 1.87 per cent. (2006 1.93 per cent.) of the Group's capital base.

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

The Group's trading market risk exposure for the year ended 31 December 2007 is analysed below.

Exposure	As at 31	As at 31	Average	2006	Highest	2006	Lowest	2006
	December	December			2007		2007	
	2007	2006	2007	£m	2007	2006	2007	2006
<b>Total Value at Risk</b>	13.2	4.5	7.6	4.2	13.9	6.4	4.0	2.9
Included in the above is the Value at Risk relating to:								
Interest rates	4.7	2.2	3.0	2.4	5.9	3.9	1.7	1.4
Credit spread	8.3	2.0	4.3	1.4	8.4	3.9	1.8	0.9
Foreign exchange	1.9	0.2	0.6	0.3	2.0	0.7	0.1	0.1
Equity risk factor	0.2	0.1	0.2	0.1	0.4	0.4		

## Derivatives

In the normal course of business, the Group uses a limited range of derivative instruments for both trading and non-trading purposes. The principal derivative instruments used are interest rate swaps, interest rate options, cross currency swaps, forward rate agreements, credit derivatives, forward foreign exchange contracts and futures. The Group uses derivatives as a risk management tool for hedging interest rate and foreign exchange rate risk.

The Group's activity in derivatives is controlled within risk management limits set by the Board and overseen by the relevant Group Risk Committees. Details of derivative contracts outstanding at the year-end are included in Note 13 to the Financial Statements.

## Liquidity Risk

***The risk that the Group does not have sufficient financial resources to meet its obligations when they are due or will have to do so at excessive cost.***

Liquidity Risk is governed by the Group Liquidity Policy Statement ("GLPS") which is approved by the Board and defines the core principles for identifying, measuring, managing and monitoring liquidity risk across the Group. Detailed liquidity risk framework documents and limit structures are in place for the Group's operations, where liquidity is managed on a group basis, and for overseas banking units subject to specific regulatory requirements. The responsibility for oversight and management of Liquidity Risk is delegated to the Group Capital Committee ("GCC").

Policy is reviewed at least annually to ensure its continued relevance to the Group's current and planned operations. Operational liquidity management is delegated to Treasury. The authority to set specific limits and guidelines and responsibility for monitoring and controlling liquidity is delegated by the GCC to the Group Funding and Liquidity Committee ("GFLC") (a sub-committee of the GCC).

The Group's banking operations in the UK comply with the FSA's Sterling Stock Liquidity approach for sterling liquidity management and regulatory reporting. A key element of the FSA's Sterling Stock Liquidity Policy is that a bank should hold a stock of high quality liquid assets that can be sold quickly and discretely in order to replace funding that has been withdrawn due to an actual or perceived problem with the bank. The objective is that this stock should enable the bank to continue business, whilst providing an opportunity to arrange more permanent funding solutions. Limits on the five day sterling net wholesale outflow and the minimum level of stock liquidity have been agreed with the FSA. In addition, GFLC has set a requirement for the stock liquidity ratio of at least 105 per cent. (FSA minimum level 100 per cent.).

HBOS also adheres to the requirements of other regulatory authorities including the Australian Prudential Regulatory Authority and the Irish Financial Regulator in whose jurisdictions the Group has branches or subsidiaries.

The internal approach to liquidity management, which has been in place for several years, goes beyond the regulatory requirements (in terms of the depth of analysis conducted and the amount of liquidity held). The approach looks at our forecast cash flows across all currencies and at longer timeframes than the regulatory rules require. At 31 December 2007, the Group's liquidity portfolio of marketable assets was £60.0bn (2006 £56.4bn). The liquidity portfolio is recorded in Treasury and predominantly comprises Treasury debt securities, excluding Grampian and Landale. The assets in the liquidity portfolio are treated in two forms. Firstly, assets which we know to be eligible under normal arrangements with the Bank of England, the European Central Bank and the Federal

Reserve. Secondly, a substantial pool of high quality secondary liquidity assets that allow us to manage through periods of stress taking into account the likely behaviours of depositors and wholesale markets. These approaches are supported by a framework of limits to ensure we are not subject to undue concentrations for either our assets or liabilities and by daily control processes to address both regulatory and internal requirements. In 2007, the primary method of realising the liquidity portfolio for cash has been via repo rather than outright sale. This framework includes:

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

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements.

In addition to day to day prudential limits, the liquidity framework has two other important components.

Firstly, HBOS “stress tests” its potential cash flow mismatch position under various scenarios on an ongoing basis, with formal Group reporting at least monthly, in compliance with FSA regulations. The cash flow mismatch position considers on balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position.

Scenarios are based on varying degrees of stress and cover both HBOS name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.

An example of a name specific scenario we model is a substantial fall in our credit rating. In such a scenario we assess the likely impact on customer deposits and assume the wholesale markets would be closed to us. Our approach is to hold substantial liquidity assets which would provide sufficient time for management to take appropriate mitigating actions. We also model the impact of systemic events across the banking sector. Typically the impact of these is less severe as wholesale markets normally continue to provide some funding and concerted central bank action would be expected to address such market dislocation.

The results of the stress testing are presented monthly to the GFLC. A formal strategic review is presented to the HBOS plc Board at least annually.

Secondly, the Group has a Liquidity Contingency Plan embedded within the Group Liquidity Policy Statement which has been designed to identify emerging liquidity concerns at an early stage, so that action can be taken to avoid a more serious crisis developing. This is achieved through the use of Early Warning Indicators (“EWIs”).

Clear guidelines are set out for the management escalation process in the event of EWIs triggering and the actions to be taken (short and medium term) should such an event take place. Responsibilities for communication with various external parties and contact details of key personnel are also clearly stated.

In response to the market dislocation in the second half of 2007, the GCC has increased the frequency of its meetings and Treasury has introduced additional metrics which are monitored daily and tailored to prevailing market conditions.

## Funding

Customer deposit growth and the supply of wholesale funding to HBOS have remained strong during the dislocation in global financial markets in the latter part of 2007.

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	<i>£bn</i>	
Loans and advances to customers	430.0	376.8
Customer accounts	243.2	211.9
Customer lending less customer accounts	186.8	164.9
Customer accounts as a % of loans and advances to customers	56.6%	56.2%

The wholesale funding capacity of the Group is dependant upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position. GFLC assesses the Group funding mix to ensure that adequate diversity is maintained. It is Group policy to manage its balance sheet profile to ensure customer deposits sourced outside Treasury represents a significant component of overall funding, and GFLC directs and coordinates the activities of the Divisions in raising liabilities from a range of sources.

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

- widening the wholesale investor base and product set;
- building and maintaining a large securitisation programme;
- accessing the covered bond market;
- utilising the geographic diversity of New York and Sydney as funding hubs for the Group; and
- extending our Medium Term Note programmes.

During 2007 the Group's wholesale funding sources were well diversified by instrument, currency and by maturity as shown in the tables on the following page. Tables are prepared on the basis that "retail" is defined using the current statutory definition, i.e., administered rate products. Wholesale funding, when issued in a foreign currency but swapped into sterling, is included at the swap exchanged amount. Wholesale funding is shown excluding any repo activity and the funding raised in the names of the conduits.

During the second half of 2007, with the increased cost of term funding we chose to reduce our term issuance and utilise our significant available capacity in money markets.

However, covered bonds and securitisation issues continue to be important funding sources for the Group with outstandings as at the end of December 2007 of £69.6bn, an increase of £5.2bn during 2007. In addition, issuance of CDs rose to £63.1bn compared with £42.5bn at the end of 2006. As at the end of December 2007, £113.9bn of wholesale funding had a maturity over one year compared with £109.8bn at the end of 2006.

## Conduits

HBOS sponsors two conduits, Grampian and Landale, which are special purpose vehicles that invest in highly rated assets and fund via the Asset Backed Commercial Paper ("ABCP") market. At 31 December 2007, investments held by Grampian totalled £18.6bn. Grampian is, and always has been, fully consolidated into our balance sheet. We also consolidated £0.6bn of assets held by Landale. Grampian is a long established, high grade credit investment vehicle that invests in diversified Asset Backed Securities of which over 99.9 per cent. are rated AAA by S&P and Aaa by Moody's. Grampian has a liquidity line in place with HBOS which covers all of the assets and programme wide credit enhancement is also provided by HBOS. Landale holds both assets originated from our own balance sheet and third party transactions. Landale has liquidity lines from HBOS and from third party banks, and therefore the former, but not the latter, are consolidated into our balance sheet.

In the latter half of 2007, due to the disruption in the ABCP market, there have been occasions when Grampian and Landale (in respect of assets backed by HBOS liquidity lines) have declined to issue ABCP given the unattractiveness of the spreads and maturities available. At these times

we therefore funded the conduits, on a temporary basis, through the available liquidity lines rather than through the ABCP market. At 31 December 2007, HBOS had provided funding to the Grampian and Landale conduits of £8.1bn.

<i>Retail and Wholesale Funding sources Instrument</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
Bank Deposits	32.9	6.7	27.9	6.6
Deposits from Customers	27.8	5.6	17.1	4.0
Certificates of Deposit	63.1	12.8	42.5	10.0
MTNs issued	42.8	8.7	41.5	9.7
Covered Bonds	23.7	4.8	17.2	4.0
Commercial Paper	16.9	3.4	17.3	4.1
Securitisation	45.9	9.3	47.2	11.1
Subordinated Debt	20.0	4.1	15.4	3.6
Other	4.9	0.9	4.9	1.1
<b>Total Wholesale</b>	<b>278.0</b>	<b>56.3</b>	<b>231.0</b>	<b>54.2</b>
Retail	215.4	43.7	194.8	45.8
<b>Total Group Funding</b>	<b>493.4</b>	<b>100.0</b>	<b>425.8</b>	<b>100.0</b>

<i>Wholesale Funding – Currency</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
US dollar	104.5	37.6	87.2	37.7
Euro	79.0	28.4	65.3	28.3
Sterling	69.7	25.1	60.7	26.3
Other	24.8	8.9	17.8	7.7
<b>Total Wholesale Funding</b>	<b>278.0</b>	<b>100.0</b>	<b>231.0</b>	<b>100.0</b>

<i>Wholesale Funding – Residual Maturity</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
Less than one year	164.1	59.0	121.2	52.5
One to two years	21.6	7.8	19.3	8.4
Two to five years	46.3	16.7	46.5	20.1
More than five years	46.0	16.5	44.0	19.0
<b>Total Wholesale Funding</b>	<b>278.0</b>	<b>100.0</b>	<b>231.0</b>	<b>100.0</b>

## **General Insurance and Long Term Assurance**

### **Business Risks**

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

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

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

- Direct risks relating to changes in the value of Group assets in support of the general insurance and long term insurance contracts;



- Indirect risks arising from policyholder funds where the assets and policyholder liabilities are matched; and
- Indirect risks associated with the management of assets held on behalf of third parties.

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

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

The majority of the Group's long term insurance and investment contract liabilities are managed within the HBOS Insurance & Investment Division and Insight Investment with approximately 3 per cent. (2006 3 per cent.) operated by the life businesses outside the UK. Day-to-day management of insurance and investment risk is undertaken by management supported by specialist risk functions. Use is made of the statutory actuarial roles, both to help ensure regulatory compliance in respect of the authorised insurance companies in the Group and to help meet Group risk management standards.

### **Long Term Assurance**

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

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

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

The quality, mix and volume of business have a significant influence on the extent of insurance and investment risk assumed by the Group and resulting profits. The quality of business written is influenced by variations in product terms as well as the average premium size, age and term profile within the particular products. Accordingly, the mix in products written may impact on profits, depending on the nature, extent and profitability of new business in addition to existing business. This risk is managed through the application of clear pricing policies that require full financial assessment for each new product, incorporating consideration of expected hurdle rates of return. Additionally, variations in administration and development costs may impact the available profit margin within the product charges. To manage this risk, there is a regular process of expense budgeting and reporting with appropriate targets set for new insurance and investment products that are developed.

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

### **Unit Linked Funds**

For unit linked funds, including consolidated collective investment schemes, which comprise 77 per cent. (2006 74 per cent.) of the Group's long term insurance and investment contract liabilities, investors bear the investment risk, with changes in the underlying investments being matched by changes in the underlying contract liabilities. Similarly, the Group manages a number of collective investment schemes where the investors bear the investment risks. The investor selects from a range of investment opportunities available from the Group in accordance with their personal risk appetite and circumstances.

On a day-to-day basis, cash outflows which are necessitated by investors withdrawing their funds are generally met by cash inflows from new investors. In circumstances where funds are contracting, or to meet unusually high levels of withdrawals, the Group sells assets in the fund in order to meet the cash demands with any dealing costs charged to the underlying unit linked fund and consequently the policyholders. The underlying assets in the unit linked funds are subject to credit and market risks in the form of interest rate, equity prices, foreign exchange and other market risks depending on the fund, including movement in property values. These changes are matched by changes in the unit linked liabilities. Accordingly, the Group is not directly exposed to significant liquidity, credit or market risks, although the investors' benefits will vary as a consequence. Decreases in the capital value of unit linked funds (as a result of falls in market values of equities, property or fixed interest assets) will however reduce the future annual investment management charges that will be earned from unit linked business. The Group estimates that if the capital value of the unit linked funds, excluding consolidated collective investment schemes, classified as investment contracts had been reduced, on average by 10 per cent. for the year, the profit before tax for the year would have decreased by £22m (2006 £25m). For unit linked contracts classified as either insurance contracts or investment contracts with DPF the Group has considered the sensitivities to a number of risks in Note 24 to the Financial Statements.

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

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

### **Non-Profit Business**

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

The ultimate amounts payable under these policies are sensitive to general trends in mortality rates. For annuitants comprising 3 per cent. (2006 3 per cent.) of the Group's long term insurance and investment contract liabilities, there is a risk that increases to life expectancy through medical advances will prove greater than that anticipated. For protection business, the risk is that an unforeseen event such as a natural disaster will cause a material increase in death rates.

The extent of the Group's exposure to insurance risks is set out in Note 26 to the Financial Statements.

### **With-Profits Fund**

The insurance and investment business includes the Clerical Medical With-Profits Fund which comprises 17 per cent. (2006 20 per cent.) of the Group's long term insurance and investment contract liabilities. The with-profits fund takes some investment risks with the aim of enhancing policyholder returns but aims to limit payouts to policyholders to that supportable by the with-profits fund's assets.

For "unitised" with-profits contracts the Group receives an annual management charge. For "traditional" with-profits contracts, which form the minority of the with-profits fund business, the

Group receives one ninth of bonuses declared to policyholders as long as there is a distributable surplus within the fund.

Ordinarily, variations in the capital value of the fund's assets would result in variations in the level of benefits available to the with-profits contract holders and accordingly a variation in the insurance and investment contracts with DPF liabilities. Included in the with-profits fund are certain contracts with minimum payment guarantees at certain policy durations and on death. Of these with-profits contracts issued between 1997 and 2001, a significant proportion have guaranteed benefits which are in the money at the balance sheet date. The costs of meeting these guarantees, up to a certain level, are met by charges to the benefits for all with-profits contract policyholders. The amount of these guaranteed benefits, net of charges to be levied on policyholder funds, was less than 1 per cent. (2006 1 per cent.) of the Group's long term insurance and investment contract liabilities at the balance sheet date. Above this level the costs are met by the free assets of the fund (the assets maintained in the fund which are not held to meet contractual liabilities). There remains a risk that Clerical Medical may suffer an additional charge in exceptional circumstances where even after management action, the fund is unable to meet the costs of guarantees within the fund. This is set out in the Principles and Practices of the With-Profits Fund, available from the Clerical Medical Investment Group website ([www.clericalmedical.co.uk](http://www.clericalmedical.co.uk)).

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

Accordingly, other than the secondary impact on the Group's annual management charges and share of bonuses declared, the insurance and other investment risks (credit, liquidity and market risks) within the with-profits fund are generally expected to be borne by the with-profits fund policyholders except in extreme scenarios. The sensitivity of the Group result to certain changes in key variables relating to insurance and investment contracts with DPF within the with-profits fund have been included in Note 24 to the Financial Statements.

Additionally, in order to demonstrate the sensitivity of the with-profits fund to certain key market variables, and consequently the ability of the with-profits fund to meet its policyholders' expectations, the Group has set out a sensitivity analysis of unallocated divisible surplus in Note 28 to the Financial Statements.

### **General Insurance**

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

The Group manages its exposure to insurance risk through a strategy which includes limitation of the nature of the risks underwritten and allowance within the price charged for the underlying risks. This allowance for risks is based on both external information and our own experience data. For all classes of insurance there are pricing models that are regularly adjusted for actual claims experience. For household insurance the Group limits its exposure to large weather events through the use of reinsurance.

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

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

Set out in Note 26 to the Financial Statements are the Group's general insurance claim provisions by policy type.

### **56 Transition to IFRS**

The 2005 statutory consolidated financial statements have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union.

An explanation of the Group's transition to IFRS on the 1 January 2005 (with 2004 comparatives) including the reconciliations of UK GAAP Balance Sheets and Profit and Loss Statements to IFRS has not been provided.

## **PART IX**

### **HISTORICAL FINANCIAL INFORMATION RELATING TO HBOS PLC**

#### **Part B – Unaudited Interim Financial Information**

##### **Basis of Financial information**

The following tables set out the unaudited interim financial information of HBOS for the six months ended 30 June 2007 and 30 June 2008. These results were prepared in accordance with IFRS. The financial information for the six months ended 30 June 2007 and 30 June 2008 set out in this Part IX has been extracted without material adjustment from the interim financial statements of HBOS for the six months ended 30 June 2008.

In this Part IX, references to “the Company” are to be taken as references to HBOS and references to “the Group” are taken as references to the HBOS Group. In addition, in this Part IX, references to the “Directors” or the “Board of Directors” are to be taken as references to the HBOS Directors and HBOS Board respectively.

**HBOS plc Consolidated Income Statement (unaudited)**

		<i>Half year ended</i>	<i>Half year ended</i>	<i>Half year ended</i>	<i>Year ended</i>
	<i>Notes</i>	<i>30 June 2008</i>	<i>30 June 2007</i>	<i>31 December 2007</i>	<i>31 December 2007</i>
		<i>£m</i>			
Interest income		18,456	15,549	19,463	35,012
Interest expense		(14,595)	(11,935)	(15,773)	(27,708)
<b>Net interest income</b>		<b>3,861</b>	<b>3,614</b>	<b>3,690</b>	<b>7,304</b>
Fees and commission income		1,149	1,193	1,185	2,378
Fees and commission expense		(546)	(539)	(579)	(1,118)
Net earned premiums on insurance contracts		2,276	3,051	2,565	5,616
Net trading income	1	(910)	141	37	178
Change in value of in-force long term assurance business		36	159	(143)	16
Net investment income related to insurance and investment business		(4,571)	3,615	998	4,613
Other operating income		1,055	1,143	1,161	2,304
<b>Net operating income</b>	<b>2</b>	<b>2,350</b>	<b>12,377</b>	<b>8,914</b>	<b>21,291</b>
Change in investment contract liabilities		2,734	(2,423)	(115)	(2,538)
Net claims incurred on insurance contracts		(1,721)	(1,433)	(1,519)	(2,952)
Net change in insurance contract liabilities		1,854	(1,388)	(856)	(2,244)
Change in unallocated surplus		231	(169)	219	50
Administrative expenses	3	(2,459)	(2,432)	(2,547)	(4,979)
Depreciation and amortisation: Intangible assets other than goodwill		(104)	(94)	(99)	(193)
Property and equipment		(104)	(116)	(108)	(224)
Operating lease assets		(508)	(500)	(485)	(985)
Goodwill impairment	5	(2)	(2)	(3)	(5)
<b>Operating expenses</b>		<b>(79)</b>	<b>(8,557)</b>	<b>(5,513)</b>	<b>(14,070)</b>
Impairment losses on loans and advances	6	(1,310)	(963)	(1,049)	(2,012)
Impairment losses on investment securities		(145)	(27)	(33)	(60)
<b>Operating profit</b>		<b>816</b>	<b>2,830</b>	<b>2,319</b>	<b>5,149</b>
Share of profits of jointly controlled entities		13	97	137	234
Share of (losses)/profits of associates		(37)	9	(9)	
Non-operating income	7	56	61	30	91
<b>Profit before taxation</b>	<b>8</b>	<b>848</b>	<b>2,997</b>	<b>2,477</b>	<b>5,474</b>
Tax on profit	9	102	(858)	(507)	(1,365)
<b>Profit after taxation</b>		<b>950</b>	<b>2,139</b>	<b>1,970</b>	<b>4,109</b>
Profit of disposal group			4		4
<b>Profit for the period</b>		<b>950</b>	<b>2,143</b>	<b>1,970</b>	<b>4,113</b>
Attributable to:					
Parent company shareholders		931	2,114	1,931	4,045
Minority interests		19	29	39	68
		<b>950</b>	<b>2,143</b>	<b>1,970</b>	<b>4,113</b>
Basic earnings per share	10	23.5p	55.0p	51.1p	106.1p
Diluted earnings per share	10	23.5p	54.6p	50.8p	105.4p

## HBOS plc Consolidated Balance Sheet (unaudited)

	Notes	As at 30 June 2008	As at 30 June 2007	As at 31 December 2007
£m				
<b>Assets</b>				
Cash and balances at central banks		1,973	1,780	2,572
Items in course of collection		1,133	1,074	945
Financial assets held for trading		46,023	58,250	54,681
Derivative assets		18,050	12,205	14,141
Loans and advances to banks		13,534	9,001	8,056
Loans and advances to customers	11	455,950	395,210	430,007
Investment securities	12	119,074	120,864	128,398
Interests in jointly controlled entities		923	652	836
Interests in associates		190	141	149
Goodwill and other intangible assets		2,811	2,739	2,790
Property and equipment		1,597	1,506	1,494
Investment properties		4,045	5,324	4,731
Operating lease assets		4,370	4,707	4,643
Deferred costs		1,130	899	1,101
Current tax asset		133		
Value of in-force long term assurance business	13	3,284	3,267	3,184
Other assets		6,224	5,396	7,468
Prepayments and accrued income		960	1,075	1,751
<b>Total Assets</b>		<b>681,404</b>	<b>624,090</b>	<b>666,947</b>
<b>Liabilities</b>				
Deposits by banks		47,005	37,530	41,513
Customer accounts		258,130	227,117	243,221
Financial liabilities held for trading		28,744	22,346	22,705
Derivative liabilities		16,470	15,061	12,311
Notes in circulation		923	859	881
Insurance contract liabilities	14	25,012	26,074	26,864
Investment contract liabilities		50,007	53,441	52,828
Unallocated surplus		1,262	1,712	1,493
Net post retirement benefit liabilities	4	725	543	347
Current tax liabilities			389	370
Deferred tax liabilities		1,601	2,726	2,530
Other liabilities		7,666	7,249	5,072
Accruals and deferred income		2,993	2,782	3,630
Provisions		174	190	175
Debt securities in issue	15	193,475	181,477	206,520
Other borrowed funds	16	26,084	22,713	24,253
<b>Total Liabilities</b>		<b>660,271</b>	<b>602,209</b>	<b>644,713</b>
<b>Shareholders' Equity</b>				
Share capital	17	1,136	1,134	1,131
Share premium		3,085	2,925	2,997
Other reserves		(1,223)	1,145	154
Retained earnings		17,102	16,317	17,567
Shareholders' Equity (excluding minority interests)		20,100	21,521	21,849
Minority interests		1,033	360	385
<b>Total Shareholders' Equity</b>		<b>21,133</b>	<b>21,881</b>	<b>22,234</b>
<b>Total Liabilities and Shareholders' Equity</b>		<b>681,404</b>	<b>624,090</b>	<b>666,947</b>

## HBOS plc Consolidated Statement of Recognised Income and Expense (unaudited)

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Net actuarial (losses)/gains from defined benefit plans (net of tax)	(292)	261	51	312
Foreign exchange translation	48	63	(61)	2
Available for sale investments:				
Net change in fair value (net of tax)	(1,954)	87	(420)	(333)
Transfer to the income statement (net of tax)	94	(129)	(55)	(184)
Cash flow hedges:				
Effective portion of changes in fair value taken to equity (net of tax)	486	74	(290)	(216)
Net gains transferred to the income statement (net of tax)	(51)	(118)	(174)	(292)
<b>Net (expense)/income recognised directly in equity</b>	<b>(1,669)</b>	<b>238</b>	<b>(949)</b>	<b>(711)</b>
Profit for the period	950	2,143	1,970	4,113
<b>Total recognised income and expense</b>	<b>(719)</b>	<b>2,381</b>	<b>1,021</b>	<b>3,402</b>
Attributable to:				
Parent company shareholders	(738)	2,352	982	3,334
Minority interests	19	29	39	68
	(719)	2,381	1,021	3,402



## HBOS plc Consolidated Cash Flow Statement (unaudited)

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007 £m</i>	<i>Year ended 31 December 2007</i>
Profit before taxation	848	2,997	5,474
Adjustments for:			
Impairment losses on loans and advances	1,310	963	2,012
Impairment losses on investment securities	145	27	60
Depreciation and amortisation	716	710	1,402
Goodwill impairment	2	2	5
Interest on other borrowed funds	702	609	1,229
Pension charge for defined benefit schemes	74	72	146
Cash contribution to defined benefit schemes	(105)	(75)	(295)
Exchange differences	867	295	(769)
Movement in derivatives held for trading	56	659	(1,487)
Other non-cash items	344	(741)	45
Net change in operating assets	(13,764)	(32,715)	(78,923)
Net change in operating liabilities	12,014	26,158	68,470
<b>Net cash flows from operating activities before tax</b>	<b>3,209</b>	<b>(1,039)</b>	<b>(2,631)</b>
Tax paid	(631)	(449)	(895)
<b>Cash flows from operating activities</b>	<b>2,578</b>	<b>(1,488)</b>	<b>(3,526)</b>
Cash flows from investing activities	(442)	(117)	(289)
Cash flows from financing activities	42	1,244	298
<b>Net increase/(decrease) in cash and cash equivalents</b>	<b>2,178</b>	<b>(361)</b>	<b>(3,517)</b>
Opening cash and cash equivalents	4,674	8,191	8,191
<b>Closing cash and cash equivalents</b>	<b>6,852</b>	<b>7,830</b>	<b>4,674</b>
<b>Analysis of Cash and Cash Equivalents</b>			
Cash and balances at central banks repayable on demand	862	457	1,061
Loans and advances to banks with an original maturity of less than three months	5,990	7,373	3,613
<b>Closing cash and cash equivalents</b>	<b>6,852</b>	<b>7,830</b>	<b>4,674</b>
<b>Investing Activities</b>			
Sale of other intangible assets	8	18	31
Purchase of other intangible assets	(148)	(142)	(249)
Sale of property and equipment	22	108	182
Purchase of property and equipment	(287)	(158)	(307)
Sale of investment properties	57	57	58
Investment in subsidiaries			(41)
Disposal of subsidiaries		115	115
Investment in jointly controlled entities and associates	(189)	(219)	(396)
Disposal of jointly controlled entities and associates	92	55	176
Dividends received from jointly controlled entities	3	43	132
Dividends received from associates		6	10
<b>Cash flows from investing activities</b>	<b>(442)</b>	<b>(117)</b>	<b>(289)</b>
<b>Financing Activities</b>			
Issue of ordinary shares	93	64	146
Issue of equity preference shares	750		
Share capital buyback, including costs		(394)	(500)
Purchase of own shares	(62)	(28)	(212)
Disposal of own shares	167		35
Issue of other borrowed funds	1,144	3,944	4,742
Repayments of other borrowed funds		(530)	(928)
Interest on other borrowed funds relating to the servicing of finance	(673)	(686)	(1,199)
Repayment of capital to minority interest	(110)		
Equity dividend paid	(1,256)	(1,101)	(1,747)
Dividends paid to minority shareholders in subsidiaries	(11)	(25)	(39)
<b>Cash flows from financing activities</b>	<b>42</b>	<b>1,244</b>	<b>298</b>

**Notes to the Condensed Financial Statements for HBOS plc for the six months ended 30 June 2007 and 30 June 2008**

**1 Net Trading Income**

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Net trading income comprises:				
Equity and commodity instruments and related derivatives	(35)	27	65	92
Interest bearing securities and related derivatives:				
Asset backed securities	(1,095)		(227)	(227)
Other	70	82	203	285
Foreign exchange and related derivatives	31	31	41	72
Fair value hedges:				
Net (losses)/gains from hedging instruments	(400)	350	834	1,184
Net gains/(losses) from hedged items	517	(349)	(878)	(1,227)
Cash flow hedge ineffectiveness recognised	2		(1)	(1)
	<u>(910)</u>	<u>141</u>	<u>37</u>	<u>178</u>

**2 Net Operating Income**

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
Included within net operating income are the following:				
Cash flow hedges:				
Net gains released from equity into income	72	169	248	417
Financial instruments at fair value through the income statement:				
Net (losses)/gains from trading financial instruments and non hedging derivatives	(1,029)	140	82	222
Net (losses)/gains from designated financial instruments	(5,880)	3,923	1,306	5,229
Available for sale financial instruments:				
Dividend income	74	13	278	291
Net realised gains on sale	36	183	80	263
Financial instruments designated as loans and receivables:				
Net realised gains on sale	3	2	1	3

### 3 Administrative Expenses

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Administrative expenses include:				
Regulatory provisions charge		79	43	122
Colleague costs:				
Wages and salaries	1,156	1,129	1,211	2,340
Social security costs	106	101	125	226
Pension costs	115	103	98	201
Other post retirement benefits	2		5	5
Expense arising from share based payments	76	71	68	139
	<u>1,455</u>	<u>1,404</u>	<u>1,507</u>	<u>2,911</u>
Accommodation, repairs and maintenance	246	224	226	450
Technology	132	134	139	273
Marketing and communication	256	187	193	380

### 4 Post Retirement Benefits

The defined benefit and defined contribution pension schemes, as well as defined benefit post retirement medical and concessionary mortgage plans, have not changed in the current period and remain as described in the Group's 2007 financial statements.

The Group's IAS19 pension deficit across all defined benefit post employment plans as at 30 June 2008 is £725m (end 2007 deficit of £347m).

The primary reason for the increase in the deficit is the fall in asset values over the period. The valuation of the liabilities is based on a discount rate of 6.25 per cent. and inflation rate of 3.90 per cent. (end 2007 5.70 per cent. and 3.40 per cent., respectively) reflecting significant changes in the markets and the yields available on the relevant bonds. The increase in the discount rate causes the liabilities to decrease in value while the increase in the inflation rate causes the value of the liabilities to increase.

The impact of increasing the discount rate by 0.1 per cent. would be to reduce the defined benefit liabilities of £7,761m at 30 June 2008 by around 2.2 per cent. and the impact of increasing the inflation rate assumption by 0.1 per cent. would be to increase the defined benefit liabilities by around 2.2 per cent.

### 5 Goodwill Impairment

The goodwill impairment of £2m relates to a partial write-down of the goodwill in respect of fund management business in Insurance & Investment division following the latest semi-annual impairment review. With the exception of the remaining £6m in respect of the fund management business, the aggregate headroom between the value in use and carrying value of goodwill recognised on the balance sheet plus net assets of the businesses is sufficiently large that changes in growth and discount rates, after allowing for current credit conditions, would have no material impact on the goodwill impairment charge.

## 6 Impairment Losses on Loans and Advances

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Opening	3,373	3,089	3,109	3,089
New impairment provisions less releases	1,374	1,003	1,108	2,111
Amounts written off	(1,056)	(926)	(800)	(1,726)
Discount unwind on impaired loans and advances to customers	(62)	(65)	(64)	(129)
Foreign exchange translation	29	8	20	28
<b>Closing</b>	<b>3,658</b>	<b>3,109</b>	<b>3,373</b>	<b>3,373</b>
New impairment provisions less releases	1,374	1,003	1,108	2,111
Recoveries of amounts previously written off	(64)	(40)	(59)	(99)
<b>Net charge to income statement</b>	<b>1,310</b>	<b>963</b>	<b>1,049</b>	<b>2,012</b>

## 7 Non-operating Income

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Profit on the sale and leaseback of certain branch premises		28		28
Profit on the part disposal of Rightmove plc	56	29	30	59
Profit on the sale of Insight Investment Management (C.I.) Limited		4		4
	<b>56</b>	<b>61</b>	<b>30</b>	<b>91</b>

## 8 Segmental Analysis

	<i>Half year ended 30 June 2008</i>						
	<i>Retail</i>	<i>Corporate</i>	<i>Insurance &amp; Investment</i>	<i>International</i>	<i>Treasury &amp; Asset Mgmt</i>	<i>Group Items</i>	<i>Total</i>
	<i>£m</i>						
Net interest income – internal	(645)	(1,020)	(39)	(896)	2,600		
Net interest income – external	2,709	2,160	(13)	1,566	(2,561)		3,861
Net fee and commission income – internal	86	5	(121)	18	12		
Net fee and commission income – external	524	193	(249)	44	91		603
Net trading income	22	(14)		(37)	(881)		(910)
Other operating income – internal	11	(15)		3	1		
Other operating income – external	7	1,001	(2,251)	8	31		(1,204)
<b>Net operating income</b>	<b>2,714</b>	<b>2,310</b>	<b>(2,673)</b>	<b>706</b>	<b>(707)</b>		<b>2,350</b>
Administrative expenses – internal	(242)	(87)	(100)	(2)	(68)	499	
Administrative expenses – external	(782)	(294)	(332)	(412)	(89)	(550)	(2,459)
Depreciation and amortisation	(32)	(528)	(24)	(32)	(3)	(97)	(716)
Goodwill impairment			(2)				(2)
Other operating expenses			2,950	148			3,098
<b>Operating expenses</b>	<b>(1,056)</b>	<b>(909)</b>	<b>2,492</b>	<b>(298)</b>	<b>(160)</b>	<b>(148)</b>	<b>(79)</b>
Impairment losses on loans and advances	(722)	(469)		(119)			(1,310)
Impairment losses on investment securities		(145)					(145)
<b>Operating profit/(loss)</b>	<b>936</b>	<b>787</b>	<b>(181)</b>	<b>289</b>	<b>(867)</b>	<b>(148)</b>	<b>816</b>
Share of profits of jointly controlled entities and associates		(34)	16	(2)	(4)		(24)
<b>Non-operating income</b>	<b>56</b>						<b>56</b>
<b>Profit/(loss) before taxation</b>	<b>992</b>	<b>753</b>	<b>(165)</b>	<b>287</b>	<b>(871)</b>	<b>(148)</b>	<b>848</b>

The IFRS H108 result of the I&I division has been impacted by falls in investment returns due to market movements and transactions with policyholders in relation to policyholder tax, offset by better insurance contract experience and the absence of significant flood claims in H108.

Half year ended 30 June 2007

	Retail	Corporate	Insurance & Investment	International £m	Treasury & Asset Mgmt	Group Items	Total
Net interest income – internal	(549)	(557)	(37)	(565)	1,708		
Net interest income – external	2,636	1,537	(13)	1,069	(1,615)		3,614
Net fee and commission income – internal	95	4	(86)	31	(44)		
Net fee and commission income – external	537	222	(283)	25	153		654
Net trading income	7	35		(6)	105		141
Other operating income – internal							
Other operating income – external	20	1,046	6,462	387	53		7,968
<b>Net operating income</b>	<b>2,746</b>	<b>2,287</b>	<b>6,043</b>	<b>941</b>	<b>360</b>		<b>12,377</b>
Administrative expenses – internal	(263)	(79)	(82)		(60)	484	
Administrative expenses – external	(832)	(335)	(297)	(314)	(108)	(546)	(2,432)
Depreciation and amortisation	(37)	(516)	(29)	(27)	(2)	(99)	(710)
Goodwill impairment			(2)				(2)
Other operating expenses			(5,194)	(219)			(5,413)
<b>Operating expenses</b>	<b>(1,132)</b>	<b>(930)</b>	<b>(5,604)</b>	<b>(560)</b>	<b>(170)</b>	<b>(161)</b>	<b>(8,557)</b>
Impairment losses on loans and advances	(678)	(235)		(50)			(963)
Impairment losses on investment securities	(22)	(5)					(27)
<b>Operating profit/(loss)</b>	<b>914</b>	<b>1,117</b>	<b>439</b>	<b>331</b>	<b>190</b>	<b>(161)</b>	<b>2,830</b>
Share of profits of jointly controlled entities and associates	(7)	108	3	2			106
<b>Non-operating income</b>	<b>57</b>				<b>4</b>		<b>61</b>
<b>Profit/(loss) before taxation</b>	<b>964</b>	<b>1,225</b>	<b>442</b>	<b>333</b>	<b>194</b>	<b>(161)</b>	<b>2,997</b>

	<i>Half year ended 31 December 2007</i>						
	<i>Retail</i>	<i>Corporate</i>	<i>Insurance &amp; Investment</i>	<i>International £m</i>	<i>Treasury &amp; Asset Mgmt</i>	<i>Group Items</i>	<i>Total</i>
Net interest income – internal	(501)	(773)	(33)	(704)	2,011		
Net interest income – external	2,513	1,844	(15)	1,288	(1,940)		3,690
Net fee and commission income – internal	95	3	(82)	(10)	(6)		
Net fee and commission income – external	538	171	(238)	20	115		606
Net trading income	(14)	30	(7)	3	25		37
Other operating income – internal	19	15		45	(79)		
Other operating income – external	38	998	3,149	265	131		4,581
<b>Net operating income</b>	<b>2,688</b>	<b>2,288</b>	<b>2,774</b>	<b>907</b>	<b>257</b>		<b>8,914</b>
Administrative expenses – internal	(409)	(72)	(31)	(6)	18	500	
Administrative expenses – external	(691)	(354)	(383)	(351)	(188)	(580)	(2,547)
Depreciation and amortisation	(33)	(502)	(28)	(27)	(2)	(100)	(692)
Goodwill impairment			(3)				(3)
Other operating expenses			(2,212)	(59)			(2,271)
<b>Operating expenses</b>	<b>(1,133)</b>	<b>(928)</b>	<b>(2,657)</b>	<b>(443)</b>	<b>(172)</b>	<b>(180)</b>	<b>(5,513)</b>
Impairment losses on loans and advances	(616)	(367)		(66)			(1,049)
Impairment losses on investment securities		(32)		(1)			(33)
<b>Operating profit/(loss)</b>	<b>939</b>	<b>961</b>	<b>117</b>	<b>397</b>	<b>85</b>	<b>(180)</b>	<b>2,319</b>
Share of profits of jointly controlled entities and associates	(2)	124	(5)	15	(4)		128
<b>Non-operating income</b>	<b>30</b>						<b>30</b>
<b>Profit/(loss) before taxation</b>	<b>967</b>	<b>1,085</b>	<b>112</b>	<b>412</b>	<b>81</b>	<b>(180)</b>	<b>2,477</b>

	Year ended 31 December 2007						
	Retail	Corporate	Insurance & Investment	International £m	Treasury & Asset Mgmt	Group Items	Total
Net interest income – internal	(1,050)	(1,330)	(70)	(1,269)	3,719		
Net interest income – external	5,149	3,381	(28)	2,357	(3,555)		7,304
Net fee and commission income – internal	190	7	(168)	21	(50)		
Net fee and commission income – external	1,075	393	(521)	45	268		1,260
Net trading income	(7)	65	(7)	(3)	130		178
Other operating income – internal	19	15		45	(79)		
Other operating income – external	58	2,044	9,611	652	184		12,549
<b>Net operating income</b>	<b>5,434</b>	<b>4,575</b>	<b>8,817</b>	<b>1,848</b>	<b>617</b>		<b>21,291</b>
Administrative expenses – internal	(672)	(151)	(113)	(6)	(42)	984	
Administrative expenses – external	(1,523)	(689)	(680)	(665)	(296)	(1,126)	(4,979)
Depreciation and amortisation	(70)	(1,018)	(57)	(54)	(4)	(199)	(1,402)
Goodwill impairment			(5)				(5)
Other operating expenses			(7,406)	(278)			(7,684)
<b>Operating expenses</b>	<b>(2,265)</b>	<b>(1,858)</b>	<b>(8,261)</b>	<b>(1,003)</b>	<b>(342)</b>	<b>(341)</b>	<b>(14,070)</b>
Impairment losses on loans and advances	(1,294)	(602)		(116)			(2,012)
Impairment losses on investment securities	(22)	(37)		(1)			(60)
<b>Operating profit/(loss)</b>	<b>1,853</b>	<b>2,078</b>	<b>556</b>	<b>728</b>	<b>275</b>	<b>(341)</b>	<b>5,149</b>
Share of profits of jointly controlled entities and associates	(9)	232	(2)	17	(4)		234
Non-operating income	87				4		91
<b>Profit/(loss) before taxation</b>	<b>1,931</b>	<b>2,310</b>	<b>554</b>	<b>745</b>	<b>275</b>	<b>(341)</b>	<b>5,474</b>

## 9 Taxation

The tax credit for the period of £102m (H1 2007 tax charge of £858m) includes a £451m tax credit (H1 2007 £167m tax charge) in respect of the tax attributable to the policyholder earnings in the Group's UK life companies. The H1 2007 tax charge of £858m includes a credit of £110m in respect of the change in the rate of UK corporation tax. Excluding these items results in an effective rate of 27.0 per cent. (H1 2007 28.3 per cent.). Included within the tax credit of £102m is an overseas tax charge of £148m (H1 2007 £110m).

The main UK corporation tax rate reduced from 30 per cent. to 28 per cent. in April 2008. The average rate of UK corporation tax for the year to December 2008 is 28.5 per cent. A reconciliation of the actual tax to the average rate of 28.5 per cent. (H1 2007 30 per cent.) is detailed below:



	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Profit before tax	848	2,997	2,477	5,474
Expected tax charge at 28.5%/30%	242	899	743	1,642
Effects of:				
Change in rates of corporation tax on deferred assets and liabilities		(110)	(68)	(178)
Expenses not deductible/(income not chargeable) for tax purposes	29	(22)	(26)	(48)
Net effect of differing tax rates overseas	20	(1)	30	29
Tax exempt gains	(35)	(35)	(55)	(90)
Policyholder tax for life assurance business	(322)	117	(104)	13
Impairment on investment securities	35	12	4	16
Adjustments in respect of previous periods	(83)	(4)	(10)	(14)
Other	12	2	(7)	(5)
Total income tax on profit	<u>(102)</u>	<u>858</u>	<u>507</u>	<u>1,365</u>
The tax expense is made up as follows:				
Tax on policyholder returns	(451)	167	(149)	18
Tax on shareholder returns	349	691	656	1,347
	<u>(102)</u>	<u>858</u>	<u>507</u>	<u>1,365</u>

## 10 Earnings Per Share

Basic and diluted earnings per ordinary share are based upon Group profit attributable to ordinary shareholders which is calculated as follows:

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
	<i>£m</i>			
Profit attributable to parent company shareholders	931	2,114	1,931	4,045
Profit attributable to preference shareholders	(51)	(51)	(29)	(80)
<b>Profit attributable to ordinary shareholders for continuing operations</b>	<u>880</u>	<u>2,063</u>	<u>1,902</u>	<u>3,965</u>

The closing share price on 26 June 2008 was 275.7p, 0.7p higher than the 275p issue price per new share under the Rights Issue resulting in an adjustment factor of 1.001. Applying the adjustment factor to the average number of ordinary shares in issue restates earnings per share as follows:

	<i>Half year ended 30 June 2007</i>	<i>Year ended 31 December 2007</i>
<b>As published:</b>		
Average number of ordinary shares in issue for basic EPS (millions)	3,746	3,735
Earnings (basic)	55.1p	106.2p
Earnings (diluted)	54.6p	105.5p
<b>Restated:</b>		
Average number of ordinary shares in issue for basic EPS (millions)	3,749	3,738
Earnings (basic)	55.0p	106.1p
Earnings (diluted)	54.6p	105.4p

## 11 Loans and Advances to Customers

	<i>As at 30 June 2008</i>	<i>As at 31 December 2007</i>
	<i>£m</i>	
Retail secured lending	238,151	235,849
Retail unsecured lending	19,880	19,831
Corporate, International and Treasury	201,577	177,700
	<hr/>	<hr/>
Gross loans and advances to customers	459,608	433,380
Impairment losses on loans and advances (Note 6)	(3,658)	(3,373)
	<hr/>	<hr/>
Net loans and advances to customers	<u>455,950</u>	<u>430,007</u>

The mix of the Group's gross lending portfolio is summarised in the following table:

	<i>As at 30 June 2008</i>	<i>As at 31 December 2007</i>
	<i>£m</i>	
Energy	2,343	2,269
Manufacturing industry	4,456	4,332
Construction and property	46,154	41,099
Hotels, restaurants and wholesale and retail trade	13,737	12,620
Transport, storage and communication	6,987	6,834
Financial	12,350	6,312
Other services	16,258	15,396
Individuals:		
Residential mortgages	235,924	235,771
Other personal lending	17,910	19,229
Non-UK residents	103,489	89,518
	<hr/>	<hr/>
<b>Total</b>	<u>459,608</u>	<u>433,380</u>

Loans and advances to customers include advances that are securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote special purpose entities, funded by the issue of debt on terms whereby some of the risks and rewards of the portfolio are retained by the subsidiary. Accordingly, all these advances are retained on the Group's balance sheet with the debt issued included within debt

securities in issue. The Group's principal securitisation programmes and the type of loans and advances securitised are as follows:

<i>Programme</i>		<i>As at</i>	<i>As at</i>
		<i>30 June</i>	<i>31 December</i>
		<i>2008</i>	<i>2007</i>
		<i>£m</i>	
Permanent	UK residential mortgages	38,770	31,577
Mound	UK residential mortgages	4,545	4,545
Swan	Australian residential mortgages	2,592	2,726
Candide	Dutch residential mortgages	3,878	2,491
Prominent	Commercial loans	1,061	1,101
Covered Bonds	UK residential mortgages	44,775	34,704
Social Housing Covered Bonds	UK residential mortgages	2,393	2,362
Pendeford	UK residential mortgages	2,088	2,508
Melrose	Commercial loans		750
Other	UK residential mortgages	103	104
		<u>100,205</u>	<u>82,868</u>

In addition to the programmes above loans and advances totalling £nil (2007 £14,089m) relating to UK residential mortgages have been securitised using credit default swaps.

## 12 Investment Securities

<i>As at 30 June 2008</i>					
	<i>Policyholder assets at fair value through the income statement</i>	<i>At fair value through the income statement</i>	<i>Available for sale £m</i>	<i>Loans and receivables</i>	<i>Total</i>
Listed					
Debt securities	17,982	6,822	30,518		55,322
Equity shares	44,764	313	206		45,283
<b>Total listed</b>	<u>62,746</u>	<u>7,135</u>	<u>30,724</u>		<u>100,605</u>
Unlisted					
Debt securities	20	277	13,845	1,697	15,839
Equity shares	89	409	2,132		2,630
<b>Total unlisted</b>	<u>109</u>	<u>686</u>	<u>15,977</u>	<u>1,697</u>	<u>18,469</u>
<b>Total</b>	<u>62,855</u>	<u>7,821</u>	<u>46,701</u>	<u>1,697</u>	<u>119,074</u>
Comprising:					
Debt securities	18,002	7,099	44,363	1,697	71,161
Equity shares	44,853	722	2,338		47,913

As at 31 December 2007

	<i>Policyholder assets at fair value through the income statement</i>	<i>At fair value through the income statement</i>	<i>Available for sale £m</i>	<i>Loans and receivables</i>	<i>Total</i>
Listed					
Debt securities	20,712	7,774	31,944		60,430
Equity shares	46,875	393	261		47,529
<b>Total listed</b>	<b>67,587</b>	<b>8,167</b>	<b>32,205</b>		<b>107,959</b>
Unlisted					
Debt securities	2	847	14,833	1,441	17,123
Equity shares	94	274	2,948		3,316
<b>Total unlisted</b>	<b>96</b>	<b>1,121</b>	<b>17,781</b>	<b>1,441</b>	<b>20,439</b>
<b>Total</b>	<b>67,683</b>	<b>9,288</b>	<b>49,986</b>	<b>1,441</b>	<b>128,398</b>
Comprising:					
Debt securities	20,714	8,621	46,777	1,441	77,553
Equity shares	46,969	667	3,209		50,845

In keeping with normal market practice, the Group enters into securities lending transactions and repurchase agreements, whereby cash and securities are temporarily received or transferred as collateral.

Debt securities with a value of £23,806m (end 2007 £14,181m) were subject to agreement to repurchase, where the transferee obtains the right to pledge or sell the asset they receive. Debt securities also include securities pledged as collateral as part of securities lending transactions amounting to £28,549m (end 2007 £11,918m).

Debt securities include asset backed securities of £16,208m (end 2007 £18,563m) which are held in the Group's Grampian conduit. This is a series of bankruptcy remote special purpose entities ("SPEs") that are funded by the issue of commercial paper and banking facilities. As some of the rewards and risks of the portfolio are retained by the Group, including the provision of liquidity facilities by Bank of Scotland plc, to the conduit, the assets and liabilities of the conduit are consolidated as part of the Group.

The Group also has a smaller conduit, Landale, which is partially consolidated. Debt securities of £552m (end 2007 £604m) are included in available for sale investments. Further details are included in Note 20.

Impairments on investment securities of £145m (H1 2007 £27m) have been charged to the income statement and there are no impairment provisions held in respect of the Group's investment securities at the period end.

Securities held as collateral as stock borrowed or under reverse repurchase agreements amounted to £51,248m (end 2007 £39,975m). These are not recognised as assets and are therefore not included above. Of this amount the Group had resold or repledged £49,169m (end 2007 £28,817m) as collateral for its own transactions.

### 13 Value of In-force Long Term Assurance Business

	30 June 2008	31 December 2007
	£m	
At 1 January	3,184	3,104
Unwind of discount rate	127	245
Release to income statement	(225)	(415)
Effect of experience in the period <sup>(1)</sup>	(83)	(201)
New business	199	567
Changes in assumptions <sup>(2)</sup>	18	(180)
Exchange translation	64	64
<b>Closing</b>	<b>3,284</b>	<b>3,184</b>

Notes:

**(1) Effect of experience in the period**

During the period to 30 June 2008 changes have been made to certain investment bonds with additional life cover being added. In accordance with IFRS 4 "Insurance Contracts" this results in these products transferring from being accounted for as investment contracts to insurance contracts. This has resulted in a £143m increase in the value of in-force long term assurance business. This is partly offset by a net £80m, principally arising from a reduction in deferred origination costs, which are charged to fees and commission expense. The overall impact of this change is an increase in profit before tax of £63m (H1 2007 £nil).

**(2) Change in assumptions**

The key assumptions used in the measurement of the value of in-force long term assurance business relating to insurance contracts and investment contracts with a discretionary participating feature ("DPF") are determined by the Board of Directors. The economic assumptions that have the greatest effect on the calculation of the value of in-force long term assurance business are set out in the Group's 2007 financial statements and there were no significant changes in the economic assumptions during the period to 30 June 2008. These assumptions require the application of material judgement and are chosen to represent a long term view of the likely economic environment.

Experience assumptions also have a significant effect on cash flow projections. The selection of these assumptions also requires the application of material judgement and is made with reference to historic trends, taking into account the analysis of actual versus expected experience as well as industry data. The experience assumptions applied in the half year to 30 June 2008 are unchanged from those used in 2007, which are set out in the Group's 2007 financial statements.

### 14 Insurance Contract Liabilities

#### Assumptions

The only significant changes to the assumptions used to calculate the value of policyholder liabilities at the half year 30 June 2008 and 30 June 2007 from those used at the year end 31 December 2007 were due to the change in valuation rates of interest which were updated to reflect prevailing economic conditions at the balance sheet date. The valuation rate of interest assumptions were broadly matched by changes in the valuation of investment securities.

The valuation rates of interest used are as follows:

	As at 30 June 2008	As at 31 December 2007
<b>Non-profit policies</b>		
Pension annuities	4.5 – 5.9%	4.1 – 5.3%
Term assurances	4.0 – 4.8%	3.5 – 4.4%
<b>Unit-linked policies</b>		
Life assurance	3.7 – 4.5%	3.3 – 4.0%
Pensions	4.2 – 5.6%	4.1 – 4.9%

In isolation an increase in the valuation rate of interest decreases liabilities leading to an increase in profits or vice versa.

## 15 Debt Securities in Issue

	<i>As at 30 June 2008</i>	<i>As at 31 December 2007</i>
	<i>£m</i>	
Bonds and medium term notes	72,430	73,818
Other debt securities	121,045	132,702
	193,475	206,520
	193,475	206,520

At 30 June 2008, debt securities in issue include £7,763m issued by the Grampian conduit (end 2007 £11,954m) and £689m issued by the Landale conduit (end 2007 £137m).

## 16 Other Borrowed Funds

	<i>As at 30 June 2008</i>	<i>As at 31 December 2007</i>
	<i>£m</i>	
Preferred securities	5,069	4,973
Preference shares	1,567	1,571
Subordinated liabilities:		
Dated	12,494	10,964
Undated	6,954	6,745
	26,084	24,253
	26,084	24,253

## 17 Reconciliation of Shareholders' Equity

	Share capital <sup>(1)</sup>	Share premium	Cash flow hedge reserve	Other reserves		Retained earnings	Minority interests <sup>(2)</sup>	Total
				Available for sale reserve	Other reserves			
	£m							
At 1 January 2008	1,131	2,997	(85)	(313)	552	17,567	385	22,234
Foreign exchange translation					48			48
Net actuarial losses from defined benefit plans						(292)		(292)
Available for sale investments:								
Net change in fair value				(1,954)				(1,954)
Transfer to the income statement				94				94
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			486					486
Net gains transferred to the income statement			(51)					(51)
Profit for the period						931	19	950
<b>Total recognised income and expense</b>			435	(1,860)	48	639	19	(719)
Dividends paid (Note 18)						(1,256)	(11)	(1,267)
Issue of new shares	5	88					750	843
Ordinary share buyback								
Repayment of capital to minority interests							(110)	(110)
Movement in own shares						105		105
Movement in share-based compensation reserve						47		47
<b>At 30 June 2008</b>	<b>1,136</b>	<b>3,085</b>	<b>350</b>	<b>(2,173)</b>	<b>600</b>	<b>17,102</b>	<b>1,033</b>	<b>21,133</b>

Notes:

(1) **Share capital**

On 29 April 2008 HBOS announced that it would make a rights issue of two new ordinary shares for every five ordinary shares held at a price of 275p per share. On 26 June 2008 a General Meeting increased the authorised share capital of HBOS plc by 2,900m ordinary shares to 7,640m ordinary shares and approved the rights issue. Nil paid shares were issued under the rights issue on 27 June 2008 and consequently at the period end 1,500m of nil paid ordinary shares were outstanding. The rights issue was completed in July and raised £4.0bn net of expenses.

(2) **Minority interests**

On 19 March 2008 HBOS Capital Funding No.4 L.P. issued £750m Fixed-to-Floating Rate Perpetual Preferred Securities at par. Discretionary distributions at a rate of 9.54 per cent. per annum payable semi-annually in arrears until 19 March 2018 at which time the interest rate will become three month LIBOR plus 6.75% per annum payable quarterly in arrears. The Group has the option to redeem these securities on 19 March 2018 and quarterly thereafter.

	Share capital	Share premium	Other reserves			Retained earnings	Minority interests	Total
			Cash flow hedge reserve	Available for sale reserve	Other reserves			
At 1 January 2007	1,139	2,856	423	203	535	15,529	486	21,171
Foreign exchange translation					63			63
Net actuarial losses from defined benefit plans						261		261
Available for sale investments:								
Net change in fair value				87				87
Net gains transferred to the income statement				(129)				(129)
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			74					74
Net gains transferred to the income statement			(118)					(118)
Profit for the period						2,114	29	2,143
Total recognised income and expense			(44)	(42)	63	2,375	29	2,381
Dividends paid (Note 18)						(1,099)	(25)	(1,124)
Issue of new shares	2	69						71
Ordinary share buyback	(7)				7	(394)		(394)
Sale of disposal group							(129)	(129)
Other movements							(1)	(1)
Movement in own shares						(28)		(28)
Movement in share-based compensation reserve						(66)		(66)
<b>At 30 June 2007</b>	<b>1,134</b>	<b>2,925</b>	<b>379</b>	<b>161</b>	<b>605</b>	<b>16,317</b>	<b>360</b>	<b>21,881</b>

	Share capital	Share premium	Other reserves			Retained earnings	Minority interests	Total
			Cash flow hedge reserve	Available for sale reserve	Other reserves			
At 1 January 2007	1,139	2,856	423	203	535	15,529	486	21,171
Foreign exchange translation				1	1			2
Net actuarial gains from defined benefit plans (net of tax)						312		312
Available for sale investments:								
Net change in fair value				(333)				(333)
Net gains transferred to the income statement				(184)				(184)
Cash flow hedges:								
Effective portion of changes in fair value taken to equity			(216)					(216)
Net gains transferred to the income statement			(292)					(292)
Profit after tax						4,045	68	4,113
Total recognised income and expense			(508)	(516)	1	4,357	68	3,402
Dividends paid (Note 18)						(1,747)	(39)	(1,786)
Issue of new shares	5	141						146
Ordinary share buyback	(13)				13	(500)		(500)
Sale of disposal group							(130)	(130)
Other movements					3	(15)		(12)
Movement in own shares						(177)		(177)
Tax on share-based compensation schemes						(36)		(36)
Movement in share-based compensation reserve						156		156
<b>At 31 December 2007</b>	<b>1,131</b>	<b>2,997</b>	<b>(85)</b>	<b>(313)</b>	<b>552</b>	<b>17,567</b>	<b>385</b>	<b>22,234</b>



## 18 Dividends

A Capitalisation Issue has been approved in lieu of the 2008 interim dividend at the General Meeting on 26 June 2008. After the balance sheet date the Directors have proposed a Capitalisation amount currently equivalent to 6.1p per ordinary share. Existing shareholders will receive a number of new shares, the amount of which will be determined on 3 October 2008 and will be based on the average of the middle market quotations for ordinary shares for the three dealing days starting on and including 1 October 2008.

The following dividends have been charged direct to retained earnings:

	<i>Half year ended 30 June 2008</i>	<i>Half year ended 30 June 2007</i>	<i>Half year ended 31 December 2007</i>	<i>Year ended 31 December 2007</i>
				<i>£m</i>
<b>Ordinary dividends</b>				
2007 interim dividend of 16.6 pence per ordinary share			619	619
2007 final dividend paid of 32.3 pence per ordinary share (2006 27.9 pence per share)	1,205	1,048		1,048
<b>Preference dividends</b>	51	51	29	80
	<u>1,256</u>	<u>1,099</u>	<u>648</u>	<u>1,747</u>

## 19 Contingent Liabilities and Commitments

	<i>As at 30 June 2008</i>	<i>As at 31 December 2007</i>
		<i>£m</i>
<b>Contingent liabilities</b>		
Acceptances and endorsements	6	43
Guarantees and irrevocable letters of credit	4,890	6,891
	<u>4,896</u>	<u>6,934</u>
<b>Commitments</b>		
Short term trade related transactions	152	115
Undrawn formal standby facilities, credit lines and other commitments to lend with a maturity:		
Up to and including one year	58,941	68,253
Over one year	32,786	31,416
	<u>91,879</u>	<u>99,784</u>

On 27 July 2007, it was announced that members of the HBOS Group, along with seven other major UK current account providers, had reached agreement with the Office of Fair Trading to commence legal proceedings in the High Court of England and Wales for a declaration (or declarations) to resolve legal uncertainties concerning the fairness and lawfulness of unarranged overdraft charges (the "Test Case"). It was also announced that HBOS and those other providers will seek a stay of all current and potential future court proceedings which are brought against them in the UK concerning these charges and have obtained the consent of the Financial Ombudsman Service not to proceed with consideration of the merits of any complaints concerning these charges that are referred to them prior to the resolution of the Test Case. By virtue of a waiver granted by the Financial Services Authority of its complaints handling rules, HBOS (and other banks, including the banks party to the Test Case) will not be dealing with or resolving customer complaints about unarranged overdraft charges while the waiver is in force. On 21 July 2008, the FSA confirmed that it is extending its waiver regarding unarranged overdraft charges complaints until 26 January 2009.

The first step in the Test Case was a trial of certain “preliminary” issues concerning the legal status and enforceability of contractual terms relating to unarranged overdraft charges.

This preliminary trial concluded on 8 February 2008 and the judgment was handed down on 24 April 2008. The judgment held that the contractual terms relating to unarranged overdraft charges currently used by the HBOS Group (i) are not unenforceable as penalties, but (ii) are not exempt from assessment for fairness under the Unfair Terms in Consumer Contract Regulations 1999 (“UTCCRs”).

At a court hearing on 22 and 23 May 2008, the Judge granted HBOS and the other Test Case banks permission to appeal his decision that unarranged overdraft charges are assessable for fairness under the UTCCRs. This appeal is likely to take place before the end of 2008. A further hearing took place in early July 2008 at which the Court was asked to consider whether terms and conditions previously used by the Test Case banks are capable of being penalties. The judgment is awaited. Depending on the outcome of the appeal and the further hearing that took place in July 2008, another hearing may be required in order for the Court to determine the fairness of the charges.

A definitive outcome of the Test Case is unlikely to be known for at least 12 months.

Given the early stage of these proceedings and the uncertainty as to their outcome, it is not practicable at this time to estimate any potential financial effect.

The Group is engaged in other litigation in the UK and overseas arising out of its normal business activities. The Group considers that none of these actions is material and has not disclosed any contingent liability in respect of these actions because it is not practical to do so.

## **20 Special Purpose Entities**

The Group sponsors special purpose entities (“SPEs”) that are used in its securitisation and funding programmes. The principal securitisation programmes are listed in Note 11. In addition, the Group sponsors two conduit programmes, Grampian and Landale, which invest in asset-backed securities funded by commercial paper or through banking facilities. Details of the assets secured under these conduit programmes are given in Note 12.

Two of the Landale SPEs are not consolidated by the Group. One is the central funding company for the conduit that obtains external funding and lends it to the purchasing companies. The second is a purchasing company that has acquired floating rate notes issued under the Group’s mortgage securitisation programmes and which is supported by liquidity lines that are provided by third party banks. These entities are not consolidated as there are insufficient indicators of control, in particular as the credit risk relating to the assets held by the entities and the liquidity risks are not borne by the Group. If these entities were consolidated the financial impact would be minimal.

## **21 Related Party Transactions**

Related party transactions and transactions with key management personnel in the half year to 30 June 2008 are similar in nature to those for the year ended 31 December 2007. Full details of the Group’s related party transactions and transactions with key management personnel for the year ended 31 December 2007 can be found in the Group’s 2007 financial statements.

## **22 Post Balance Sheet Events**

On 18 July 2008, the Group completed the Rights Issue announced on 29 April 2008, raising £4.0bn after expenses.

A Capitalisation Issue has been approved in lieu of the 2008 interim dividend as explained in Note 18.

## PART X

### RECONCILIATION OF ACCOUNTING POLICIES

#### Unaudited reconciliation of HBOS Group financial information to IFRS as applied by Lloyds TSB

The following unaudited reconciliations summarise the material adjustments which reconcile HBOS Group's audited consolidated income statement and consolidated net assets for each of the three years ended 31 December 2005, 2006 and 2007 and the unaudited consolidated results for the six months ended 30 June 2008, as previously reported by HBOS, to estimates of those that would have been reported had HBOS Group applied the accounting policies applied by Lloyds TSB Group in the preparation of its audited consolidated financial statements for the year ended 31 December 2007.

Note	6 months ended 30 June 2008	Year ended		
	31 December 2007	31 December 2006	31 December 2005	
	£m	£m	£m	£m
<b>Profit for the period as reported by HBOS Group</b>	950	4,113	3,939	3,262
Differences from Lloyds TSB accounting policies increasing reported profit for the period:				
– Pensions (1)	—	—	2	—
<b>Profit for the period under Lloyds TSB Group accounting policies</b>	<u>950</u>	<u>4,113</u>	<u>3,941</u>	<u>3,262</u>

  

Note	As at 30 June 2008	As at		
	31 December 2007	31 December 2006	31 December 2005	
	£m	£m	£m	£m
<b>Net assets as reported by HBOS Group</b>	21,133	22,234	21,171	18,456
Differences from Lloyds TSB accounting policies increasing/ (decreasing) reported net assets:				
– Pensions (1)	137	(158)	138	298
<b>Net assets under Lloyds TSB Group accounting policies</b>	<u>21,270</u>	<u>22,076</u>	<u>21,309</u>	<u>18,754</u>

Note:

(1) Pensions

IAS 19 'Employee Benefits' allows an entity to either:

- (a) apply a "corridor" approach under which actuarial gains or losses within 10% of the greater of the scheme's assets or liabilities are not recognised on the balance sheet. Actuarial gains or losses outside of this corridor are recognised as a charge spread over a period not longer than the average remaining working lives of the members of the scheme;
- (b) adopt any systemic method that results in faster recognition of actuarial gains and losses than in (a), provided that the same basis is applied to both gains and losses and the basis is applied consistently from period to period; or
- (c) recognise, through the statement of recognised income and expense, all actuarial gains and losses for all of its defined benefit retirement obligations.

Lloyds TSB Group has adopted option (a); HBOS has adopted option (c). The table above sets out the differences between these approaches for the HBOS Group pension schemes. In the six months to 30 June 2008, the income statement charge would have been the same under both bases. As at 30 June 2008, the net assets reported would have been £137 million higher under the policy adopted by Lloyds TSB Group.

The Directors  
Lloyds TSB Group plc  
25 Gresham Street  
London  
EC2V 7HN

PricewaterhouseCoopers LLP  
Savannah House  
3 Ocean Way  
Ocean Village  
Southampton SO14 3TJ

Citigroup Global Markets Limited  
Citigroup Centre  
Canada Square  
London  
E14 5LB

Merrill Lynch International  
Merrill Lynch Financial Centre  
2 King Edward Street  
London  
EC1A 1HQ

UBS Limited  
1 Finsbury Avenue  
London  
EC2M 2PP

3 November 2008

Dear Sirs

**Lloyds TSB Group plc (the “Company”): Proposed acquisition of HBOS plc**

We report on the reconciliations (the “**Reconciliations**”) set out in Part X of the Company’s circular dated 3 November 2008 (the “**Circular**”) of the consolidated profit for the period for each of the years in the three-year period ended 31 December 2007 and the interim period ended 30 June 2008, and of the consolidated net assets as at 30 June 2008, 31 December 2007, 31 December 2006 and 31 December 2005, together the “**Financial Information**”, as previously reported in the consolidated financial statements of HBOS plc prepared under International Financial Reporting Standards (“**IFRS**”), showing the adjustments necessary to restate them on the basis of the Company’s accounting policies used in preparing the Company’s audited consolidated financial statements for the year ended 31 December 2007. This report is required by items 13.5.27R(2)(b) and 13.5.30R(2) of the Listing Rules of the United Kingdom Listing Authority (the “**Listing Rules**”) and is given for the purpose of complying with those Listing Rules and for no other purpose.

**Responsibilities**

It is the responsibility of the directors of the Company (the “**Directors**”) to prepare the Reconciliations in accordance with Listing Rules 13.5.27R(2)(a) and 13.5.30R(2).

It is our responsibility to form an opinion, as required by Listing Rules 13.5.27R(2)(b) and 13.5.30R(2), as to whether:

- (a) the Reconciliations have been properly compiled on the basis stated; and
- (b) the adjustments are appropriate for the purpose of presenting the Financial Information (as adjusted) on a basis consistent in all material respects with the Company’s accounting policies,

and to report that opinion to you.

PricewaterhouseCoopers LLP is a limited liability partnership registered in England with registered number OC303525. The registered office of PricewaterhouseCoopers LLP is 1 Embankment Place, London WC2N 6RH. PricewaterhouseCoopers LLP is authorised and regulated by the Financial Services Authority for designated investment business.

The Reconciliations are based on the audited consolidated balance sheets as at 31 December 2007, 31 December 2006 and 31 December 2005, the unaudited consolidated balance sheet as at 30 June 2008 and the consolidated income statements for each of the periods then ended of HBOS plc which were the responsibility of the directors of HBOS plc and the audited consolidated balance sheets and audited consolidated income statements were audited by KPMG Audit Plc. We do not accept any responsibility for any of the historical financial statements of HBOS plc, nor do we express any opinion on those financial statements.

Save for any responsibility which we may have to those persons to whom this report is expressly addressed and which we may have to shareholders of the Company as a result of the inclusion of this report in the Circular, to the fullest extent permitted by law we do not assume any responsibility and will not accept any liability to any other person for any loss suffered by any such person as a result of, arising out of, or in accordance with this report or our statement, required by and given solely for the purposes of complying with item 13.4.1R(6) of the Listing Rules, consenting to its inclusion in the Circular.

### **Basis of opinion**

We conducted our work in accordance with the Standards for Investment Reporting issued by the Auditing Practices Board in the United Kingdom. The work that we performed for the purpose of making this report, which involved no independent examination of any of the underlying financial information, consisted primarily of checking whether the unadjusted Financial Information of HBOS plc has been accurately extracted from an appropriate source, assessing whether all adjustments necessary for the purpose of presenting the Financial Information on a basis consistent in all material respects with the Company's accounting policies have been made, examination of evidence supporting the adjustments in the Reconciliations and checking the arithmetical accuracy of the calculations within the Reconciliations.

We planned and performed our work so as to obtain the information and explanations we considered necessary in order to provide us with reasonable assurance that the Reconciliations have been properly compiled on the basis stated and that the adjustments are appropriate for the purpose of presenting the Financial Information (as adjusted) on a basis consistent in all material respects with the Company's accounting policies.

Our work has not been carried out in accordance with auditing standards generally accepted in the United States of America and accordingly should not be relied upon as if it had been carried out in accordance with those standards.

### **Opinion**

In our opinion:

- (a) the Reconciliations have been properly compiled on the basis stated; and
- (b) the adjustments are appropriate for the purpose of presenting the Financial Information (as adjusted) on a basis consistent in all material respects with the Company's accounting policies.

Yours faithfully

PricewaterhouseCoopers LLP  
Chartered Accountants

**PART XI**  
**UNAUDITED PRO FORMA NET ASSETS STATEMENT**  
**OF THE ENLARGED GROUP AS AT 30 JUNE 2008**

**Unaudited pro forma net assets statement of the Enlarged Group as at 30 June 2008**

The unaudited pro forma net assets statement of the Enlarged Group as at 30 June 2008 and the notes thereto set out in this Part XI (together the “pro forma net assets statement”) are based on the unaudited interim financial information of the Lloyds TSB Group and the HBOS Group, prepared under IFRS after applying the adjustments described in the notes set out below. The unaudited pro forma net assets statement has been prepared for illustrative purposes only and, because of its nature, addresses a hypothetical situation and does not, therefore, represent Lloyds TSB Group’s or the Enlarged Group’s actual financial position or results. The pro forma net assets statement has been prepared on the basis set out in the notes below and in accordance with item 13.3.3R of the Listing Rules.

Note	Adjustments							Pro forma
	Lloyds TSB Group (1)	Lloyds TSB Placement (2)	HBOS Group (3)	HBOS Rights Issue (4)	Lloyds TSB Share Issue (5)	HBOS Share Issue (6)	Other (7)	
	£m	£m	£m	£m	£m	£m	£m	£m
<b>Assets</b>								
Cash and balances at central banks	3,616	760	1,973	4,000	5,500	11,500	(130)	27,219
Items in course of collection from banks	1,883	—	1,133	—	—	—	—	3,016
Trading and other financial assets at fair value through profit or loss	52,037	—	116,699	—	—	—	—	168,736
Derivative financial instruments	9,914	—	18,050	—	—	—	—	27,964
Loans and advances to banks	29,319	—	13,534	—	—	—	—	42,853
Loans and advances to customers	229,621	—	457,647	—	—	—	—	687,268
Available-for-sale financial assets	25,032	—	46,701	—	—	—	—	71,733
Investment property	3,366	—	4,045	—	—	—	—	7,411
Goodwill	2,358	—	1,938	—	—	—	—	4,296
Value of in-force business	2,101	—	3,284	—	—	—	—	5,385
Other intangible assets	182	—	873	—	—	—	—	1,055
Tangible fixed assets	2,856	—	5,967	—	—	—	—	8,823
Other assets	5,497	—	9,560	—	—	—	—	15,057
<b>Total assets</b>	<b>367,782</b>	<b>760</b>	<b>681,404</b>	<b>4,000</b>	<b>5,500</b>	<b>11,500</b>	<b>(130)</b>	<b>1,070,816</b>
<b>Liabilities</b>								
Deposits from banks	40,207	—	47,005	—	—	—	—	87,212
Customer accounts	162,129	—	258,130	—	—	—	—	420,259
Items in course of transmission to banks	835	—	—	—	—	—	—	835
Trading and other financial liabilities at fair value through profit or loss	3,572	—	28,744	—	—	—	—	32,316
Derivative financial instruments	9,931	—	16,470	—	—	—	—	26,401
Debt securities in issue	58,437	—	193,475	—	—	—	—	251,912
Liabilities arising from insurance contracts and participating investment contracts	35,780	—	25,012	—	—	—	—	60,792
Liabilities arising from non participating investment contracts	16,331	—	50,007	—	—	—	—	66,338
Unallocated surplus within insurance businesses	433	—	1,262	—	—	—	—	1,695
Other liabilities	11,306	—	11,582	—	—	—	—	22,888
Retirement benefit obligations	1,925	—	588	—	—	—	—	2,513
Current tax liabilities	108	—	—	—	—	—	—	108
Deferred tax liabilities	632	—	1,601	—	—	—	—	2,233
Other provisions	381	—	174	—	—	—	—	555
Subordinated liabilities	14,694	—	26,084	—	1,000	3,000	—	44,778
<b>Total liabilities</b>	<b>356,701</b>	<b>—</b>	<b>660,134</b>	<b>—</b>	<b>1,000</b>	<b>3,000</b>	<b>—</b>	<b>1,020,835</b>
<b>Net assets</b>	<b>11,081</b>	<b>760</b>	<b>21,270</b>	<b>4,000</b>	<b>4,500</b>	<b>8,500</b>	<b>(130)</b>	<b>49,981</b>
<b>Key balance sheet measures (Note 10)</b>								
Risk-weighted assets	153,873	—	331,555	—	—	—	—	485,428
Core tier 1 capital	9,522	760	17,587	4,000	4,500	8,500	(2,303)	42,566
Core tier 1 capital ratio	6.2%		5.3%					8.8%

## Notes to pro forma net assets statement

The pro forma net assets statement includes appropriate adjustments to account for the events directly associated with the Acquisition. In addition, adjustments have been made to reflect the fundraisings (net of costs) undertaken by Lloyds TSB and HBOS post 30 June 2008, the Lloyds TSB Placing and Open Offer, the New Preference Shares, the HBOS Placing and Open Offer and the New HBOS Preference Shares. Any potential synergy benefits are not included within the pro forma net assets statement. Lloyds TSB costs which are expected to be directly incurred as part of the Acquisition, the Lloyds TSB Placing and Open Offer and the Preference Shares have been included within the pro forma net assets statement. HBOS costs which are expected to be directly incurred as part of the Acquisition, the HBOS Placing and Open Offer and the New HBOS Preference Share Issue have not been included.

1. The consolidated financial information of Lloyds TSB Group in the pro forma net assets statement has been extracted without material adjustment from the Lloyds TSB interim results announcement as at 30 June 2008 published by Lloyds TSB on 30 July 2008.
2. This adjustment represents the net proceeds received by Lloyds TSB as a result of the placing of 284,400,000 new Lloyds TSB Shares for 270p each on 19 September 2008.
3. The consolidated financial information of the HBOS Group in this pro forma net assets statement reflects the consolidated financial information in its interim financial report as at 30 June 2008, published by HBOS on 31 July 2008, following: (i) adjustments for material differences between the accounting policies of HBOS Group and Lloyds TSB Group; and (ii) reformatting in order to be consistent with the Lloyds TSB Group financial statements to the extent that the information required to make these reclassifications is available in the HBOS Group interim financial report.

Footnote	<i>HBOS Group as at 30 June 2008</i> (a)	<i>Accounting policy alignment</i> (b)	<i>Balance sheet reclassifications</i> (c)	<i>Alignment of balance sheet captions</i> (d)	<i>HBOS Group as at 30 June 2008 (Adjusted)</i> (Adjusted)
	£m	£m	£m	£m	£m
<b>Assets</b>					
Cash and balances at central banks	1,973	—	—	—	1,973
Items in course of collection from banks	1,133	—	—	—	1,133
Trading and other financial assets at fair value through profit or loss	—	—	116,699(i)	—	116,699
Financial assets held for trading	46,023	—	(46,023)(i)	—	—
Derivative assets	18,050	—	—	(18,050)	—
Derivative financial instruments	—	—	—	18,050	18,050
Loans and advances to banks	13,534	—	—	—	13,534
Loans and advances to customers	455,950	—	1,697(i)	—	457,647
Investment securities	119,074	—	(119,074)(i)	—	—
Available for sale financial assets	—	—	46,701(i)	—	46,701
Interests in jointly controlled entities	923	—	(923)(ii)	—	—
Interests in associates	190	—	(190)(ii)	—	—
Goodwill and other intangible assets	2,811	—	(2,811)(iii)	—	—
Goodwill	—	—	1,938(iii)	—	1,938
Other intangible assets	—	—	873(iii)	—	873
Property and equipment	1,597	—	—	(1,597)	—
Tangible fixed assets	—	—	4,370(iv)	1,597	5,967
Investment property	4,045	—	—	—	4,045
Operating lease assets	4,370	—	(4,370)(iv)	—	—
Deferred costs	1,130	—	(1,130)(ii)	—	—
Current tax assets	133	—	(133)(ii)	—	—
Value of in-force long term assurance business	3,284	—	—	—	3,284
Other assets	6,224	—	3,336(ii)	—	9,560
Prepayments and accrued income	960	—	(960)(ii)	—	—
<b>Total assets</b>	<b>681,404</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>681,404</b>



Footnote	HBOS Group as at 30 June 2008 (a)	Accounting policy alignment (b)	Balance sheet reclassifications (c)	Alignment of balance sheet captions (d)	HBOS Group as at 30 June 2008 (Adjusted)
	£m	£m	£m	£m	£m
<b>Liabilities</b>					
Deposits by banks	47,005	—	—	—	47,005
Customer accounts	258,130	—	—	—	258,130
Trading and other financial liabilities at fair value through profit or loss	—	—	—	28,744	28,744
Financial liabilities held for trading	28,744	—	—	(28,744)	—
Derivative liabilities	16,470	—	—	(16,470)	—
Derivative financial instruments	—	—	—	16,470	16,470
Notes in circulation	923	—	(923)(v)	—	—
Insurance contract liabilities	25,012	—	—	(25,012)	—
Liabilities arising from insurance contracts and participating investment contracts	—	—	—	25,012	25,012
Investment contract liabilities	50,007	—	—	(50,007)(i)	—
Liabilities arising from non- participating investment contracts	—	—	—	50,007(i)	50,007
Unallocated surplus	1,262	—	—	(1,262)	—
Unallocated surplus within insurance business	—	—	—	1,262	1,262
Net post retirement benefit liabilities	725	(137)	—	(588)	—
Retirement benefit obligations	—	—	—	588	588
Deferred tax liabilities	1,601	—	—	—	1,601
Other liabilities	7,666	—	3,916(v)	—	11,582
Accruals and deferred income	2,993	—	(2,993)(v)	—	—
Other provisions	174	—	—	—	174
Subordinated liabilities	—	—	26,084(vi)	—	26,084
Debt securities in issue	193,475	—	—	—	193,475
Other borrowed funds	26,084	—	(26,084)(vi)	—	—
<b>Total liabilities</b>	<b>660,271</b>	<b>(137)</b>	<b>—</b>	<b>—</b>	<b>660,134</b>
<b>Net assets</b>	<b>21,133</b>	<b>137</b>	<b>—</b>	<b>—</b>	<b>21,270</b>

(a) The financial information of HBOS Group as at 30 June 2008 has been extracted without material adjustment from HBOS's interim financial report as at 30 June 2008 published by HBOS on 31 July 2008.

(b) The accounting policy alignments are discussed further in Part X of this document.

(c) These reclassifications are in relation to:

- (i) the reclassification of Financial assets held for trading (£46,023m) and certain Investment securities (£70,676m) to Trading and other financial assets at fair value through profit or loss; and the remainder of Investment securities (£48,398m) reclassified to Available-for-sale financial assets (£46,701m) and Loans and Advances to customers (£1,697m).
- (ii) the reclassification of Interests in jointly controlled entities (£923m), Interests in associates (£190m), Deferred costs (£1,130m), Current tax assets (£133m) and Prepayments and accrued income (£960m) to Other assets;
- (iii) the reclassification of Goodwill and intangible assets into their separate components;
- (iv) the reclassification of Operating lease assets (£4,370m) to Tangible fixed assets;
- (v) reclassification of Notes in circulation (£923m) and Accruals and deferred income (£2,993m) to Other liabilities; and
- (vi) reclassification of Other borrowed funds (£26,084m) to Subordinated liabilities.

(d) These reclassifications reflect the alignment of balance sheet captions used by Lloyds TSB Group and HBOS Group.

- (i) the reclassification of Investment contract liabilities to Liabilities arising from non-participating investment contracts. HBOS Group discloses Investment contract liabilities on the face of its balance sheet. Lloyds TSB Group discloses Liabilities arising from insurance contracts and participating investment contracts and Liabilities arising from non-participating investment contracts on the face of its balance sheet. The HBOS 2008 interim accounts did not include an analysis of Investment contract liabilities and therefore, for the purposes of the *pro forma* net assets statement, the entire Investment contract liabilities amount has been classified within Liabilities arising from non-participating investment contracts. At 31 December 2007, HBOS' annual report and accounts disclosed that £7,192m of investment contracts with discretionary participation features were included within Investment contract liabilities.

4. This adjustment represents the proceeds (net of costs) received by HBOS as a result of its rights issue announced on 29 April 2008, as disclosed in its rights issue prospectus dated 19 June 2008.
5. This adjustment represents the estimated gross proceeds and recognition of the preference shares as an accounting liability arising from the Placing and Open Offer and the New Preference Share Issue. See note 7 below for details of costs associated with the Placing and Open Offer and New Preference Share Issue.
6. This adjustment represents the estimated gross proceeds and recognition of the preference shares as an accounting liability arising from the HBOS Placing and Open Offer and the New HBOS Preference Shares. No account has been taken of HBOS' costs associated with the HBOS Placing and Open Offer and the HBOS new preference share issue.
7. Lloyds TSB estimated costs directly attributable to the Acquisition are £60m. In addition, the Lloyds TSB estimated costs directly attributable to the Placing and Open Offer and the New HBOS Preference Share Issue are £70m. These costs have been deducted from cash and balances at central banks for the purposes of the pro forma net assets statement.
8. Save for the fundraisings and costs of the transactions set out in notes (2) and (4) above, no account has been taken of the trading or other transactions of Lloyds TSB or HBOS Group, including the sale by HBOS of BankWest and St Andrew's, since 30 June 2008.
9. The Acquisition gives rise to negative goodwill, which will be recognised in the income statement in the year of acquisition. On the same basis as the pro forma net assets statement, the negative goodwill has been calculated as follows:

	<i>£m</i>
Equity consideration (note 9 (i))	13,992
Costs of the transaction (note 7)	60
	14,052
Less net assets of HBOS Group (note 9 (ii))	(31,470)
Negative goodwill	17,418

- (i) The calculation of consideration is based on the Closing Price of Lloyds TSB ordinary shares of 179.2p as listed on the Daily Official List of the UK Listing Authority on 29 October 2008 and assumes that there will be 12,906m HBOS Shares, including those issued as a result of the HBOS Placing and Open Offer, in issue at completion and that each HBOS share will be exchanged for 0.605 Lloyds TSB shares.
- (ii) The net assets of HBOS are stated after:
  - (a) adjusting for the accounting policy alignment discussed further in Part X of this document;
  - (b) adjusting for the minority interests (£1,033m) as disclosed in the HBOS Group interim financial report as at 30 June 2008 published by HBOS on 31 July 2008;
  - (c) adjusting for the preference shares not included within other borrowed funds (£1,267m) extracted from the HBOS Group interim financial report as at 30 June 2008 published by HBOS on 31 July 2008 (pg 9, note 7); and
  - (d) adjusting for the HBOS rights issue and HBOS Placing and Open Offer (see notes (4) and (6)).

No additional intangible assets have been recognised as part of the Acquisition and no fair value adjustments have been made.
10. The other adjustment comprises (Notes 1, 2, 3):
  - (a) Lloyds TSB estimated costs directly attributable to the Acquisition are £60m.
  - (b) Lloyds TSB estimated costs directly attributable to the Placing and Open Offer are £70m.
  - (c) The elimination of the HBOS available for sale reserve which at 30 June 2008 amounted to £2,173m (see note 17, page 231).

- 
- (1) Based on a review of non-public information provided by HBOS, Lloyds TSB has made a preliminary assessment that net negative capital adjustments of no more than £10bn after tax would need to be made to HBOS's financial position for core Tier 1 capital purposes as a result of the Acquisition. The amount of the capital adjustments takes into account the elimination of the HBOS available for sale ("AFS") reserve at 30 September 2008 and includes the effects of the application of market based credit spreads at September 2008 to HBOS's portfolios. A comprehensive assessment of the fair values of HBOS's assets will be undertaken following completion of the Acquisition, the provisional results of which will be published in Lloyds TSB's 2009 interim report. The actual capital adjustments will reflect the conditions that exist at the Effective Date.

Based on published information at 30 June 2008, and taking into account Lloyds TSB's equity placing completed on 19 September 2008, the Placing and Open Offer, HBOS's rights issue announced on 29 April 2008 and the HBOS Placing and Open Offer as well as the net negative capital adjustments to HBOS's financial position referred to previously, the Enlarged Group would have had a core Tier 1 ratio in excess of 7%. In calculating this core Tier 1 ratio no account has been taken of the trading performance of Lloyds TSB or HBOS or of other transactions by Lloyds TSB or HBOS since 30 June 2008, including the sale by HBOS of BankWest and St Andrews, except for the equity placing completed by Lloyds TSB on 19 September 2008.

- (2) The impact of the negative capital adjustments referred to above on the Enlarged Group's net tangible assets is reduced by the amount of HBOS available for sale ("AFS") reserve which at 30 September 2008 amounted to approximately £4bn.
- (3) In addition, the review of non-public information provided by HBOS has identified a positive fair value adjustment for the Enlarged Group's net tangible assets in respect of HBOS's own debt. This is of a similar magnitude to the capital adjustments affecting core Tier 1 capital (excluding the AFS reserve adjustment) but will be affected, and could theoretically be eliminated by, *inter alia*, movements in credit spreads on HBOS's debt between the date of the review and the Effective Date.

The Directors  
Lloyds TSB Group plc  
25 Gresham Street  
London  
EC2V 7HN

Citigroup Global Markets Limited  
Citigroup Centre  
Canada Square  
London  
E14 5LB

Merrill Lynch International  
Merrill Lynch Financial Centre  
King Edward Street  
London  
EC1A 1HQ

UBS Limited  
1 Finsbury Avenue  
London  
EC2M 2PP

3 November 2008

Dear Sirs

**Lloyds TSB Group plc (the “Company”)**

We report on the pro forma net assets statement (the “**Pro forma financial information**”) set out in Part XI of the Company’s circular dated 3 November 2008 (the “**Circular**”) which has been prepared on the basis described in the notes to the Pro forma financial information, for illustrative purposes only, to provide information about how the proposed acquisition of HBOS plc by the Company might have affected the financial information presented on the basis of the accounting policies adopted by the Company in preparing its interim financial statements for the period ended 30 June 2008. This report is required by item 13.3.3R of the Listing Rules of the UK Listing Authority (the “**Listing Rules**”) and is given for the purpose of complying with that Listing Rule and for no other purpose.

**Responsibilities**

It is the responsibility of the directors of the Company to prepare the Pro forma financial information in accordance with item 13.3.3R of the Listing Rules.

It is our responsibility to form an opinion, as required by item 13.3.3R of the Listing Rules as to the proper compilation of the Pro forma financial information and to report our opinion to you.

In providing this opinion we are not updating or refreshing any reports or opinions previously made by us on any financial information used in the compilation of the Pro forma financial information, nor do we accept responsibility for such reports or opinions beyond that owed to those to whom those reports or opinions were addressed by us at the dates of their issue.

PricewaterhouseCoopers LLP is a limited liability partnership registered in England with registered number OC303525. The registered office of PricewaterhouseCoopers LLP is 1 Embankment Place, London WC2N 6RH. PricewaterhouseCoopers LLP is authorised and regulated by the Financial Services Authority for designated investment business.

Save for any responsibility which we may have to those persons to whom this report is expressly addressed and which we may have to shareholders of the Company as a result of the inclusion of this report in the Circular, to the fullest extent permitted by law we do not assume any responsibility and will not accept any liability to any other person for any loss suffered by any such person as a result of, arising out of, or in accordance with this report or our statement, required by and given solely for the purposes of complying with item 13.4.1R(6) of the Listing Rules, consenting to its inclusion in the Circular.

### **Basis of opinion**

We conducted our work in accordance with the Standards for Investment Reporting issued by the Auditing Practices Board in the United Kingdom. The work that we performed for the purpose of making this report, which involved no independent examination of any of the underlying financial information, consisted primarily of comparing the unadjusted financial information with the source documents, considering the evidence supporting the adjustments and discussing the Pro forma financial information with the directors of the Company.

We planned and performed our work so as to obtain the information and explanations we considered necessary in order to provide us with reasonable assurance that the Pro forma financial information has been properly compiled on the basis stated and that such basis is consistent with the accounting policies of the Company.

Our work has not been carried out in accordance with auditing standards or other standards and practices generally accepted in the United States of America or auditing standards of the Public Company Accounting Oversight Board (United States) and accordingly should not be relied upon as if it had been carried out in accordance with those standards and practices.

### **Opinion**

In our opinion:

- (i) the Pro forma financial information has been properly compiled on the basis stated; and
- (ii) such basis is consistent with the accounting policies of the Company.

Yours faithfully

PricewaterhouseCoopers LLP  
Chartered Accountants

## PART XII

### ADDITIONAL INFORMATION

#### 1 Responsibility

The Lloyds TSB Directors, whose names appear in paragraph 4 of this Part XII, accept responsibility for the information contained in this document. To the best of the knowledge and belief of the Lloyds TSB Directors (who have taken all reasonable care to ensure that such is the case) the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information.

Nicholas Macpherson (acting in his capacity as Permanent Secretary to HM Treasury) (the “HM Treasury Responsible Person”) accepts responsibility for the information contained in this document relating to HM Treasury, including any statements of expectation or intention on the part of HM Treasury. To the best of the knowledge and belief of the HM Treasury Responsible Person (who has taken all reasonable care to ensure that such is the case), the information contained in this document for which he is responsible is in accordance with the facts and does not omit anything likely to affect the import of such information.

#### 2 Capital Resources and Liquidity

The effective management of capital and risk remains central to Lloyds TSB’s strategy. Lloyds TSB continues to be focused on the maintenance of a strong capital base, to ensure this base expands appropriately and to utilise capital efficiently throughout Lloyds TSB’s activities to both maintain a prudent relationship between the capital base and the underlying risks of the business and also optimise returns to shareholders. It is intended that this same approach will apply in the Enlarged Group. In the pursuit of this focused approach to capital and risk management, Lloyds TSB follows the supervisory requirements of the FSA. During 2008, the key focus of capital adequacy has shifted to the ratio of core Tier 1 capital to risk-weighted assets. At 30 June 2008 Lloyds TSB had a core Tier 1 ratio of 6.2 per cent.

In the context of continued turbulence and uncertainty in financial markets, combined with the deteriorating global economic outlook, the Lloyds TSB Board believes it is essential to maintain higher levels of capital in order to ensure the Enlarged Group remains resilient to any further shocks to the financial system and that it remains competitive. Upon completion of the Placing and Open Offer, Lloyds TSB will issue approximately 2.6 billion Open Offer Shares in accordance with the terms of the Placing and Open Offer Agreement and HBOS will issue approximately 7.5 billion HBOS Open Offer Shares in accordance with the terms of the HBOS Placing and Open Offer Agreement (which will as a result of the Acquisition be exchanged into approximately 4.5 billion Lloyds TSB Shares), raising in aggregate approximately £13 billion. The fair value of these new shares is £12.8 billion based on the closing price of the Lloyds TSB Shares of 179.2 pence per share set forth in the London Stock Exchange Daily Official List on 29 October 2008, the last practicable date prior to the date of this document. Upon completion of the Acquisition and the Placing and Open Offer, Lloyds TSB will also issue 1 million New Preference Shares with an aggregate liquidation preference of £1 billion to HM Treasury in accordance with the terms of the Preference Share Subscription Agreement, and HBOS will issue 3 million New HBOS Preference Shares with an aggregate liquidation preference of £3 billion to HM Treasury in accordance with the terms of the HBOS Preference Share Subscription Agreement, such issues raising in aggregate approximately £4 billion. Based on published information at 30 June 2008, and taking into account Lloyds TSB’s equity placing completed on 19 September 2008, the Placing and Open Offer, HBOS’s rights issue announced on 29 April 2008 and the HBOS Placing and Open Offer, Lloyds TSB estimates that the Enlarged Group would have had a core Tier 1 ratio of 8.8 per cent. at 30 June 2008. Lloyds TSB has made a preliminary assessment that net negative capital adjustments of no more than £10 billion after tax would need to be made to HBOS’s financial position for core Tier 1 capital purposes as a result of the Acquisition, the effect of which would mean that the Enlarged Group would have a Core Tier 1 ratio 7 per cent.

Within Lloyds TSB the liquidity management framework focuses on both overall balance sheet structure and the control, within prudent limits, of risk arising from the maturity mismatch of assets and liabilities across the balance sheet, as well as from undrawn commitments and other contingent obligations. The aim of Lloyds TSB’s balance sheet structure management is to maintain substantial diversification, minimise concentration across Lloyds TSB’s various deposit

sources and control the level of reliance on total short-term wholesale sources of funds (both secured and unsecured). As part of Lloyds TSB's planning process, it regularly reviews the forecast structure of its balance sheet over the planning period, and updates the funding plan as appropriate. In addition, Lloyds TSB continuously monitors the level of large deposits taken from individual bank, corporate, non-bank financial institution and other customer types and also reviews the significant cash outflows therefrom to monitor concentration and trends. Lloyds TSB operates within the context of a full suite of liquidity metrics to ensure that the Group is within the liquidity risk appetite set by the Board.

During 2008, global financial markets have experienced extremely turbulent conditions. As a consequence of this, governments and central banks have undertaken a series of escalating actions in the attempt to improve liquidity within their respective banking systems. In September and October the Bank of England, the European Central Bank and the US Federal Reserve announced a number of new mechanisms and tools for the provision of liquidity to banks in their respective jurisdictions, including those in which Lloyds TSB and HBOS operate. Such measures include weekly and longer term repurchase agreements, expanding the types of collateral accepted by these central banks as security for funding; and co-ordinating global action to strengthen the banking system and functioning of the interbank markets. On 8 October 2008, the UK Government announced a broad range of measures intended to ease both the cause and the symptoms of the current difficulties in the UK banking system, including the provision of liquidity and funding support to banks. This currently consists of the Special Liquidity Scheme, whereby banks and building societies can exchange eligible securities for UK Treasury bills; and a guarantee on short and medium term debt issuance by HM Treasury.

However, there can be no assurance that these global measures will succeed in improving the funding and liquidity of the markets in which the major banks, including Lloyds TSB and HBOS, operate. Lloyds TSB believes the Enlarged Group remains relatively well positioned to access a number of wholesale funding sources from a range of counterparties, markets, sectors and geographical markets. However, despite the relatively advantageous situation enjoyed by the Enlarged Group, the uncertainty facing the markets is such that management believe that no institution is immune from the effects of an extended closure of the wholesale markets without the support of the central bank and/or government. It is likely that in this context, the Enlarged Group will continue to draw on the Special Liquidity Scheme, and will take advantage of the guaranteed funding provided by HM Treasury.

As discussed above, the global markets for short, medium, and long term sources of funding on which banks rely to support their business activities have undergone a period of unprecedented upheaval and contraction, which has led to direct intervention by HM Treasury (via the introduction of the government guarantee scheme for senior funding) and the Bank of England (via the extended Long Term Repo facility, and the new Discount Window facility) in order to provide further assurance of liquidity support for the markets. The Enlarged Group is eligible to participate in the schemes, and will use these tools as appropriate in future liquidity and funding management, particularly in an environment as currently experienced.

Due to the severity of this dislocation which has catalysed unprecedented levels of government intervention around the world and extraordinary uncertainty facing the banking industry in the medium term, and the availability of the UK Government facilities described above being conditional upon, *inter alia*, the passing of various resolutions including those relating to the Acquisition, the United Kingdom Listing Authority has agreed that a statement regarding the adequacy of working capital for at least the next twelve months should not be required in this document. There is therefore no working capital statement in this document.

### 3 Share Capital

The following table shows the authorised and issued share capital of the Company, as at 29 October 2008, being the latest practicable date prior to the publication of this document:

Class of Share	Authorised		Issued and fully paid	
	Number	Amount	Number	Amount
Ordinary Shares of £0.25 each	6,911,052,632	£1,727,763,158	5,972,853,501	£1,493,213,375
Limited Voting Ordinary Shares of £0.25 each	78,947,368	£19,736,842	78,947,368	£19,736,842
Preference Shares of £0.25 each	175,000,000	£43,750,000	600,400	£150,100
Preference Shares of US\$0.25 each	160,000,000	US\$40,000,000	1,000,000	US\$250,000
Preference Shares of €0.25 each	160,000,000	€40,000,000	0	0
Preference Shares of ¥25 each	50,000,000	¥1,250,000,000	0	0

The authorised, issued and fully paid share capital of the Company immediately following completion of the Placing and Open Offer, the New Preference Share Issue, the HBOS Preference Share Scheme and the Acquisition<sup>(1)</sup> is expected to be as follows:

Class of Share	Authorised		Issued and fully paid	
	Number	Amount	Number	Amount
Ordinary Shares of £0.25 each	21,822,960,853	£5,455,740,213	16,367,220,640	4,091,805,160
Limited Voting Ordinary Shares of £0.25 each	78,947,368	£19,736,842	78,947,368	£19,736,842
Preference Shares of £0.25 each	800,000,000	£200,000,000	603,700,400	£150,925,100
Preference Shares of US\$0.25 each	160,000,000	US\$40,000,000	3,250,000	US\$812,500
Preference Shares of €0.25 each	160,000,000	€40,000,000	—	—
Preference Shares of ¥25 each	50,000,000	¥1,250,000,000	—	—

Note:

(1) The number of Lloyds TSB Shares in issue immediately following the Placing and Open Offer, the New Preference Share Issue, the HBOS Preference Share Scheme and the Acquisition assumes (i) that the maximum number of Lloyds TSB Shares and Lloyds TSB Preference Shares to be issued pursuant to the Placing and Open Offer, the New Preference Share Issue and the HBOS Preference Share Scheme have been issued, (ii) no other issues of Lloyds TSB Shares or Lloyds TSB Preference Shares (including under Lloyds TSB Share Plans) between 29 October 2008, being the last practicable date prior to the publication of this document, and the Effective Date, and (iii) no other issues of HBOS Shares (including under the HBOS Share Schemes) between 29 October 2008, being the last practicable date prior to the publication of this document, and the Effective Date.

### 4 Lloyds TSB Directors

The following table sets out information relating to each of the Lloyds TSB Directors:

Name	Age	Current position in respect of Lloyds TSB
<b>Executive Directors:</b>		
J Eric Daniels	57	Group Chief Executive
Archie G Kane	56	Group Executive Director, Insurance & Investments
G Truett Tate	58	Group Executive Director, Wholesale & International Banking
Tim J W Tookey	46	Group Finance Director
Helen A Weir CBE	46	Group Executive Director, UK Retail Banking
<b>Non-Executive Directors:</b>		
Sir Victor Blank	65	Chairman
Wolfgang C G Berndt <sup>(1)</sup>	66	Non-Executive Director
Ewan Brown CBE FRSE <sup>(1)</sup>	66	Non-Executive Director
Jan P du Plessis <sup>(1)</sup>	54	Non-Executive Director
Philip N Green <sup>(1)</sup>	55	Non-Executive Director
Sir Julian Horn-Smith <sup>(1)</sup>	59	Non-Executive Director
Lord Leitch <sup>(1)</sup>	61	Non-Executive Director
Sir David Manning GCMG CVO <sup>(1)</sup>	58	Non-Executive Director
Carolyn J McCall OBE <sup>(1)</sup>	47	Non-Executive Director
Martin A Scicluna <sup>(1)</sup>	57	Non-Executive Director

Note:

(1) Denotes Independent Non-Executive Director



## 5 Interests of the Lloyds TSB Directors

As at 29 October 2008 (being the latest practicable date prior to the publication of this document), the interests (all of which are beneficial unless otherwise stated) of the Lloyds TSB Directors, their immediate families and (so far as is known to them or could with reasonable diligence be ascertained by them) persons connected (within the meaning of section 252 of the Companies Act) with the Lloyds TSB Directors in the issued ordinary share capital of Lloyds TSB, including: (i) those arising pursuant to transactions notified to Lloyds TSB pursuant to DTR 3.1.2R; or (ii) those of persons connected with the Lloyds TSB Directors, which would, if such connected person were a Lloyds TSB Director, be required to be disclosed under (i) above, together with the interests which are expected to subsist immediately following Admission, are set out in the following table:

	<i>As at 29 October 2008</i>		<i>Interests immediately following Admission<sup>(1)</sup></i>	
	<i>Number of Lloyds TSB Shares</i>	<i>Percentage of issued ordinary share capital of Lloyds TSB</i>	<i>Number of Lloyds TSB Shares</i>	<i>Percentage of enlarged issued ordinary share capital of Lloyds TSB</i>
<b>Lloyds TSB Directors</b>				
<b>Executive Directors:</b>				
J Eric Daniels	422,777	0.01	422,777	0.00
Archie G Kane	203,820	0.00	203,820	0.00
G Truett Tate	74,831	0.00	74,831	0.00
Tim J W Tookey	2,252	0.00	2,252	0.00
Helen A Weir CBE	61,581	0.00	61,581	0.00
<b>Non-Executive Directors:</b>				
Sir Victor Blank	301,199	0.01	301,199	0.00
Wolfgang C G Berndt	170,000	0.00	170,000	0.00
Ewan Brown CBE FRSE	5,074	0.00	5,074	0.00
Jan P du Plessis	50,000	0.00	50,000	0.00
Philip N Green	5,000	0.00	5,000	0.00
Sir Julian Horn-Smith	5,000	0.00	5,000	0.00
Lord Leitch	10,000	0.00	10,000	0.00
Sir David Manning GCMG CVO	4,500	0.00	4,500	0.00
Carolyn J McCall OBE	0.00	0.00	0.00	0.00
Martin A Scicluna	0.00	0.00	0.00	0.00

Note:

(1) Figures are calculated assuming (i) that the interests of the Lloyds TSB Directors as at close of business on 29 October 2008, being the last practicable date prior to the publication of this document, do not change, (ii) that the maximum number of Lloyds TSB Shares to be issued pursuant to the Placing and Open Offer have been issued, (iii) no Lloyds TSB Shares (including under Lloyds TSB Share Plans) are issued between 29 October 2008, being the last practicable date prior to the publication of this document, and the Effective Date, and (iv) no HBOS Shares (including under the HBOS Share Schemes) are issued between 29 October 2008, being the last practicable date prior to the publication of this document, and the Effective Date.

Taken together, the combined percentage interest of the Lloyds TSB Directors in the issued ordinary share capital of Lloyds TSB as at 29 October 2008 was approximately 0.02 per cent.

Details of options over Lloyds TSB Shares held by the Lloyds TSB Directors are set out below. They are not included in the interests of the Lloyds TSB Directors shown in the table above.

### Directors' options and awards

The following Lloyds TSB Directors had interests in the following options and awards relating to Lloyds TSB Shares under one or more of the Lloyds TSB Share Plans (each as defined in the Definitions section of this document) as at 29 October 2008 (being the latest practicable date prior to publication of this document):

<i>Name</i>	<i>Share plan</i>	<i>Date of grant</i>	<i>Number of Shares</i>	<i>Option price (£)</i>	<i>Market price at date of award (£)</i>	<i>Vested/ Unvested</i>	<i>Exercise period/ vesting date/year</i>
J Eric Daniels	Lloyds TSB Group executive share option scheme	18.03.04	131,484	4.1925	—	Vested	21.02.08 - 17.03.14
	Lloyds TSB Group executive share option scheme	17.03.05	430,547	4.7425	—	Vested	17.03.08 - 16.03.15
	Lloyds TSB Group sharesave scheme	05.04.06	2,236	4.18	—	Unvested	01.06.09 - 30.11.09
	Lloyds TSB performance share plan – Bonus shares	20.03.06	50,944		5.661	Unvested	20.03.09
	Lloyds TSB performance share plan – Performance shares	20.03.06	172,694		5.661	Unvested	20.03.09
	Lloyds TSB long-term incentive plan	12.05.06	507,692		5.20	Unvested	2009
	Lloyds TSB long-term incentive plan	08.03.07	534,322		5.39	Unvested	2010
	Lloyds TSB long-term incentive plan	04.04.08	838,735		4.6275	Unvested	2011
	Overall Total		2,668,654				
Archie G Kane	Lloyds TSB Group executive share option scheme	04.03.99	27,000	8.875		Unvested	04.03.02 - 03.03.09
	Lloyds TSB Group executive share option scheme	06.03.00	64,786	5.495		Unvested	06.03.03 - 05.03.10
	Lloyds TSB Group executive share option scheme	08.08.00	11,841	6.155		Unvested	08.08.03 - 07.08.10
	Lloyds TSB Group executive share option scheme	06.03.01	34,759	6.55		Unvested	06.03.04 - 05.03.11
	Lloyds TSB Group executive share option scheme	18.03.04	73,255	4.1925		Vested	21.02.08 - 17.03.14
	Lloyds TSB Group executive share option scheme	17.03.05	247,891	4.7425		Vested	17.03.08 - 16.03.15
	Lloyds TSB performance share plan – Bonus shares	20.03.06	20,531		5.661	Unvested	20.03.09
	Lloyds TSB performance share plan – Performance shares	20.03.06	69,598		5.661	Unvested	20.03.09
	Lloyds TSB long-term incentive plan	12.05.06	288,460		5.20	Unvested	2009
	Lloyds TSB long-term incentive plan	08.03.07	306,122		5.39	Unvested	2010
	Lloyds TSB long-term incentive plan	06.03.08	413,309		4.2825	Unvested	2011
	Overall Total		1,557,552				
G Truett Tate	Lloyds TSB Group executive share option scheme	18.03.04	64,400	4.1925		Vested	21.02.08 - 17.03.14
	Lloyds TSB Group executive share option scheme	12.08.04	27,357	4.03		Vested	21.02.08 - 11.08.14
	Lloyds TSB Group executive share option scheme	17.03.05	247,891	4.7425		Vested	17.03.08 - 16.03.15
	Lloyds TSB performance share plan – Bonus shares	20.03.06	27,358		5.661	Unvested	20.03.09
	Lloyds TSB performance share plan – Performance shares	20.03.06	92,738		5.661	Unvested	20.03.09
	Lloyds TSB long-term incentive plan	12.05.06	297,114		5.20	Unvested	2009
	Lloyds TSB long-term incentive plan	08.03.07	333,951		5.39	Unvested	2010
	Lloyds TSB long-term incentive plan	04.04.08	518,638		4.6275	Unvested	2011
	Overall Total		1,609,447				
Tim J W Tookey	Lloyds TSB Group Executive Share Plan 2003	19.04.06	35,305	Nil	—	Unvested	20.04.09 - 19.10.09
	Lloyds TSB Long-term Incentive Plan	12.05.06	54,258		5.20	Unvested	2009
	Lloyds TSB Long-term Incentive Plan	08.03.07	52,875		5.39	Unvested	2010
	Lloyds TSB Long-term Incentive Plan	06.03.08	71,220		4.2825	Unvested	2011
	Lloyds TSB Group Sharesave Scheme	02.04.08	2,798	3.43	—	Unvested	01.06.11 - 30.11.13
	Overall Total		216,456				
Helen A Weir CBE	Lloyds TSB Group executive share option scheme	29.04.04	77,868	4.2475		Vested	21.02.08 - 28.04.14
	Lloyds TSB Group executive share option scheme	17.03.05	247,891	4.7425		Vested	17.03.08 - 16.03.15
	Lloyds TSB performance share plan – Bonus shares	20.03.06	20,062		5.661	Unvested	20.03.09
	Lloyds TSB performance share plan – Performance shares	20.03.06	68,008		5.661	Unvested	20.03.09
	Lloyds TSB long-term incentive plan	12.05.06	288,460		5.20	Unvested	2009
	Lloyds TSB long-term incentive plan	08.03.07	320,037		5.39	Unvested	2010
Lloyds TSB long-term incentive plan	04.04.08	506,482		4.6275	Unvested	2011	
Overall Total		1,528,808					
Sir Victor Blank	Lloyds TSB Group sharesave scheme	02.04.08	4,897	3.43		Unvested	01.06.13 - 30.11.13

Save as disclosed in this paragraph 5, no Lloyds TSB Director nor their immediate families, nor any person connected with any Lloyds TSB Director within the meaning of section 252 of the Companies Act has any interests (beneficial or non-beneficial) in the share capital of Lloyds TSB or any of its subsidiaries.

## 6 Directors' Service Agreements

### 6.1 Remuneration of Directors

Details of the remuneration of the Lloyds TSB Directors, with whom Lloyds TSB Bank plc has entered into service agreements, relating to their salary, pension and other benefits (other than share options) are shown below:

<i>Lloyds TSB Directors</i>	<i>Salary and fees £'000</i>	<i>Other cash benefits £'000<sup>1</sup></i>	<i>Non-cash benefits £'000<sup>2</sup></i>	<i>Pension: Lloyds TSB defined contribution scheme (DC) or defined benefit scheme (DB)</i>
<b>Executive Directors</b>				
J Eric Daniels	1,035	108	8	DB
Archie G Kane	590	22	23	DB
G Truett Tate	640	25	24	DC
Tim J W Tookey	600 <sup>3</sup>	25	1	DC
Helen A Weir CBE	625	96	22	DC <sup>4</sup>
<b>Non-executive Directors</b>				
Sir Victor Blank	640	12	17	N/A

Notes:

- (1) This includes flexible benefit payments (4 per cent. of basic salary), an education allowance and tax planning allowance for J Eric Daniels, payments to certain directors who elect to take cash rather than a company car under the car scheme and a cash pension supplement for Helen A Weir CBE.
- (2) This includes amounts relating to the use of a company car, use of a company driver and private medical insurance.
- (3) Tim J W Tookey's salary prior to appointment as Group Finance Director on 30 October 2008 was £475,000 per annum.
- (4) The amount for Helen A Weir CBE is a contribution to the defined contribution scheme. She also receives the cash pension supplement referred to at footnote 1.

Other than in relation to Tim J W Tookey, whose salary was increased at the time of his appointment to the Lloyds TSB Board on 30 October 2008 there have been no changes to the terms upon which the executive Lloyds TSB Directors (the "Executive Directors") are employed in the six months prior to the date of this document.

### 6.2 Annual incentive scheme

The Executive Directors currently participate in the Lloyds TSB annual incentive scheme for executive directors. Awards under this scheme are based on individual contribution and overall corporate results. Half of the bonus opportunity is driven by corporate performance based on the stretching budget relating to profit before tax and economic profit. The lower of profit before tax and economic profit will determine the extent to which the target has been met. The other half of the bonus opportunity is determined by divisional achievement driven through individual performance. Individual targets relevant to improving overall business performance are contained in a balanced scorecard and are grouped under the following headings: Financial; Franchise Growth; Customer Service; Risk; and People Development. These targets are weighted differently for each of the executive directors, reflecting differing strategic priorities. The non-financial measures include key performance indicators relating to process efficiency, service quality and employee engagement.

The maximum bonus opportunity is 200 per cent. (225 per cent. for Mr Daniels) of basic salary for the achievement of exceptional performance targets. The maximum payment under the corporate half of the bonus is only available if exceptional performance is achieved against the stretching corporate budget. An amount equal to 50 per cent. of this element of the bonus is available on the achievement of the stretching corporate budget. Failure to achieve at least 90 per cent. of the stretching budget would result in no payment under the corporate half of the bonus.

Awards under the annual incentive scheme are made in cash only.

Lloyds TSB announced on 13 October 2008 that although the Lloyds TSB Directors are each entitled to take cash as an alternative to shares in respect of their 2008 bonus it would ask the Executive Directors to agree to receive such entitlement in Lloyds TSB Shares (which would be subject to a restriction on sale until December 2009). The Executive Directors have responded positively to this request and have each now agreed to receive Lloyds TSB Shares in lieu of their cash entitlement in respect of such bonus, with this restriction on sale.

For 2009 and future years, Lloyds TSB will undertake a review of their executive remuneration arrangements with a view to ensuring compliance with the conditions relating to the Proposed Government Funding and in particular, the Association of British Insurers' industry best practice code on executive pay and remuneration and any new FSA code on risk-based remuneration.

### **6.3 Lloyds TSB Share Plans**

The Executive Directors are also eligible to participate in the Lloyds TSB Share Plans. Executive Directors currently have outstanding share options and awards under the Lloyds TSB Long Term Incentive Plan, the Performance Share Plan, the Shareplan, the Executive Share Option Schemes and the Sharesave Scheme. Details of outstanding options and awards can be found on page 250 of this document.

### **6.4 Pension Schemes**

Executive Directors are either entitled to participate in the Lloyds TSB Group's defined benefit pension schemes (based on salary and length of service, with a maximum pension of two thirds of final salary), or the Lloyds TSB Group's defined contribution scheme (under which their final entitlement will depend on their contributions and the final value of their fund). The defined benefit schemes are closed to new entrants on recruitment.

Those directors who joined the Lloyds TSB Group after 1 June 1989 and are members of a defined benefit scheme have pensions provided on salary in excess of the earnings cap either through membership of a funded unapproved retirement benefits scheme ("FURBS") or by an unfunded pension promise.

Retirement pensions accrue at rates of between one sixtieth and one thirtieth of basic salary.

Directors have a normal retirement age of 60. However, following the implementation of The Employment Equality (Age) Regulations 2006, they may now choose to delay their retirement until age 65. In the event of death in service, a lump sum of four times salary is payable plus, for members of a defined benefit scheme, a spouse's pension of two-thirds of the member's prospective pension. On death in retirement, a spouse's pension of two-thirds of the member's pension is payable. The defined benefit schemes are non-contributory. Members of defined contribution schemes are required to contribute.

If Mr Daniels and Mr Kane cease to be employed by reason of redundancy and are aged 50 or more, their employment contracts state that Lloyds TSB shall procure that an immediate pension shall be payable from the date of cessation of employment based on final pensionable salary and pensionable service at the time of cessation but without any reduction for commencement of payment before the age of 60.

### **6.5 Benefits on Termination of Employment of Lloyds TSB Directors**

Save as set out below, the Lloyds TSB Directors' service agreements make no provision for compensation in the event of early termination of their employment.

The service agreements for G Truett Tate, Tim J W Tookey and Helen A Weir specify that the compensation payable in the event of termination without cause should be calculated on base salary only for the applicable notice period. Lloyds TSB will pay them 12 monthly payments of one month's base salary or, in the case of Helen A Weir and G Truett Tate, a lump sum of 12 months' base salary. Their service agreements provide that any such sums will be reduced by any remuneration received from any new employment in respect of the same period.

The service agreements for Sir Victor Blank, J Eric Daniels and Archie G Kane provide for 12 months' notice (6 months in the case of Sir Victor). In the event of termination without cause, the compensation payable to them would be based on their base salary and contractual benefits for the applicable notice period. In accordance with the Lloyds TSB Group's policy, Lloyds TSB would

expect such compensation to be reduced by any remuneration from alternative employment and be paid on a monthly basis.

It is not the Lloyds TSB Group's policy to compensate executive directors for loss of bonus in respect of any period of notice of termination.

The non-executive Lloyds TSB Directors (the "Non-Executive Directors") (other than Sir Victor Blank) do not have service agreements or notice periods, although they each have letters of engagement reflecting their responsibilities and commitments. Under the Articles of Association of the Company, all Lloyds TSB Directors must retire and seek election by Lloyds TSB Shareholders at the annual general meeting following next after his or her appointment. No compensation would be paid to any non-executive director (other than Sir Victor Blank, whose entitlement is set out above) in the event of early termination.

Details of the Chairman and Executive Directors' notice periods under their service agreements with Lloyds TSB Bank plc are set out below:

<i>Name</i>	<i>Date of current contract</i>	<i>Notice period – from company</i>	<i>Notice period – from executive</i>
Sir Victor Blank	25 January 2006	6 months	6 months
J Eric Daniels	19 October 2001	12 months	6 months
Archie G Kane	9 February 2000	12 months	6 months
G Truett Tate	29 July 2004	12 months	6 months
Tim J W Tookey	10 February 2006	12 months	6 months
Helen A Weir CBE	4 March 2004	12 months	6 months

## **7 Details of Key Individuals Important to HBOS's Business**

As far as the Company is aware, the following persons are key individuals who are important to the business of HBOS:

<i>Name</i>	<i>Position</i>
Dennis Stevenson	Chairman
Andy Hornby	Chief Executive
Peter Cummings	Chief Executive, Corporate
Jo Dawson	Chief Executive, Retail Distribution, Insurance & Investment
Mike Ellis	Group Finance Director
Philip Gore-Randall	Chief Operating Officer
Colin Matthew	Chief Executive, Strategy, International and Treasury & Asset Management
Dan Watkins	Chief Executive, Retail Products
Harry Baines	Company Secretary & Group Counsel
Peter Hickman	Group Risk Director

As disclosed in the Chairman's letter in Part I of this document, Lloyds TSB has announced Board, Company secretary and other Group executive committee appointments to the Enlarged Group with effect from completion of the Acquisition. Of those listed above, Jo Dawson is to be appointed Wealth and International Director of the Enlarged Group and Harry Baines is to be appointed General Counsel and Company Secretary of the Enlarged Group. At this stage, other than as described in paragraph 7.1 below, no further decisions have been taken in respect of future appointments (if any) of the above-named individuals within the Enlarged Group.

### **7.1 Consultancy agreement**

Andy Hornby has agreed in principle to provide his services to Lloyds TSB on a consultancy basis to assist with integration-related matters. The appointment will commence when the Acquisition becomes Effective and is terminable on one month's notice by either party. Mr Hornby's consultancy fee is £60,000 per month.

## **8 Major Shareholders of Lloyds TSB**

As at 29 October 2008 (the latest practicable date prior to the publication of this document), notifications had been received of the following interests in three per cent. or more of Lloyds TSB's issued ordinary share capital:

Shareholder	Prior to Admission of the Consideration Shares and the Open Offer Shares <sup>1</sup>		Following Admission of the Consideration Shares and the Open Offer Shares <sup>1</sup>	
	Number of Lloyds TSB Shares	Percentage of issued ordinary share capital	Number of Lloyds TSB Shares	Percentage of issued ordinary share capital
HM Treasury	0	0	7,123,501,794	43.52
Legal & General Investment Management Limited	232,229,960 <sup>2</sup>	4.11	232,229,960 <sup>2</sup>	1.41
Barclays PLC	216,216,951	3.84	216,216,951	1.31
The Capital Group Companies, Inc.	272,152,525	4.86	272,152,525	1.65

Note:

(1) Figures are calculated assuming (i) that the interests of the existing major shareholders as at close of business on 29 October 2008, being the last practicable date prior to the publication of this document, do not change, (ii) that the maximum number of Lloyds TSB Shares to be issued pursuant to the Placing and Open Offer have been issued, (iii) no Lloyds TSB Shares (including under Lloyds TSB Share Plans) are issued between 29 October 2008, being the last practicable date prior to the publication of this document, and the Effective Date, (iv) no HBOS Shares (including under the HBOS Share Schemes) are issued between 29 October 2008, being the last practicable date prior to the publication of this document, and the Effective Date, (v) that no existing Lloyds TSB Shareholders or HBOS Shareholders acquire any Open Offer Shares or HBOS Open Offer Shares, as the case may be; and (vi) that the existing major shareholders do not own any HBOS Shares.

(2) Direct interest.

Save as disclosed above, the Lloyds TSB Directors are not aware of any person who is interested (within the meaning of rule 5 of the Disclosure and Transparency Rules), directly or indirectly, in the total voting rights attaching to, three per cent. or more of the issued share capital of the Company.

As at 29 October 2008, being the latest practicable date prior to the publication of this document, the Company was not aware of any person or persons who directly, indirectly, jointly or severally, exercise or could exercise control over the Company nor is it aware of any arrangements the operation of which may, at a subsequent date, result in a change in control of the Company.

None of the Company's major shareholders has, or will have, different voting rights attached to the Lloyds TSB Shares they hold.

## 9 Material Contracts

### 9.1 Lloyds TSB Material Contracts

The following are all of the contracts (not being contracts entered into in the ordinary course of business) that have been entered into by members of the Lloyds TSB Group: (i) within the two years immediately preceding the date of this document which are, or may be, material to the Lloyds TSB Group; or (ii) at any time and contain obligations or entitlements which are, or may be, material to the Lloyds TSB Group as at the date of this document:

#### 9.1.1 Implementation Agreement entered into on 18 September 2008

On 18 September 2008, Lloyds TSB and HBOS entered into the Implementation Agreement, as subsequently amended and restated on 13 October 2008. The Implementation Agreement provides, *inter alia*, for the implementation of the Scheme and contains certain assurances and confirmations between the parties. Under the terms of the Implementation Agreement, Lloyds TSB has retained the right to effect the Acquisition by way of an Offer.

Lloyds TSB and HBOS have each undertaken to co-operate and take all steps as are within their power and are necessary and reasonable to implement the Scheme as soon as reasonably practicable.

In the Implementation Agreement, HBOS has agreed to certain non-solicitation commitments with Lloyds TSB. Additionally, HBOS has agreed to pay Lloyds TSB an inducement fee (inclusive of value added tax) of one per cent. of the offer value under the Acquisition (based on the Closing Price of a Lloyds TSB Share on the Business Day prior to the occurrence of the relevant event below), if:

- the HBOS Directors do not unanimously and without qualification recommend the HBOS Shareholders to vote in favour of the Scheme and the resolutions necessary to implement the Scheme or they (or any committee of the HBOS Directors) withdraw, or adversely modify, or qualify their recommendation to HBOS Shareholders to vote in favour of the Scheme and/or the resolutions necessary to implement the Scheme at or prior to the HBOS General Meeting and the Court Meeting; or
- at any time after approval of the Scheme by HBOS Shareholders at the Court Meeting but before the grant of the Court Orders, the HBOS Directors, in exercise of their fiduciary duties, decide not to proceed with the Scheme; or
- without the consent of Lloyds TSB, HBOS withdraws the Scheme or takes steps to defer (or adjourn) the holding of the Court Meeting or the HBOS General Meeting or the Court Hearings to approve the Scheme to a date later than 28 February 2009; or
- a Competing Proposal is announced prior to the Scheme lapsing or being withdrawn, which Competing Proposal subsequently becomes or is declared wholly unconditional or is completed.

Furthermore, HBOS has agreed that, prior to the earlier of the Effective Date and the termination of the Implementation Agreement, it will not, and will procure that no member of the HBOS Group will, subject to the fiduciary duties of the HBOS Directors and without the prior consent of the other party (such consent not to be unreasonably withheld or delayed), save to the extent necessary or required to give effect to the proposed issue of preference shares and the HBOS Placing and Open Offer, *inter alia*:

- carry on business other than in the ordinary course and in all material respects consistently with past practice;
- alter the nature or scope of its business in any material way;
- enter into any transaction which would be classified as a Class 2 or Class 1 transaction under the Listing Rules;
- amend the general terms of employment of its employees or the terms of employment of its directors in any way, other than in the ordinary course of business or pursuant to periodic salary or wage reviews;
- other than dividends declared but not yet paid as at the date of the Implementation Agreement, declare, set aside or pay any dividends on or make any other distribution in respect of the share capital of HBOS;
- allot, issue, authorise or propose the issuance of any share capital or any securities convertible into share capital, or rights, warrants or options to acquire any share capital of HBOS other than the allotment and issue of shares pursuant to the HBOS Share Option Schemes as of the date of the Implementation Agreement or pursuant to the Scheme;
- submit to its shareholders for approval in any general meeting any resolution which, if passed, would constitute approval for the purposes of Rule 21.1 of the Code or seek the consent of the Panel to proceed without such approval; or
- enter into an agreement to do any of the foregoing.

The above restrictions shall not prevent any member of the HBOS Group from doing anything (or refraining from doing anything) that is required by any applicable law or regulation or relevant legal or regulatory body.

The Implementation Agreement will terminate in certain circumstances, including if the Court Orders sanctioning the Scheme are not granted, or any resolutions required to approve and implement the Scheme are not passed by HBOS Shareholders or Lloyds TSB Shareholders.

#### **9.1.2 Placing Agreement entered into on 19 September 2008**

On 19 September 2008, Lloyds TSB entered into a placing agreement (for the purposes of this summary, the “**Placing Agreement**”) with Citigroup Global Markets U.K. Equity Limited and Merrill Lynch (for the purposes of this summary, the “**Managers**”), under which the Managers agreed, as agents for Lloyds TSB, to use their reasonable endeavours to procure by way of placing subscribers for 284,400,000 new ordinary shares of 25 pence each in Lloyds TSB at a price of 270 pence per share (for the purposes of this summary, the

“**Placing**”). The Managers agreed that, to the extent that they were unable to procure placees to subscribe for the shares, the Managers themselves would subscribe for such shares.

The Placing Agreement provided for the payment by Lloyds TSB to the Managers of a commission of 1.0 per cent. of the aggregate proceeds of the Placing, together with any VAT payable thereon. Lloyds TSB also agreed to pay all other costs, charges and expenses of, or incidental to, the Placing Agreement, the Placing, the allotment and issue of new ordinary shares in Lloyds TSB, including the listing fees payable to the UK Listing Authority, the fees of the London Stock Exchange, printing costs, registrars’ fees, Lloyds TSB’s legal expenses, the Managers’ reasonable out-of-pocket expenses, and all related irrecoverable VAT, if applicable.

The Placing Agreement contains certain representations, warranties and indemnities by Lloyds TSB in favour of the Managers. Lloyds TSB has agreed that, for a period of 90 days following the settlement date of the placing, it will not issue any new ordinary shares and certain other instruments (other than, *inter alia*, new Lloyds TSB ordinary shares for the purposes of the Acquisition) without the prior consent of the Managers.

### **9.1.3 Placing and Open Offer Agreement entered into with effect from 13 October 2008**

Pursuant to a placing and open offer agreement effective as of 13 October 2008 entered into between Lloyds TSB, HM Treasury, Citigroup Global Markets Limited, Citigroup Global Markets U.K. Equity Limited, Merrill Lynch and UBS, (i) Lloyds TSB has agreed to invite Qualifying Shareholders to apply to acquire Open Offer Shares at the Issue Price by way of the Open Offer, (ii) Citi, Merrill Lynch and UBS were appointed as joint sponsors and joint bookrunners and have agreed to use reasonable endeavours to procure placees to acquire the Open Offer Shares at not less than the Issue Price on the basis that the Open Offer Shares placed will be subject to clawback to the extent they are taken up under the Open Offer and (iii) HM Treasury has agreed that, to the extent not placed or taken up under the Open Offer, HM Treasury will acquire such Open Offer Shares itself at the Issue Price.

In consideration of its services under the Placing and Open Offer Agreement, HM Treasury will be paid (i) a commission of 0.5 per cent. of the aggregate value of the Open Offer Shares at the Issue Price per Open Offer Share payable on the earlier of Admission of the Open Offer Shares and the second business day after the day on which the Placing and Open Offer Agreement is terminated and (ii) a further commission of 1 per cent. of the aggregate value of the Open Offer Shares acquired by placees (including HM Treasury) at the Issue Price per Open Offer Share, payable on Admission of the Open Offer Shares. Lloyds TSB will pay all legal and other costs and expenses of HM Treasury, Citi, Merrill Lynch and UBS and the costs and expenses of HM Treasury’s financial advisers incurred in connection with the Placing and Open Offer and the New Preference Share Issue. HM Treasury is entitled to deduct its commissions and expenses from any payment made in acquiring any Open Offer Shares.

Lloyds TSB shall also bear all costs and expenses relating to the Placing and Open Offer and the New Preference Share Issue, including (but not limited to) the fees and expenses of its professional advisers, the cost of preparation, advertising, printing and distribution of this document, the Prospectus and all other documents connected with the Placing and Open Offer and the New Preference Share Issue, the listing fees of the FSA and other FSA fees, any charges by CREST and the fees of the London Stock Exchange.

The obligations of HM Treasury, Citi, Merrill Lynch and UBS under the Placing and Open Offer Agreement are subject to certain conditions including, among others:

- (i) Admission of the Open Offer Shares and Admission of the New Preference Shares becoming effective by not later than 8.00 a.m. on 19 January 2009 (or such later time and date as HM Treasury may agree);
- (ii) the obtaining or waiver of such regulatory approvals, authorisations and consents as may be required as a consequence of the activities contemplated by the Placing and Open Offer Agreement and the Preference Share Subscription Agreement;



- (iii) there having occurred or being reasonably likely to occur, in the opinion of HM Treasury (acting in good faith), no event which has resulted or may result in a material adverse change in or affecting the condition (financial, operational, legal or otherwise), profitability, prospects, solvency, business affairs or operations of the Lloyds TSB Group taken as a whole, whether or not arising in the ordinary course of business;
- (iv) the Acquisition having been announced on terms such that, if the Acquisition becomes Effective in accordance with its terms, the HBOS Shares shall be acquired by Lloyds TSB on terms such that, in consideration of the cancellation or transfer of the HBOS Shares it has acquired pursuant to the Placing and Open Offer, HM Treasury (or its nominee) shall receive Lloyds TSB Shares;
- (v) the Acquisition being subject only to those conditions which are required for implementation, specifically the requisite shareholder approval, court approval of the Scheme, regulatory clearances without which the proposed Acquisition may not be implemented and the listing and admission of the Consideration Shares; and
- (vi) (a) resolutions 1 and 3 (as set out in the notice convening the Lloyds TSB General Meeting) having been approved by Lloyds TSB Shareholders and the resolutions necessary to implement the Acquisition having been approved by HBOS Shareholders; (b) the Scheme Court Hearing (but not the Reduction Court Hearing) having been held and the Scheme Court Order having been made; and (c) the agreement pursuant to which the HBOS Placing and Open Offer will be conducted not having terminated in accordance with its terms prior to the Scheme Court Hearing having been held and the Scheme Court Order having been made.

Certain of the conditions to the Placing and Open Offer Agreement may be waived by HM Treasury in its sole discretion. However, the condition described in paragraph (vi) above is, among others, not capable of waiver by HM Treasury.

HM Treasury may terminate the Placing and Open Offer Agreement in certain circumstances. In particular, HM Treasury may terminate the Placing and Open Offer Agreement where a condition is not satisfied (or, where permitted, waived). However, HM Treasury shall only invoke such a termination right if it does not consider it to be necessary that the arrangements contemplated by the Placing and Open Offer Agreement proceed to completion in order to maintain the financial stability of the United Kingdom. On a termination event arising, Citi, Merrill Lynch and UBS are not entitled to terminate the Placing and Open Offer Agreement but may resign their role as sponsor.

Each of Citi, Merrill Lynch and UBS may terminate its obligations under the Placing and Open Offer Agreement in certain circumstances at any point up to Admission of the Consideration Shares. On termination by Citi, Merrill Lynch or UBS, the Placing and Open Offer Agreement will continue to be in force as between the non-terminating parties.

The proceeds of the Placing and Open Offer are to be used by Lloyds TSB for such regulatory capital purposes as may be agreed with HM Treasury, the Bank of England and the Financial Services Authority.

Lloyds TSB has given and will give certain representations and warranties and indemnities in relation to Lloyds TSB and HBOS to each of HM Treasury, Citi, Merrill Lynch and UBS under the Placing and Open Offer Agreement. The liabilities of Lloyds TSB are unlimited as to time and amount.

Lloyds TSB has, under the Placing and Open Offer Agreement, undertaken to comply with certain conditions which are discussed in greater detail in Part V ("Conditions relating to the Proposed Government Funding") of this Circular. HM Treasury has committed to enter into discussions with Lloyds TSB to clarify the scope and duration of certain of such conditions.

HM Treasury is entitled to novate its rights and obligations under the Placing and Open Offer Agreement to any entity which is wholly owned, directly or indirectly, by HM Treasury.

#### **9.1.4 Preference Share Subscription Agreement entered into with effect from 13 October 2008**

Lloyds TSB and HM Treasury entered into the Preference Share Subscription Agreement, with effect from 13 October 2008, pursuant to which HM Treasury agreed to acquire, and Lloyds TSB agreed to allot and issue to HM Treasury, the New Preference Shares for a total consideration of £1,000,000,000 (before costs and expenses). Lloyds TSB and HM Treasury

have agreed that applications will be made to the UKLA for the New Preference Shares to be admitted to the Official List and to the London Stock Exchange for the New Preference Shares to be admitted to trading on the London Stock Exchange's Regulated Market. The New Preference Shares will be cleared through CREST. Lloyds TSB has agreed to pay the costs and expenses of HM Treasury in relation to the negotiation of the Preference Share Subscription Agreement and the subscription for, and allotment and issue of, the New Preference Shares (including, without limitation, any stamp duty or stamp duty reserve tax).

Under the Preference Share Subscription Agreement, the New Preference Share Issue is conditional upon the Placing and Open Offer Agreement becoming unconditional in accordance with its terms.

The New Preference Shares will pay a fixed non-cumulative dividend of 12 per cent., payable semi-annually in arrear, for the first five years after their issue. Thereafter, they will pay a variable dividend, equal to three month sterling LIBOR plus 7 per cent., payable quarterly in arrear. The payment of such dividends is at the sole discretion of the Lloyds TSB Board.

For so long as dividend payments have not been made on the New Preference Shares, Lloyds TSB may not (subject to certain exceptions) declare or pay dividends or other distributions upon any parity or junior securities, or redeem, purchase or otherwise acquire any such securities. In addition, until the New Preference Shares are redeemed or repurchased in full, Lloyds TSB may not declare or pay any dividend on its ordinary shares or redeem, purchase, cancel or otherwise acquire any of its ordinary shares or effect a reduction of its ordinary share capital which involves a distribution to holders of the ordinary shares.

The New Preference Shares do not carry voting rights, and holders may not speak at general meetings of Lloyds TSB, save for in the following limited circumstances:

- (i) if a resolution is proposed either varying or abrogating any of the rights and restrictions attached to the New Preference Shares or to wind up, or in relation to the winding up of, Lloyds TSB (and then in each such case only to speak and vote upon any such resolution); and
- (ii) if on the applicable dividend payment date immediately preceding the date of notice of any general meeting of Lloyds TSB Shareholders, the dividend on the New Preference Shares has not been declared and paid in full, holders of the New Preference Shares will be entitled to speak and to vote upon all resolutions proposed at such general meeting. In these circumstances only, the rights of the holders of the New Preference Shares to speak and vote will continue until Lloyds TSB has resumed the payment in full of dividends on the New Preference Shares.

Subject to notifying the FSA and being in compliance with its capital adequacy requirements (to the extent they apply at the time), Lloyds TSB has the right to redeem the New Preference Shares at the liquidation preference of £1,000 plus accrued dividends, in whole or in part, with effect from the date five years and one day after their issue.

The New Preference Shares will be issued credited as fully paid and will rank *pari passu* in all respects with the most senior preference shares then in issue and any other class of shares in issue at the time the New Preference Shares are issued pursuant to the Preference Share Subscription Agreement, or subsequently issued and which are expressed to rank equally with the New Preference Shares. The New Preference Shares rank ahead of the Lloyds TSB Shares.

The Preference Share Subscription Agreement is conditional upon the Placing and Open Offer Agreement described elsewhere herein becoming unconditional in accordance with its terms. In addition, Lloyds TSB is giving the same warranties to HM Treasury as are contained in the Placing and Open Offer Agreement. The Preference Share Subscription Agreement will terminate upon termination of the Placing and Open Offer Agreement in accordance with its terms. HM Treasury is entitled to novate its rights and obligations under the Preference Share Subscription Agreement to any entity which is wholly-owned, directly or indirectly, by HM Treasury.

## **9.2 HBOS Material Contracts**

The following are all of the contracts (not being contracts entered into in the ordinary course of business) that have been entered into by members of the HBOS Group: (i) within the two years immediately preceding the date of this document which are, or may be, material to the HBOS Group; or (ii) at any time and contain obligations or entitlements which are, or may be, material to the HBOS Group as at the date of this document:

### **9.2.1 Implementation Agreement**

On 18 September 2008, Lloyds TSB and HBOS entered into the Implementation Agreement, as subsequently amended and restated on 13 October 2008. Please see the summary in paragraph 9.1.1 of this Part XII above.

### **9.2.2 HBOS Rights Issue Underwriting Agreement**

Under an Underwriting Agreement dated 29 April 2008, HBOS appointed each of Morgan Stanley and Dresdner Bank AG, London branch, on a several basis, as joint underwriters to the HBOS rights issue and appointed each of Morgan Stanley and Dresdner Kleinwort as joint sponsors in connection with admission.

Whilst the HBOS rights issue was completed in accordance with its terms, HBOS gave certain customary representations and warranties to the underwriters and customary indemnities to the underwriters and certain persons connected with the underwriters and joint sponsors. The representations, warranties and indemnities given by HBOS are uncapped as to duration and amount.

### **9.2.3 Agreement for the Sale of BankWest and St Andrew's to Commonwealth Bank of Australia**

On 8 October 2008, HBOS Australia Pty Ltd (for the purposes of this paragraph 9.2.3, the "**Seller**") and Commonwealth Bank of Australia (for the purposes of this paragraph 9.2.3, the "**Buyer**") entered into a deed (for the purposes of this paragraph 9.2.3, the "**Share Sale Deed**") pursuant to which the Seller has agreed to sell to the Buyer the issued ordinary share capital in each of Bank of Western Australia Ltd (for the purposes of this paragraph 9.2.3, "**BankWest**"), St Andrew's Australia Pty Ltd (for the purposes of this paragraph 9.2.3, "**St Andrew's**") and HBOS Australia Group (Services) Pty Ltd (for the purposes of this paragraph 9.2.3, "**HBOSGS**").

The purchase price for the shares will be AUS\$2.1 billion (for the purposes of this paragraph 9.2.3, the "**Purchase Price**"), apportioned as AUS\$2.037 billion for the BankWest shares, AUS\$63 million for the St Andrew's shares and AUS\$2 for the HBOSGS. The Purchase Price is subject to adjustment after completion based on the net assets of the BankWest, St Andrews and HBOSGS businesses at completion.

Under the terms of the Share Sale Deed, BankWest will also redeem 530,000,000 redeemable preference shares in the capital of BankWest held by HBOS for the sum of AUS\$530 million payable to HBOS at completion.

Completion is conditional upon the approval of the Australian Competition and Consumer Commission, the Australian Treasurer and the Australian Prudential Regulatory Authority.

HBOS has guaranteed all of the obligations of the Seller under the Share Sale Deed. HBOS has also given customary business warranties in favour of the Buyer.

### **9.2.4 HBOS Placing and Open Offer Agreement entered into with effect from 13 October 2008**

HBOS, Morgan Stanley, Dresdner Kleinwort and HM Treasury entered into the HBOS Placing and Open Offer Agreement with effect from 13 October 2008, pursuant to which (i) HBOS has agreed to invite qualifying shareholders to apply to acquire 7,482,394,366 HBOS Open Offer Shares at the issue price of 113.6 pence per Share by way of an open offer, (ii) Morgan Stanley and Dresdner Kleinwort were appointed as joint sponsors, joint bookrunners and joint placing agents and have agreed to use reasonable endeavours to procure placees to acquire the HBOS Open Offer Shares at not less than the price of 113.6 pence per share on the basis that the HBOS Open Offer Shares placed will be subject to clawback to the extent they are taken up under the HBOS Open Offer and (iii) HM Treasury has agreed that, to the extent not placed or taken up under the HBOS Open Offer, HM Treasury will acquire such HBOS Open Offer Shares itself at the price of 113.6 pence per share.

In consideration of its services under the HBOS Placing and Open Offer Agreement, HM Treasury will be paid (i) a commission of 0.5 per cent. of the aggregate value of the HBOS Open Offer Shares at the issue price per HBOS Open Offer Share payable on the earlier of the issue of the HBOS Open Offer Shares and the second business day after the day on which the HBOS Placing and Open Offer Agreement is terminated and (ii) a further commission of 1 per cent. of the aggregate value of the HBOS Open Offer Shares acquired by placees (including HM Treasury) at the issue price per HBOS Open Offer Share, payable on the issue of the HBOS Open Offer Shares. HBOS will pay all legal and other costs and expenses of HM Treasury, Morgan Stanley and Dresdner Kleinwort and the costs and expenses of HM Treasury's financial advisers incurred in connection with the HBOS Placing and Open Offer and the New HBOS Preference Share issue.

HBOS shall also bear all costs and expenses relating to the HBOS Placing and Open Offer and the New HBOS Preference Share issue, including (but not limited to) the fees and expenses of its professional advisers, the cost of preparation, advertising, printing and distribution of the issue documents and all other documents connected with the HBOS Placing and Open Offer and the HBOS Preference Share Subscription Agreement, the registrars' fees, the listing fees payable to the UK Listing Authority, any charges by CREST and the fees of the London Stock Exchange as applicable.

The obligations of HM Treasury, Morgan Stanley and Dresdner Kleinwort under the HBOS Placing and Open Offer Agreement are subject to certain conditions including, among others:

- (i) in the opinion of HM Treasury (acting in good faith) no event having occurred or being reasonably likely to occur which has resulted in or may result in a material adverse change in or affecting the condition (financial, operational, legal or otherwise), profitability, prospects, solvency, business affairs or operations of the HBOS Group, taken as a whole, whether or not arising in the ordinary course of business;
- (ii) the Acquisition having been made on terms such that, if the Acquisition becomes effective in accordance with its terms, the HBOS Placing Shares shall be acquired by Lloyds TSB on terms such that in consideration of the cancellation or transfer of the HBOS Placing Shares, the holders of HBOS Placing Shares shall receive ordinary shares in the capital of Lloyds TSB;
- (iii) the passing of the resolutions to be proposed at the HBOS Court Meeting and the HBOS General Meeting and to approve and implement the Acquisition and the HBOS Placing and Open Offer and the Scheme having been sanctioned by the Court at the Scheme Hearing; and
- (iv) the obtaining of all applicable regulatory approvals and authorisations.

HM Treasury is entitled to waive certain conditions in its absolute discretion. HM Treasury may only invoke a condition where HM Treasury does not consider it to be necessary that the arrangements contemplated by the HBOS Placing and Open Offer Agreement and by the HBOS Preference Share Subscription Agreement proceed to completion in order to maintain the financial stability of the United Kingdom.

HM Treasury may terminate the HBOS Placing and Open Offer Agreement in certain specified circumstances, but only where HM Treasury does not consider it to be necessary that the arrangements contemplated by the HBOS Placing and Open Offer Agreement and by the HBOS Preference Share Subscription Agreement proceed to completion in order to maintain the financial stability of the United Kingdom.

Each of Morgan Stanley and Dresdner Kleinwort may terminate its obligations under the HBOS Placing and Open Offer Agreement in certain circumstances. On termination by Morgan Stanley or Dresdner Kleinwort, the HBOS Placing and Open Offer Agreement will continue to be in force as between the non-terminating parties.

The proceeds of the HBOS Placing and Open Offer are to be used by HBOS for such regulatory capital purposes as may be agreed with HM Treasury, the Bank of England and the Financial Services Authority.

HBOS has given certain customary representations and warranties and indemnities to each of HM Treasury, Morgan Stanley and Dresdner Kleinwort under the HBOS Placing and Open Offer Agreement. The liabilities of HBOS are unlimited as to time and amount.

HM Treasury is entitled to novate its rights and obligations under the Placing and Open Offer Agreement to any entity which is wholly owned, directly or indirectly, by HM Treasury.

HBOS has undertaken not to declare or pay any dividend or make any distribution on or in respect of its ordinary shares or set aside any sum to provide for payment of any such dividend or distribution; or redeem, purchase, cancel or otherwise acquire in any way any of its ordinary shares or effect a reduction of its ordinary share capital which involves distribution to holders of the ordinary shares until the New HBOS Preference Shares are redeemed or repurchased in full.

HBOS has given certain undertakings to HM Treasury in support of HM Treasury's objective of providing assistance to the UK banking industry, as follows:

- (i) HBOS Directors will relinquish bonuses for 2008.
- (ii) The enlarged group remuneration will reflect long-term value creation and will take account of risk. The reward for board members will take into account internal relative compensation packages and perceived fairness in the current economic climate. On losing the confidence of the board, the board members can be dismissed at a reasonable and fair cost.
- (iii) To commit to a new FSA Code on risk based remuneration.
- (iv) HM Treasury will work with the board on its appointment of two new independent directors, unless HM Treasury's holding of the Enlarged Group falls below 25 per cent., in which case it will be consulted on the appointment of one independent director.
- (v) In relation to mortgages, to immediately restore and maintain the availability and active marketing of competitively priced mortgage lending until the end of 2011 at a level at least equivalent to that of 2007 (provided that HBOS shall not be required to engage in uncommercial activities); to participate in industry initiatives and comply with government codes/guidance until at least the end of 2011; to make available a sum to be agreed for the establishment and maintenance of shared equity/shared ownership schemes; and to support ongoing expansion of financial capability initiatives.
- (vi) In relation to SMEs, to immediately restore and maintain the availability and active marketing of competitively priced lending to SMEs until the end of 2011 at a level at least equivalent to that of 2007 (provided that HBOS shall not be required to engage in uncommercial activities); and to publish an annual report containing specified information relating to SMEs.

The above undertakings shall apply until HM Treasury or the European Commission determines or a court of competent jurisdiction finally determines that HBOS is no longer in receipt of the aid which is the subject of the decision. HM Treasury has agreed in certain circumstances, to consult with HBOS with a view to making submissions to the European Commission to obtain clarity as to the duration of the conditions and/or seek their disapplication.

Lloyds TSB anticipates that following completion of the Acquisition the conditions relating to the Proposed Government funding set out in Part V (and not the conditions set out in the HBOS Placing and Open Offer Agreement) will apply to the Enlarged Group.

HM Treasury is entitled to novate its rights and obligations under the HBOS Placing and Open Offer Agreement to any entity which is wholly-owned, directly or indirectly, by HM Treasury.

#### **9.2.5 HBOS Preference Share Subscription Agreement entered into with effect from 13 October 2008**

HBOS and HM Treasury entered into the HBOS Preference Share Subscription Agreement with effect from 13 October 2008, pursuant to which HM Treasury agreed to acquire, and HBOS agreed to allot and issue to HM Treasury, the New HBOS Preference Shares for a total consideration of £3,000,000,000 (before costs and expenses). HBOS has agreed to pay the costs and expenses of HM Treasury in relation to the negotiation of the HBOS Preference Share Subscription Agreement and the subscription for, and allotment and issue of, the New HBOS Preference Shares (including, without limitation, any stamp duty or stamp duty reserve tax).

Under the HBOS Preference Share Subscription Agreement, the issue and allotment of the New HBOS Preference Shares is conditional upon the HBOS Placing and Open Offer Agreement becoming wholly unconditional in accordance with its terms. Once issued, the New HBOS Preference Shares will be subject to the HBOS Preference Share Scheme and acquired by Lloyds TSB in accordance with the HBOS Preference Share Scheme in exchange for Replacement Lloyds TSB Preference Shares.

The New HBOS Preference Shares will pay a fixed non-cumulative dividend of 12 per cent., payable semi-annually in arrear, for the first five years after their issue. Thereafter, they will pay a per annum variable dividend, equal to three month sterling LIBOR plus 7 per cent., payable quarterly in arrear. The payment of such dividends is at the sole discretion of the HBOS Board.

For so long as dividend payments have not been made on the New HBOS Preference Shares, HBOS may not (subject to certain exceptions) declare or pay dividends or other distributions upon any parity or junior securities, or redeem, purchase or otherwise acquire any such securities. In addition, until the New HBOS Preference Shares are redeemed or purchased in full, HBOS may not declare or pay any dividend on its ordinary shares or redeem, purchase, cancel or otherwise acquire any of its ordinary shares or effect a reduction of its ordinary share capital which involves a distribution to holders of the ordinary shares.

The New HBOS Preference Shares do not carry voting rights, and holders may not speak at general meetings of HBOS, save for in the following limited circumstances:

- (i) if a resolution is proposed either varying or abrogating any of the rights and restrictions attached to the New HBOS Preference Shares or to wind up, or in relation to the winding up of, HBOS (and then in each such case only to speak and vote upon any such resolution); and
- (ii) if on the applicable dividend payment date immediately preceding the date of notice of any general meeting of HBOS Shareholders, the dividend on the New HBOS Preference Shares has not been declared and paid in full, holders of the New HBOS Preference Shares will be entitled to speak and to vote upon all resolutions proposed at such general meeting. In these circumstances only, the rights of the holders of the New HBOS Preference Shares to speak and vote will continue until HBOS has resumed the payment in full of dividends on the New HBOS Preference Shares.

Subject to notifying the FSA and being in compliance with its capital adequacy requirements (to the extent they apply at the time), HBOS has the right to redeem the New HBOS Preference Shares at the liquidation preference of £1,000 plus accrued dividends, in whole or in part, with effect from the date five years and one day after their issue.

The New HBOS Preference Shares will be issued credited as fully paid and will rank *pari passu* in all respects with the most senior preference shares then in issue and any other class of shares in issue at the time the New HBOS Preference Shares are issued pursuant to the HBOS Preference Share Subscription Agreement, or subsequently issued and which are expressed to rank equally with the New HBOS Preference Shares. The New HBOS Preference Shares rank ahead of the HBOS Shares.

The HBOS Preference Share Subscription Agreement is conditional upon, the HBOS Placing and Open Offer Agreement described elsewhere herein becoming unconditional in accordance with its terms. In addition, HBOS is giving the same warranties to HM Treasury as are contained in the HBOS Placing and Open Offer Agreement. The HBOS Preference Share Subscription Agreement will terminate upon termination of the HBOS Placing and Open Offer Agreement in accordance with its terms.

HM Treasury is entitled to novate its rights and obligations under the HBOS Preference Share Agreement to any entity which is wholly-owned, directly or indirectly, by HM Treasury.

## **10 Related Party Transactions**

Other than as disclosed in note 49 of its audited financial statements for the financial year ended 31 December 2005 and in note 45 of its audited financial statements for the financial years ended 31 December 2006 and 2007, such notes being incorporated by reference into this document, Lloyds TSB has not entered into any related party transactions other than with wholly owned subsidiaries during the period covered by the historical financial information.

Furthermore, in the current financial year up to 30 June 2008 Lloyds TSB has not entered into any material transactions with related parties other than the trading transactions on arm's length terms as described below.

At 30 June 2008, the Lloyds TSB Group's pension funds had call deposits with Lloyds TSB Bank plc amounting to £24 million.

The Lloyds TSB Group manages 102 Open Ended Investment Companies (OEICs), and of these 44 are consolidated. The Lloyds TSB Group invested £315 million and redeemed £179 million in the unconsolidated OEICs during the six months to 30 June 2008 and had investments, at fair value, of £3,138 million at 30 June 2008. The Lloyds TSB Group earned fees of £117 million from the unconsolidated OEICs in the six months to 30 June 2008. The Company held no investments in OEICs at any time during the first half of 2008.

The Lloyds TSB Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 30 June 2008, these companies had total assets of approximately £3,571 million, total liabilities of approximately £3,547 million and for the six months ended 30 June 2008 had turnover of £1,248 million and made a net loss of approximately £5 million. In addition, the Lloyds TSB Group has provided £691 million of financing to these companies on which it received £21 million of interest income in the six month period to 30 June 2008.

Furthermore, in the period between 30 June 2008 and 29 October 2008 (being the last practicable date prior to the publication of this document) Lloyds TSB has not entered into any material related party transactions.

## **11 Litigation**

### **11.1 Litigation relating to the Lloyds TSB Group**

Save as set out below, there are no governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which Lloyds TSB is aware) during the year preceding the date of this document which may have, or have had in the recent past, significant effects on the financial position or profitability of Lloyds TSB and/or the Lloyds TSB Group:

#### **11.1.1 *UK Competition Commission investigation of payment protection insurance***

The Competition Commission is formally investigating the supply of PPI services (except store card PPI) to non-business customers in the UK.

On 5 June 2008, the Competition Commission issued its provisional findings, to the effect that there are market features which prevent, restrict or distort competition in the supply of PPI to non-business customers, with an adverse effect on competition and with resulting detriments to consumers.

The Competition Commission has therefore also considered what remedies should be adopted to regulate the future supply of PPI. A remedies notice issued with the provisional findings sets out a range of possible remedies under consideration at this stage which contemplate: (i) measures requiring greater disclosure of information about PPI policies prior to, or at, the point of sale of the policy; (ii) a prohibition on the sale of PPI at the point of sale of any credit product and within a fixed time period after the credit sale; (iii) a requirement that all PPI policies be subject to annual renewal, with renewal occurring only if the customer "opted in" (and, for single premium policies, a right for a customer who did not "opt in" to receive a rebate in cash); (iv) a requirement that distributors of PPI should provide an annual statement to each customer, containing a reminder of certain key facts about the policy, including the customer's right to cancel the policy; (v) a prohibition on the sale of single premium PPI policies, or other restrictions on the sale and/or terms of such policies; (vi) a requirement that PPI policies embody certain minimum standards of cover; (vii) a range of measures requiring disclosure of customer-related information, or other forms of co-operation, between market participants, to facilitate the sale and administration of policies by stand-alone and other providers of PPI; and (viii) the imposition of a regulatory cap on the price of some or all kinds of PPI policy; and, for retail PPI a remedy to allow retail PPI customers better to compare retail PPI and standalone PPI and to switch more easily.

If the Competition Commission decides to confirm its provisional findings to the effect that market features restrict competition in the supply of PPI with resulting adverse effects, it is expected to issue its provisional decision as to what remedies to adopt in November 2008. The Commission expects to issue its final report by February 2009.

On 1 July 2008 the Financial Ombudsman Service referred concerns regarding the handling of PPI complaints to the FSA as an issue of wider implication. The Lloyds TSB Group and other industry members and trade associations have made submissions to the FSA regarding this referral. The matter was considered at the FSA Board meeting on 25 September 2008. We are awaiting further developments.

On 30 September 2008 the FSA published a statement arising from its ongoing thematic review of PPI sales. In the statement, which was directed at the industry generally, the FSA highlighted certain concerns and indicated that it was escalating its regulatory intervention and considering appropriate action to deal with on-going non-compliant sales practices and to remedy non-compliant past sales. The FSA plans to publish an update on the third phase of the thematic work in the first quarter of 2009.

## **11.1.2 UK Office of Fair Trading**

11.1.2.1 The following reviews and inquiries are being carried out:

In April 2007, the UK Office of Fair Trading (“OFT”) commenced an investigation into the fairness of current account overdraft charges. At the same time it commenced a market study into wider questions about competition and price transparency in the provision of personal current accounts.

On 27 July 2007, following agreement between the OFT and eight UK financial institutions, the OFT issued High Court legal proceedings against those institutions, including the Lloyds TSB Group and the HBOS Group, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to requests for unplanned overdrafts. On 24 April 2008, the High Court ruled on the preliminary issues of whether the financial institutions’ terms and conditions in relation to unplanned overdraft charges are capable of being assessed for fairness under the Unfair Terms in Consumer Contracts Regulations 1999 or are capable of amounting to penalties at common law. The High Court determined, in relation to the financial institutions’ current terms and conditions, that the relevant charges are not capable of amounting to penalties but that they are assessable for fairness under the Unfair Terms in Consumer Contracts Regulations 1999. On 22 May 2008, the Lloyds TSB Group and the HBOS Group, along with the other relevant financial institutions, were given permission to appeal the finding that unplanned overdraft charges are assessable for fairness under the Unfair Terms in Consumer Contracts Regulations 1999. The appeal hearing commenced on 28 October 2008. A further hearing was held on 7 to 9 July to consider whether the financial institutions’ historical terms and conditions are similarly not capable of being penalties, and to consider whether their historical terms are assessable for fairness. On 8 October 2008, the High Court issued its judgment broadly holding that these unplanned overdraft charges are not capable of being penalties, although it has invited further clarification from a number of banks, including the Lloyds TSB Group, before making any formal ruling on their historical terms and conditions. Subject to the outcome of any appeal in relation to whether the charges are assessable for fairness, it is expected that there will be further substantive hearings to establish whether the charges are fair. If various appeals are pursued, the proceedings may take a number of years to conclude.

On 16 July 2008, the OFT released a report following the market study referred to above. The OFT is now engaging in a period of consultation. The OFT has stated that at the conclusion of the consultation period, it will publish a summary of the responses received, and that it will then aim to publish a further or final report in early 2009 which will contain recommendations for the banking industry.



The FSA has agreed, subject to certain conditions, that the handling of customer complaints on this issue can be suspended until the earlier of either conclusion of the proceedings or 26 January 2009, subject to any renewal or extension which the FSA may agree. Cases before the Financial Ombudsman Service and the County Courts are also currently stayed pending the outcome of the legal proceedings initiated by the OFT. The Lloyds TSB Group intends to continue to defend its position strongly. Accordingly, no provision in relation to the outcome of this litigation has been made. Depending on the High Court's determinations, a range of outcomes is possible, some of which could have a significant financial impact on the Lloyds TSB Group and the HBOS Group. The ultimate impact of the litigation on the Lloyds TSB Group or the Enlarged Group can only be known at its conclusion.

#### 11.1.2.2 Interchange Fees

The European Commission has adopted a formal decision finding that an infringement of EC competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the EEA. This decision has been appealed to the European Court of First Instance. The Lloyds TSB Group and the HBOS Group (along with certain other MasterCard issuers) have applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of a uniform fallback interchange fee are compatible with EC competition laws. The European Commission has objected to these proposed interventions. The Court of First Instance has not yet decided whether to allow the proposed interventions to proceed. Meanwhile, the European Commission and the UK's Office of Fair Trading are pursuing investigations with a view to deciding whether arrangements adopted by other payment card schemes for the levying of uniform fallback interchange fees in respect of domestic and/or cross-border payment transactions also infringe EC and/or UK competition laws. The ultimate impact of the investigations on the Lloyds TSB Group or the Enlarged Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

#### 11.1.3 Office of Foreign Assets Control

There has been increased scrutiny of the financial institutions sector, especially in the US, with respect to combating money laundering and terrorist financing and enforcing compliance with economic sanctions. The Office of Foreign Assets Control ("OFAC") administers US laws and regulations in relation to US economic sanctions against designated foreign countries, nationals and others and the Lloyds TSB Group has been conducting a review of its conduct with respect to historical US dollar payments involving countries, persons or entities subject to those sanctions. The Lloyds TSB Group has provided information relating to its review of such historical payments to a number of authorities including OFAC, the US Department of Justice and the New York County District Attorney's office which, along with other authorities, have been reported to be conducting a broader review of sanctions compliance by non-US financial institutions. The Lloyds TSB Group is included in ongoing discussions with these and other authorities with respect to agreeing a resolution of their investigations. Discussions have advanced towards resolution and the Lloyds TSB Group provided £180 million in respect of this matter in the first half of 2008.

#### 11.2 Litigation relating to the HBOS Group

Save as set out in paragraphs 11.1.1 and 11.1.2 above insofar as they relate to the HBOS Group, there are no governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which Lloyds TSB is aware) during the year preceding the date of this document which may have, or have had in the recent past, significant effects on the financial position or profitability of HBOS and/or the HBOS Group.

## **12 Significant Change**

### **12.1 Lloyds TSB Group**

Save for a further deterioration in insurance volatility during October, and save as disclosed in the third paragraph of the section headed 'Strong relationship banking growth in Wholesale and International Banking', the third paragraph of the section headed 'In a difficult economic environment, asset quality remains satisfactory' and the section headed 'Insurance volatility' in paragraph 7 of Part VII ("Information on the Lloyds TSB Group") of this document, there has been no significant change in the financial or trading position of the Lloyds TSB Group since 30 June 2008, the date to which Lloyds TSB's last published interim financial information was prepared.

### **12.2 HBOS Group**

Save for the £4 billion net cash proceeds raised by HBOS in its rights issue in July 2008 and as disclosed in the sections headed 'Group Overview', 'Divisional Review' and 'Outlook' in Part XIII ("HBOS Interim Management Statement 3 November 2008") of this document, which sets out the current trading, trends and prospects of the HBOS Group, there has been no significant change in the financial or trading position of the HBOS Group since 30 June 2008, the date to which HBOS's last published interim financial information (which is set out in Part IX ("Historical financial information relating to HBOS plc") of this document) was prepared.

## **13 The Consideration Shares and the Open Offer Shares**

The Consideration Shares to be issued pursuant to the Acquisition and the Open Offer Shares will be ordinary shares of 25 pence each in the capital of Lloyds TSB. The Consideration Shares and the Open Offer Shares will be issued in registered form, will be capable of being held in both certificated and uncertificated form, will be issued credited as fully paid and will rank *pari passu* in all respects with the existing Lloyds TSB Shares.

## **14 Consents**

Citi, whose address is Citigroup Centre, Canada Square, London E14 5LB, has given and has not withdrawn its written consent to the inclusion in this document of references to its name in the form and context in which they appear.

Lazard, whose address is 50 Stratton Street, London W1J 8LL, has given and has not withdrawn its written consent to the inclusion in this document of references to its name in the form and context in which they appear.

Merrill Lynch, whose address is Merrill Lynch Financial Centre, 2 King Edward Street, London EC1A 1HQ, has given and has not withdrawn its written consent to the inclusion in this document of references to its name in the form and context in which they appear.

UBS, whose address is 1 Finsbury Avenue, London EC2M 2PP, has given and has not withdrawn its written consent to the inclusion in this document of references to its name in the form and context in which they appear.

PricewaterhouseCoopers LLP has given and has not withdrawn its written consent to the inclusion in this document of its reports on the unaudited reconciliation of accounting policy differences and unaudited *pro forma* statement of net assets set out in Part X ("Reconciliation Of Accounting Policies") and Part XI ("Unaudited pro forma net assets statement of the Enlarged Group as at June 2008") of this document, respectively, in the form and context in which they appear.

## **15 Incorporation by reference**

Attention is drawn to the following information which is incorporated by reference into this document:

*Information incorporated by reference (and page reference in this document)*

Accounting policies, presentation and estimates, page 2

Details of related party transactions, page 262

Conditions to the Scheme, page 48

*Document reference*

Lloyds TSB Group Interim Results for the six months ended 30 June 2008 (pages 36, 37 and 38)

Lloyds TSB Group audited financial statements for the financial year ended 31 December 2005 (note 49), 31 December 2006 (note 45), and 31 December 2007 (note 45)

The announcement made by Lloyds TSB on 18 September 2008 of the Acquisition, as supplemented by the announcement made on 13 October 2008 announcing the revised terms of the Acquisition

## **16 Documents available for inspection**

Copies of the following documents:

- (A) the Memorandum and Articles of Association of the Company;
- (B) the annual reports and audited consolidated accounts of the Lloyds TSB Group for the three financial years ended 31 December 2007;
- (C) the annual reports and audited consolidated accounts of the Lloyds TSB Group for the three financial years ended 31 December 2007 on Form 20F;
- (D) the unaudited interim results of the Lloyds TSB Group for the six months ended 30 June 2008;
- (E) the unaudited Interim Results of the Lloyds TSB Group for the six months ended 30 June 2007 and 30 June 2008 on Form 6K;
- (F) the audited consolidated accounts of the HBOS Group for the three financial years ended 31 December 2007, 2006 and 2005;
- (G) the unaudited interim financial information of HBOS plc for the six months ended 30 June 2008;
- (H) the consent letters referred to in paragraph 14 above;
- (I) the report from PricewaterhouseCoopers LLP set out in Part X (“Reconciliation of Accounting Policies”) of this document;
- (J) the report from PricewaterhouseCoopers LLP set out in Part XI (“Unaudited pro forma net assets statement of the Enlarged Group as at 30 June 2008”) of this document;
- (K) each material contract referred to in paragraph 9.1 of this Part XII (“Additional Information”);
- (L) the service contracts of the Lloyds TSB Directors; and
- (M) this document,

are available for inspection during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted) for a period from the date of publication of this document until Admission at:

- (i) the registered office of the Company, Henry Duncan House, 120 George Street, Edinburgh, Midlothian EH2 4LH; and
- (ii) the offices of Linklaters LLP, One Silk Street, London EC2Y 8HQ.

## **17 Source of HM Treasury funding**

HM Treasury will fund any acquisition of Lloyds TSB Shares through central government debt and cash management operations.

## **18 Middle Market Quotations**

The middle market quotations for Lloyds TSB on the first business day of each of the six months preceding the date of this document and on 29 October 2008 being the latest practicable date prior

to the posting of this document, as derived from the London Stock Exchange Daily Official List, were:

<b>2008</b>	<i>pence</i>
29 October	179.20
1 October	250.00
1 September	307.50
1 August	300.00
1 July	301.00
2 June	377.25
1 May	430.75

## **19 Historical financial information relating to Lloyds TSB**

### **Basis of financial information**

The financial statements of Lloyds TSB included in the consolidated audited annual report and accounts of Lloyds TSB for the financial years ended 2005, 2006 and 2007, on Form 20F, together with the audit reports thereon, (available at [http://www.investorrelations.lloydstsb.com/ir/company\\_reports\\_page.asp](http://www.investorrelations.lloydstsb.com/ir/company_reports_page.asp)) are incorporated by reference into this document. The audit reports for each of the financial years ended 31 December 2005, 31 December 2006 and 31 December 2007 were unqualified. The financial statements for the years ended 2005, 2006 and 2007 were prepared in accordance with IFRS.

The financial statements of Lloyds TSB included in the unaudited interim financial information for the six months ended 30 June 2007 and 30 June 2008 on Form 6K (available at [http://www.investorrelations.lloydstsb.com/ir/company\\_reports\\_page.asp](http://www.investorrelations.lloydstsb.com/ir/company_reports_page.asp)) are incorporated by reference into this document. These results were prepared in accordance with IFRS.

If you wish to receive a paper copy of any of the above documents, please telephone 0845 600 3579 or send a request in writing addressed to The Secretary, Lloyds TSB Group plc, 25 Gresham Street, London EC2V 7HN. Please have the accompanying proxy form available, as you will be asked to quote the account number shown on the form. Calls to this number are charged at approximately 2p per minute if calling from a BT landline during day time hours, other telephone providers costs may vary.

### **Cross Reference List**

The following list is intended to enable investors to identify easily specific items of information which have been incorporated by reference into this document.

#### *(a) Financial Statements for the year ended 2005*

The page numbers below refer to the relevant pages of the annual report and accounts of Lloyds TSB for the financial year ended 2005:

- Turnover – page 59; and
- Net profit/loss before and after taxation – page 59;
- Other operating income – page 75;
- Charge for taxation – page 78;
- Earnings per share – page 78;
- Ordinary dividends and dividends per share – page 99; and
- Minority interests – page 103.

#### *(b) Financial Statements for the year ended 2006*

The page numbers below refer to the relevant pages of the annual report and accounts of Lloyds TSB for the financial year ended 2006:

- Turnover – page 63;
- Net profit/loss before and after taxation – page 63;
- Other operating income – page 80;
- Charge for taxation – page 83;
- Earnings per share – page 84;
- Ordinary dividends and dividends per share – page 106; and

- Minority interests – page 119.

(c) *Financial Statements for the year ended 2007*

The page numbers below refer to the relevant pages of the annual report and accounts of Lloyds TSB for the financial year ended 2007:

- Turnover – page 77;
- Net profit/loss before and after taxation – page 77;
- Other operating income – page 95;
- Charge for taxation – page 98;
- Earnings per share – page 99;
- Ordinary dividends and dividends per share – page 125;
- Minority interests – page 144;
- Consolidated statement of assets and liabilities – pages 78 and 79;
- Consolidated cash flow statement – page 81; and
- Significant accounting policies and notes to the group accounts – pages 82 to 147.

(d) *Unaudited interim information: Financial Statements for the half year ended 30 June 2008*

The page numbers below refer to the relevant pages of the 2008 Interim Results for the half year ended 30 June 2008:

- Consolidated income statement – page 30;
- Net profit/loss before and after taxation – page 30;
- Minority interests – page 30
- Charge for taxation – page 44;
- Other operating income – page 52;
- Earnings per share – page 57; and
- Ordinary dividends and dividends per share – page 63.

## 20 Interests of Lloyds TSB's Connected Advisers in Lloyds TSB Relevant Securities

As at the close of business on 29 October 2008 (being the latest practicable date prior to the publication of this document) the following connected advisers (as defined in the City Code) to Lloyds TSB (“**connected advisers**”) were interested (as defined in the City Code) in, or had rights to subscribe for, the following relevant securities (being Lloyds TSB Shares and any securities convertible into or carrying rights to subscribe for Lloyds TSB Shares, “**relevant securities**”):

		<i>Number of relevant securities</i>
Citigroup Global Markets Inc.	Proprietary	1,474 Lloyds TSB Shares
Citigroup Global Markets Inc.	Managed Accounts	907 Lloyds TSB Shares
Citigroup Global Markets Inc.	Proprietary	1.1 Lloyds TSB ADRs <sup>1</sup>
Citigroup Global Markets Inc.	Managed Accounts	275,032.88 Lloyds TSB ADRs <sup>1</sup>
Citigroup Derivative Markets Inc.		-8,600 Lloyds TSB ADRs <sup>1</sup>
Citigroup Derivative Markets Inc.	Long interest option	17,600 Lloyds TSB ADRs <sup>1</sup>
Citigroup Derivative Markets Inc.	Short interest option	-2,700 Lloyds TSB ADRs <sup>1</sup>
Citigroup Trust Delaware, N.A.		931 Lloyds TSB ADRs <sup>1</sup>
Citigroup Trust, N.A. (Florida)		401.16 Lloyds TSB ADRs <sup>1</sup>
Citibank N.A., Hong Kong Branch	Long interest option	87,000 Lloyds TSB Shares
Citibank N.A., Hong Kong Branch	Short interest option	-87,000 Lloyds TSB Shares
Citibank N.A., Singapore Branch	Long interest option	4,804,950 Lloyds TSB Shares
Citibank N.A., Singapore Branch	Short interest option	-4,804,950 Lloyds TSB Shares
UBS Wealth Mgmt Australia		298,890 Lloyds TSB Shares
UBS Financial Services Inc.		2,371 Lloyds TSB ADRs <sup>1</sup>

Notes:

(1) Each Lloyds TSB ADR represents four Lloyds TSB Shares.

Save for any borrowed shares which have been either on-lent or sold, as at the close of business on 29 October 2008 (being the latest practicable date prior to the publication of this document) the following Lloyds TSB connected advisers had borrowed or lent only the following relevant securities:

	<i>Number of relevant securities</i>	<i>Borrowed / Lent</i>
Citigroup Global Markets Inc.	5,000,000 Lloyds TSB Shares	Borrowed from Citigroup Global Markets U.K. Equity Limited
Citigroup Global Markets Inc.	5,000,000 Lloyds TSB Shares	Lent to Citigroup Global Markets U.K. Equity Limited

**21 General**

- (a) Other than as set out in this document, no agreement, arrangement or understanding (including any compensation arrangement) exists between HM Treasury or any person acting in concert with HM Treasury and any of the Lloyds TSB Directors, recent directors, shareholders or recent shareholders of Lloyds TSB, which has any connection with or is dependent upon the proposals set out in this document.
- (b) As at 29 October 2008 (being the last practicable date prior to the publication of this document), no agreement, arrangement or understanding exists whereby any of the Lloyds TSB Shares that may be acquired by HM Treasury in pursuance of the Placing and Open Offer and the Acquisition will be transferred to any other persons. HM Treasury is entitled to novate its rights and obligations under the Placing and Open Offer Agreement to any entity which is wholly owned, directly or indirectly, by HM Treasury.
- (c) The proposed dispensation from Rule 9 of the City Code relates to HM Treasury and its nominees. The address of HM Treasury is 1 Horse Guards Road, London SW1A 2HQ.

## PART XIII

### HBOS Interim Management Statement 3 November 2008

#### ***Group Overview***

The Group is operating in difficult market conditions. Relative to 2007, in the nine months to the end of September 2008, profitability has been impacted by higher impairments, negative fair value adjustments to the Treasury Portfolio, the sale of BankWest and short term fluctuations in investment returns. However, despite higher funding costs, net interest income from our banking businesses has increased and our Insurance & Investment business has made a good contribution. This, together with tight Group cost control, demonstrates the strength of our core business.

HBOS's capital ratios benefit from the proceeds of the Rights Issue and capitalisation of the interim dividend for 2008. As at 30 September 2008, our Tier 1 ratio was 8.1% and our Core Tier 1 ratio 6.0%.

The proposed placing of £8.5bn additional equity and £3bn 12% preference shares in January 2009, subject to shareholder approval, would be equivalent to an increase in the relevant capital ratios at that time of some 340bps for Tier 1 and 250bps for Core Tier 1. Most importantly, this injection of capital is linked to the provision of Government guarantees for certain wholesale funding issuance. This materially strengthens the Group's funding position following deposit outflows in September and in the first half of October, which have now slowed significantly.

The proposed acquisition of the HBOS Group by Lloyds TSB is proceeding according to plan. As announced today, the Lloyds TSB meeting to approve the acquisition of HBOS will be held on 19 November 2008. HBOS expects to hold a General Meeting to approve the acquisition by Lloyds TSB, and the placing of equity and preference shares, in December 2008. Subject to shareholder approval and legal and regulatory clearances, HBOS expects the transaction to complete in January 2009.

#### ***Divisional Review***

##### ***Retail***

The Retail business is proving resilient in difficult market conditions. The strength of Retail net interest income underpins profitability. The Retail net interest margin for the year as a whole is expected to be broadly stable relative to the margin reported for the first half of 2008, benefiting from the extended life and re-pricing of mortgages, despite higher funding costs. Costs remain firmly under control. The HBOS multi-brand franchise remains strong; both new business sales and brand tracking among customers remain robust.

Secured lending arrears have risen broadly in line with our expectations. This, together with the decline in house prices, has resulted in an increase in the secured impairment charge to £440m for the nine month period to 30 September 2008 (£213m 30 June 2008). Unsecured lending arrears are as expected, giving rise to an impairment charge of £806m for the period to 30 September 2008 (£509m 30 June 2008). As previously indicated, this is below the level reported for the same period in 2007.

##### ***Residential Mortgages and Arrears Trends***

At the end of September 2008, mainstream mortgages accounted for 71.9% of balances (72.1% 30 June 2008), Buy-to-Let (BTL) 13.3% (12.8% 30 June 2008), Self Certified 12.6% (12.9% 30 June 2008) and other Lending 2.2% (2.2% 30 June 2008).

Mortgage book Loan to Value (LTV) ratios are based on mortgage balances at the relevant month end and the most recent quarterly regional house price data (currently end September 2008). On this basis, the average LTV ratio of our mortgage book was 52% at the end of September 2008 (48% 30 June 2008). On the same basis the average LTV of the impaired book was 69% at the end of September 2008 (63% 30 June 2008). The equivalent figures for impaired mainstream and specialist mortgages were 62% (57% 30 June 2008) and 77% (71% 30 June 2008) respectively.

Total secured impaired loans increased to £5,623m (£5,138m 30 June 2008), 2.37% of end September 2008 balances (2.16% 30 June 2008).

The analysis of mortgage arrears at the end of September 2008, excluding repossessions, is shown in Table 1 below:

<i>Table 1</i>	<i>Cases as a % of total mortgages</i>			<i>Value of debt as a % of total mortgages</i>		
	<i>End Sep 2008</i>	<i>End Jun 2008</i>	<i>End Dec 2007</i>	<i>End Sep 2008</i>	<i>End Jun 2008</i>	<i>End Dec 2007</i>
Mainstream	1.26	1.23	1.16	1.51	1.44	1.33
Specialist *	2.80	2.49	1.97	3.69	3.27	2.59
<b>Total</b>	<b>1.55</b>	<b>1.46</b>	<b>1.30</b>	<b>2.12</b>	<b>1.95</b>	<b>1.67</b>

\*Specialist includes BTL where arrears cases, excluding repossessions, were 1.60% of total BTL mortgages at the end of September 2008 (1.33% 30 June 2008) and 2.08% of value of debt on BTL mortgages (1.73% 30 June 2008). Self Certified arrears cases, excluding repossessions, were 3.59% of total Self Certified mortgages at the end of September 2008 (3.22% 30 June 2008) and 4.61% of value of debt on Self Certified mortgages (4.12% 30 June 2008).

### **Corporate**

While Corporate performance has been impacted by higher impairments and lower non interest income, we have seen a modest increase in net interest income, notwithstanding higher funding costs. Costs remain firmly under control.

Since the half year, the Corporate credit environment has deteriorated, with an increasing number of customers operating under stressed conditions. The construction and real estate sectors have been impacted more severely than other sectors where current performance indicates lower levels of stress. We have been actively managing the increasing proportion of credits moving into the high risk category and will continue to do so.

The total impairment charge for the nine month period to 30 September 2008 has increased to £1,721m (£469m 30 June 2008). The third quarter charge reflects a significant increase in the collective provision in view of the worsening economic outlook. Corporate's exposure to property-related sectors accounts for around 60% of the individual provision charge. The third quarter charge also reflects certain risk concentrations and the impact of falling asset values on likely recoveries, both on existing and newly impaired assets.

The Corporate investment portfolio for the period to 30 September 2008 showed a loss of £93m (£134m profit 30 June 2008), taking into account profits on the sale of investment securities, other operating income, and share of profits/losses of associates and jointly controlled entities, less impairment on investment securities. Losses from associates and jointly controlled entities were £105m in the period to 30 September (£34m loss 30 June 2008) and impairment of investment securities increased to £284m (£145m 30 June 2008). As at 30 September 2008, the book value of the investment portfolio was £4.8bn (£4.9bn 30 June 2008).

### **Insurance & Investment**

Our Insurance & Investment division continues to make a good contribution to Group profitability. New insurance sales continue to show good growth in both household and motor, offset by lower repayment business. Lower weather-related claims experience compared to 2007 continues to support underlying profit performance. Trends in investment sales seen in the first half of 2008 have continued in the second half reflecting both market volatility and investor confidence with increased demand for both capital-guaranteed and cash-based products. Solvency ratios remain strong notwithstanding market falls, reflecting ongoing risk mitigation activity.

### **International**

As previously announced, the sale of BankWest and St. Andrew's Insurance in Australia is scheduled to complete before the end of 2008 and result in a pre-tax loss of some £690m (including goodwill written-off) but is positive in terms of the effect on capital ratios. The net interest margin benefits from some asset re-pricing but, in the short term, this is more than offset by higher funding costs. Cost growth reflects the investment we have made in our International operations. The International credit environment has deteriorated and while there is some upward pressure on impairments, this is from a low base. Progress in European Financial Services (EFS) is satisfactory, although investment sales in Germany have slowed in current market conditions.



### **Treasury Portfolio**

As at 30 September, losses due to market dislocation totalled £1,827m (£1,095m 30 June 2008), including £457m impairment losses on the Banking Book relating to Lehmans and Washington Mutual (£Nil 30 June 2008). Further impairment losses of around £150m are expected to be taken in relation to Icelandic banks.

Following the International Accounting Standards Board's (IASB) decision to permit the reclassification of assets held in the Trading Book, HBOS has transferred out of the Trading Book into the Banking Book Asset Backed Securities (ABS) and FRNs with fair values of £9.1bn and £3.1bn respectively, with effect from 1 July 2008. This leaves ABS and FRNs with fair values of £2.1bn and £1.5bn still held on the Trading Book. Negative fair value adjustments (FVAs) to securities held in the Banking Book in the period to 30 September totalled on a post tax basis £3.8bn (£1.9bn 30 June 2008), including £588m in respect of securities transferred from the Trading Book.

FVAs reflect increasing illiquidity in the securities markets and recent credit rating downgrades to the investment portfolio. At 30 September, 88.3% of our ABS portfolio by nominal value was rated AAA, 6.4% AA and 2% A, compared to 93%, 3.9% and 1.3% respectively at 30 June 2008. Our Alt-A portfolio at 30 September had an average mark to market of 65%, with 75.3% by nominal value being AAA rated, 14.6% being AA rated and 2.4% A rated, compared to 97.4%, 2.3% and nil respectively at 30 June 2008. Exposure to monolines calculated on our own internal methodology totalled £1.1bn at 30 September (£0.7bn 30 June 2008).

### **Outlook**

While the credit environment will remain challenging, HBOS's robust capital position, to be further enhanced by the injection of capital and liquidity facilitated by the UK Government, reinforces the Group to meet such challenges. HBOS's strong brands and leadership positions in UK Retail banking, its multi-brand approach and distribution strength in the insurance and investment markets and more selective approach to corporate and international markets, offer good growth opportunities when the current cycle turns. These opportunities will be further advanced as HBOS joins the enlarged Lloyds TSB Group in January 2009, subject to shareholder and regulatory approvals.

Certain statements made in this announcement constitute forward-looking statements within the meaning of the United States Private Securities Litigation Reform Act of 1995.

Forward looking statements can be identified by the use of words such as "may", "will", "expect", "intend", "estimate", "anticipate", "believe", "plan", "seek", "continue" or similar expressions and relate to, among other things, the performance of the various business units of HBOS in the near to medium term, the amount by which HBOS expects to write down the value of certain of its assets, the expectations of HBOS in respect of the rights issue, its capital ratios and its dividend payout ratio, the business strategy of HBOS and its plans and objectives for future operations. Such statements are based on current expectations and, by their nature, are subject to a number of risks and uncertainties that could cause actual results and performance to differ materially from any expected future results or performance, expressed or implied, by the forward-looking statement. Factors that might cause forward looking statements to differ materially from actual results, include among other things, general economic conditions in the European Union, in particular in the United Kingdom, and in other countries in which HBOS has business activities or investments, including the United States; the inability of HBOS to hedge certain risks economically; the adequacy of its impairment provisions and loss reserves; and the potential exposure of HBOS to various types of market risk, such as interest rate risk, foreign exchange rate risk, credit risk and commodity and equity price risk. These forward-looking statements speak only as of the date of this announcement. The information and opinions contained in this announcement are subject to change without notice and, subject to compliance with applicable law, HBOS assumes no responsibility or obligation to update publicly or review any of the forward-looking statements contained herein.

## DEFINITIONS

The following definitions apply throughout this Circular (except in Part IX (“**Historical Financial Information Relating to HBOS plc**”)) unless the context otherwise requires:

“ <b>Acquisition</b> ”	means the proposed acquisition by Lloyds TSB of HBOS by means of the Scheme (or by means of the Offer if Lloyds TSB so elects in accordance with the terms described in Part III of this document and subject to the consent of the Panel);
“ <b>Admission</b> ”	means admission of the Open Offer Shares and/or the Consideration Shares, as the case may be, to the Official List and to trading on the London Stock Exchange’s main market for listed securities becoming effective in accordance with, respectively, the Listing Rules and the Admission and Disclosure Standards;
“ <b>Admission and Disclosure Standards</b> ”	means the requirements contained in the publication of the London Stock Exchange “Admission and Disclosure Standards” (as amended from time to time) containing, amongst other things, the admission requirements to be observed by companies seeking admission to trading on the London Stock Exchange’s main market for listed securities;
“ <b>Announcement</b> ”	means the announcement made by Lloyds TSB on 18 September 2008 of the Acquisition, as supplemented by the announcement made on 13 October 2008 announcing the revised terms of the Acquisition;
“ <b>Application Form</b> ”	means the personalised application form on which Qualifying Shareholders may apply for Open Offer Shares under the Open Offer;
“ <b>Bank of Scotland</b> ”	means Bank of Scotland plc (formerly The Governor and Company of the Bank of Scotland), a subsidiary of HBOS;
“ <b>Basel II</b> ”	means the New Capital Adequacy Framework issued in June 2004 by the Basel Committee, as implemented by Directive 2006/48/EC and Directive 2006/49/EC;
“ <b>BSP Act</b> ”	means the Banking (Special Provisions) Act 2008;
“ <b>Business Day</b> ”	means a day (excluding Saturdays or Sundays and public holidays) on which banks generally are open for business in the City of London and Edinburgh;
“ <b>Capital Reduction</b> ”	means the proposed reduction of share capital of HBOS comprised in the Scheme;
“ <b>Capitalisation Amount</b> ”	means the nominal amount of the final dividend equivalent in respect of the financial year ending 31 December 2008;
“ <b>Capitalisation Issue</b> ”	means the proposed issue of the Capitalisation Shares;
“ <b>Capitalisation Issue Record Date</b> ”	means the record date for the Capitalisation Issue;
“ <b>Capitalisation Issue Shares</b> ”	means the Lloyds TSB Shares to be issued in connection with the Capitalisation Issue;
“ <b>Cheltenham &amp; Gloucester</b> ” or “ <b>C&amp;G</b> ”	means Cheltenham & Gloucester plc;

<b>“Circular”</b>	means this document which is being made available to Lloyds TSB Shareholders in relation to the Acquisition and the Placing and Open Offer, including the notice of the Lloyds TSB General Meeting;
<b>“Citi”</b>	means Citigroup Global Markets Limited when referred to in its capacity as joint sponsor, joint corporate broker and financial adviser and Citigroup Global Markets U.K. Equity Limited when referred to in its capacity as joint bookrunner;
<b>“City Code”</b>	means the City Code on Takeovers and Mergers;
<b>“Closing Price”</b>	means the closing middle-market quotation of an HBOS Share or a Lloyds TSB Share as derived from the London Stock Exchange Daily Official List (as the context requires);
<b>“Companies Act”</b>	means the Companies Act 2006 (as amended) in so far as in force;
<b>“Company’s Registrars” or “Receiving Agent”</b>	means Equiniti Limited, a company incorporated under the laws of England and Wales;
<b>“Competing Proposal”</b>	means an offer referred to in announcement made by a third party, which is not acting in concert with Lloyds TSB, of a firm intention to make an offer (whether by way of general offer or scheme of arrangement or otherwise and whether or not subject to pre-conditions) for HBOS pursuant to Rule 2.5 of the City Code;
<b>“Competition Commission”</b>	means the body corporate known as the Competition Commission as established under section 45 of the Competition Act 1998, as amended;
<b>“Conditions”</b>	means the conditions to the Scheme becoming Effective, set out in full in Appendix I of the announcement made on 13 October 2008 announcing the revised terms of the Acquisition;
<b>“Consideration ADRs”</b>	means the Lloyds TSB ADRs proposed to be issued pursuant to the Acquisition;
<b>“Consideration Shares”</b>	means the Lloyds TSB Shares proposed to be issued (or delivered in full or in part from treasury stock) and credited as fully paid pursuant to the Acquisition;
<b>“Court”</b>	means the Court of Session in Edinburgh;
<b>“Court Hearings”</b>	means the Scheme Court Hearing or the Reduction Court Hearing, as the case may be;
<b>“Court Meeting”</b>	means the meeting of the Scheme Shareholders and any adjournment thereof to be convened pursuant to an order of the Court pursuant to section 896 of the Companies Act for the purpose of considering and, if thought fit, approving the Scheme (with or without amendment);
<b>“Court Orders” or “Orders”</b>	means the Scheme Court Order and the Reduction Court Order respectively or, where the context so requires, either of them;
<b>“CREST”</b>	means the relevant system (as defined in the CREST Regulations) in respect of which Euroclear is the Operator (as defined in the CREST Regulations);
<b>“CREST Regulations”</b>	means the Uncertificated Securities Regulations 2001 (SI 2001 No. 01/378), including any modification thereof or any regulations in substitution therefore made under section 207 of the Companies Act and for the time being in force;
<b>“Disclosure and Transparency Rules or DTR”</b>	means the Disclosure and Transparency Rules of the UK Listing Authority;

<b>“Effective”</b>	means, in the context of the Acquisition:  (i) if the Acquisition is implemented by way of the Scheme, the Scheme having become effective pursuant to its terms; or  (ii) if the Acquisition is implemented by way of a takeover offer under section 974 of the Companies Act, the takeover offer having been declared or become unconditional in all respects in accordance with the requirements of the City Code;
<b>“Effective Date”</b>	means the date on which the Scheme becomes Effective in accordance with its terms;
<b>“Enlarged Group”</b>	means with effect from the Effective Date, the combined Lloyds TSB Group and HBOS Group following the Effective Date;
<b>“Enlarged Group Ordinary Share Capital”</b>	means all of the issued Lloyds TSB Shares at the date immediately following the Acquisition becoming Effective;
<b>“Enlarged Group HMT Preference Shares”</b>	means the New Preference Shares, together with such preference shares as are issued by Lloyds TSB to HM Treasury in exchange for the New HBOS Preference Shares, pursuant to the HBOS Preference Share Scheme;
<b>“Equiniti”</b>	means Equiniti Limited, a company incorporated under the laws of England and Wales;
<b>“Euroclear”</b>	means Euroclear UK & Ireland Limited;
<b>“Excess Application Facility”</b>	means the arrangement pursuant to which Qualifying Shareholders may apply for Open Offer Shares in excess of their Open Offer Entitlements;
<b>“Existing Ordinary Shares”</b>	means the Lloyds TSB Shares in issue at the Open Offer Record Date;
<b>“Financial Services Authority” or “FSA”</b>	means the Financial Services Authority of the United Kingdom;
<b>“FSMA”</b>	means the Financial Services and Markets Act 2000;
<b>“Halifax”</b>	means Halifax Group Limited (formerly Halifax Group plc), a subsidiary of HBOS;
<b>“HBOS”</b>	means HBOS plc, registered in Scotland (no. SC218813);
<b>“HBOS ADRs”</b>	means the American Depositary Receipts of HBOS, each representing one HBOS Share;
<b>“HBOS Articles”</b>	means the articles of association of HBOS in force from time to time;
<b>“HBOS Board”</b>	means the board of directors of HBOS as at the date of this Circular;
<b>“HBOS Deposit Agreement”</b>	means the deposit agreement, dated 18 October 2006, between HBOS plc, The Bank of New York, as depositary, and the owners and holders of HBOS ADRs issued thereunder (as amended or restated);
<b>“HBOS Directors”</b>	means the directors of HBOS as at the date of this Circular, and <b>“HBOS Director”</b> means any one of them;
<b>“HBOS General Meeting”</b>	means the general meeting of HBOS Shareholders (and any adjournment thereof) to be convened, <i>inter alia</i> , for the purposes of considering and, if thought fit, approving certain resolutions in connection with the Scheme, including any adjournment thereof;
<b>“HBOS Group”</b>	means HBOS and its subsidiary undertakings;

<b>“HBOS Interim Results”</b>	means the condensed consolidated unaudited financial statements of HBOS for the six months to 30 June 2008 prepared in accordance with the Disclosure and Transparency Rules and with IAS 34 “Interim Financial Reporting” consolidated by the European Union;
<b>“HBOS Open Offer”</b>	means the offer by HBOS to qualifying HBOS Shareholders to apply for the HBOS Open Offer Shares on the terms and subject to the prospectus to be published by HBOS and any associated application form;
<b>“HBOS Open Offer Shares”</b>	means the new HBOS Shares to be offered to qualifying HBOS Shareholders under the HBOS Open Offer and for which HM Treasury has agreed to acquire pursuant to the HBOS Placing and Open Offer Agreement (subject to clawback in respect of valid applications by qualifying HBOS Shareholders and excluding shares taken up by third party placees);
<b>“HBOS Placing”</b>	means the conditional placing by HBOS of the HBOS Open Offer Shares with HM Treasury;
<b>“HBOS Placing and Open Offer”</b>	means the HBOS Placing and the HBOS Open Offer;
<b>“HBOS Placing and Open Offer Agreement”</b>	means the agreement relating to the HBOS Placing and Open Offer entered into with effect from 13 October 2008 by HBOS, HM Treasury, Morgan Stanley and Dresdner Kleinwort;
<b>“HBOS Preference Shareholders”</b>	means the registered holders of the HBOS Preference Shares;
<b>“HBOS Preference Shares”</b>	means each class of preference shares issued by HBOS from time to time;
<b>“HBOS Preference Share Scheme”</b>	means the proposed scheme of arrangement under sections 895 to 899 of the Companies Act between HBOS and HBOS Preference Shareholders, with or subject to any modification thereof or addition thereto or condition agreed by HBOS and Lloyds TSB and which the Court may think fit to approve or impose;
<b>“HBOS Preference Share Scheme Circular”</b>	means the circular to be issued by HBOS in respect of the recommended proposal of the cancellation of the HBOS Preference Shares and the issue of the Replacement Preference Shares by Lloyds TSB;
<b>“HBOS Preference Share Subscription Agreement”</b>	means the agreement entered into between HBOS and HM Treasury, effective as of 13 October 2008, in connection with the issue of New HBOS Preference Shares;
<b>“HBOS Shareholders”</b>	means the registered holders of HBOS Shares and such term shall, where the context requires, include holders of HBOS ADRs, as the case may be, and <b>“HBOS Shareholder”</b> means any of such holders;
<b>“HBOS Shares”</b>	means ordinary shares of 25 pence each in the capital of HBOS (including shares underlying HBOS ADRs) and <b>“HBOS Share”</b> means any one of them;
<b>“HBOS Share Schemes”</b>	means the HBOS plc Sharesave Plan 2001, the HBOS plc International Sharesave Plan 2001, the HBOS plc Inland Revenue Approved Employee Share Option Plan 2002, the Bank of Scotland 1995 Executive Stock Option Scheme, the Bank of Scotland 1996 Executive Stock Option Scheme, the St James’s Place Partners Share Option Schemes, the HBOS plc International Free Shares Plan, the HBOS plc Long Term Executive Bonus Plan, the HBOS plc Special Long Term Bonus Plan, the HBOS plc Australian Free Shares plan, the HBOS plc

Annual Bonus Plan, the HBOS plc Share Incentive Plan, the HBOS plc Approved Profit Sharing Scheme, the ICC Bank Employee Share Ownership Scheme and the Insight Investment Management Share Option Plan; and “**HBOS Share Scheme**” means any one of them;

“ <b>HMRC</b> ”	means Her Majesty’s Revenue and Customs;
“ <b>HM Treasury</b> ”	means the Commissioners of Her Majesty’s Treasury (or, where HM Treasury has nominated a nominee to acquire any shares which HM Treasury would otherwise be obliged to acquire, such nominee);
“ <b>IAS</b> ”	means International Accounting Standards;
“ <b>IFRS</b> ”	means International Financial Reporting Standards as adopted for use in the European Union;
“ <b>Implementation Agreement</b> ”	means the implementation agreement dated 18 September 2008 between Lloyds TSB and HBOS in relation to the Acquisition as amended and restated on 13 October 2008;
“ <b>Issue Price</b> ”	means 173.3 pence per Open Offer Share;
“ <b>Lazard</b> ”	means Lazard & Co., Limited;
“ <b>LIBOR</b> ”	means London Interbank Offering Rate;
“ <b>Listing Rules</b> ”	means the Listing Rules of the UK Listing Authority;
“ <b>Lloyds TSB</b> ” or the “ <b>Company</b> ”	means Lloyds TSB Group plc registered in Scotland (no. 95000);
“ <b>Lloyds TSB ADRs</b> ”	means the American Depositary Receipts of Lloyds TSB, each representing four Lloyds TSB Shares;
“ <b>Lloyds TSB Board</b> ” or “ <b>Lloyds TSB Board of Directors</b> ”	means the board of directors of Lloyds TSB as at the date of this document;
“ <b>Lloyds TSB Deposit Agreement</b> ”	means the amended and restated deposit agreement to be entered into between Lloyds TSB Group plc, The Bank of New York, as depositary, and the owners and holders of Lloyds TSB ADRs issued thereunder;
“ <b>Lloyds TSB Directors</b> ”	means the directors of Lloyds TSB as at the date of this document, and “ <b>Lloyds TSB Director</b> ” means any one of them;
“ <b>Lloyds TSB General Meeting</b> ”	means the general meeting of Lloyds TSB to be held at 11.00 a.m. on 19 November 2008 at the Scottish Exhibition and Conference Centre, Glasgow G3 8YW, or any adjournment thereof, to consider and, if thought fit, to approve, among other things, the Acquisition and the issue of Lloyds TSB Shares in connection with the Placing and Open Offer;
“ <b>Lloyds TSB Group</b> ”	means Lloyds TSB and its subsidiary undertakings from time to time (and, other than for the purposes of the working capital statement in paragraph 2 of Part XII (“Additional Information”) of this document, being the Enlarged Group following completion of the Acquisition);
“ <b>Lloyds TSB Interim Results</b> ”	means the condensed consolidated half year unaudited financial statements of Lloyds TSB prepared in accordance with the Disclosure and Transparency Rules and with IAS 34 “Interim Financial Reporting” as adopted by the European Union;

<b>“Lloyds TSB Preference Shares”</b>	means preference shares of 25 pence each in the capital of Lloyds TSB, and <b>“Lloyds Preference Share”</b> means any one of them;
<b>“Lloyds TSB Scotland”</b>	means Lloyds TSB Scotland plc;
<b>“Lloyds TSB Share Plans”</b>	means the Lloyds TSB Long-term Incentive Plan 2006, the Lloyds TSB Deferred Bonus Plan 2008, the Lloyds TSB Performance Share Plan, the Lloyds TSB Group Executive Share Plan 2003, the Lloyds TSB Group No. 1 Executive Share Option Scheme 1997, the Lloyds TSB Group No. 2 Executive Share Option Scheme 1997, the Lloyds TSB Group Sharesave Scheme 2007, the Lloyds TSB Group Sharesave Scheme 1997 and the Lloyds TSB Group Shareplan and <b>“Lloyds TSB Share Plan”</b> means any one of them;
<b>“Lloyds TSB Shareholders”</b>	means holders of Lloyds TSB Shares and <b>“Lloyds TSB Shareholder”</b> means any one of them;
<b>“Lloyds TSB Shares”</b>	means ordinary shares of 25 pence each in the capital of Lloyds TSB (including shares underlying Lloyds TSB ADRs and, if the context requires, the Consideration Shares, the Open Offer Shares and the limited voting shares) and <b>“Lloyds TSB Share”</b> means any one of them;
<b>“London Stock Exchange”</b>	means London Stock Exchange plc;
<b>“Merrill Lynch”</b>	means Merrill Lynch International;
<b>“New HBOS Preference Shares”</b>	means the £3,000,000,000 Fixed to Floating Callable Non-Cumulative Preference Shares to be issued by HBOS to HM Treasury pursuant to the HBOS Preference Share Subscription Agreement, effective as of 13 October 2008;
<b>“New Preference Share Issue”</b>	means the issue of the New Preference Shares by Lloyds TSB pursuant to the Preference Share Subscription Agreement;
<b>“New Preference Shares”</b>	means the £1,000,000,000 Fixed to Floating Callable Non-Cumulative Preference Shares to be issued by Lloyds TSB to HM Treasury pursuant to the Preference Share Subscription Agreement, effective as of 13 October 2008;
<b>“NYSE”</b>	means the New York Stock Exchange, Inc.;
<b>“Offer”</b>	means, should Lloyds TSB elect to make the Acquisition by way of a contractual offer, the recommended offer to be made by Lloyds TSB for HBOS, on the terms and subject to the Conditions set out in this document and to be set out in the formal Offer Document and where the context admits, any subsequent revision, variation, extension or renewal of such offer;
<b>“Offer Document”</b>	means, should the Acquisition be implemented by means of the Offer, the document to be sent to HBOS Shareholders;
<b>“Office of Fair Trading” or “OFT”</b>	means the UK Office of Fair Trading;
<b>“Official List”</b>	means the official list of the UK Listing Authority;
<b>“Open Offer”</b>	means the offer by Lloyds TSB to Qualifying Shareholders constituting an invitation to apply for the Open Offer Shares on the terms and subject to the conditions set out in the Prospectus and in the Application Form (as applicable);
<b>“Open Offer Entitlement”</b>	means an entitlement to apply for Open Offer Shares allocated to a Qualifying Shareholder pursuant to the Open Offer;
<b>“Open Offer Record Date”</b>	means 12 December 2008;

<b>“Open Offer Shares”</b>	means the new Lloyds TSB Shares to be offered to Qualifying Shareholders under the Open Offer and for which HM Treasury has agreed to acquire pursuant to the Placing and Open Offer Agreement, subject to clawback in respect of valid applications by Qualifying Shareholders;
<b>“Overseas Shareholders”</b>	means Lloyds TSB Shareholders or HBOS Shareholders who are resident in, ordinarily resident in, or citizens of, jurisdictions outside the United Kingdom;
<b>“Panel” or “Takeover Panel”</b>	means The Panel on Takeovers and Mergers;
<b>“PD Regulation”</b>	means Commission Regulation (EC) No 809/2004;
<b>“Placing”</b>	means the conditional placing by Lloyds TSB of the Open Offer Shares with HM Treasury;
<b>“Placing and Open Offer”</b>	means the Placing and Open Offer;
<b>“Placing and Open Offer Agreement”</b>	means the agreement relating to the Placing and Open Offer entered into with effect from 13 October 2008 by the Company, HM Treasury, Citigroup Global Markets Limited, Citigroup Global Markets U.K. Equity Limited, Merrill Lynch and UBS;
<b>“Pounds”, “pence”, “£” and “p”</b>	means the lawful currency of the United Kingdom;
<b>“PPI”</b>	means payment protection insurance;
<b>“Preference Share Scheme”</b>	means the proposed scheme of arrangement under sections 895 to 899 of the Companies Act between HBOS and relevant classes of HBOS Preference Shareholders, with or subject to any modification thereof or in addition thereto or conditions agreed by HBOS and Lloyds TSB and which the Court may think fit to approve or impose;
<b>“Preference Share Subscription Agreement”</b>	means the preference share subscription agreement entered into with effect from 13 October 2008 by the Company and HM Treasury in connection with the New Preference Share Issue;
<b>“Proposed Government Funding”</b>	means the proposed funding by the UK Government as part of a co-ordinated package of capital and funding measures for the UK banking sector as announced on 8 October 2008;
<b>“Prospectus”</b>	means the prospectus expected to be issued by Lloyds TSB in mid-November 2008;
<b>“Prospectus Rules”</b>	means the rules for the purposes of Part VI of FSMA in relation to the offers of securities to the public and the admission of securities to trading on a regulated market;
<b>“Qualifying CREST Shareholders”</b>	means Qualifying Shareholders holding Lloyds TSB Shares in uncertificated form in CREST;
<b>“Qualifying Non-CREST Shareholders”</b>	means Qualifying Shareholders holding Lloyds TSB Shares in certificated form;
<b>“Qualifying Shareholders”</b>	means holders of Lloyds TSB Shares on the register of members of Lloyds TSB Shares at the Open Offer Record Date with the exclusion of Lloyds TSB Shareholders with a registered address in a Restricted Jurisdiction (as to be more fully set out in the Prospectus);
<b>“Reduction Court Hearing”</b>	means the hearing by the Court of the petition to confirm the Capital Reduction under section 137 of the Companies Act 1985 (as amended or re-enacted);
<b>“Reduction Court Order”</b>	means the order of the Court confirming the Capital Reduction under section 137 of the Companies Act 1985 (as amended or re-enacted);



<b>“Registrar of Companies”</b>	means the Registrar of Companies in Scotland, within the meaning of the Companies Act;
<b>“Regulatory Information Service”</b>	means any of the services authorised from time to time by the Financial Services Authority for the purposes of disseminating regulatory announcements;
<b>“Replacement Lloyds TSB Preference Shares”</b>	means the preference shares to be issued by Lloyds TSB in exchange for the HBOS Preference Shares pursuant to the HBOS Preference Share Scheme;
<b>“Resolutions”</b>	means the resolutions set out in the notice convening the Lloyds TSB General Meeting at the end of this Circular;
<b>“Restricted Jurisdiction”</b>	means any jurisdiction where either sending the Scheme Document or the Prospectus or issuing Consideration Shares or Open Offer Shares would violate the law of that jurisdiction;
<b>“Rule 9 Waiver”</b>	means the waiver agreed to be granted by the Panel, subject to the passing by the Lloyds TSB Shareholders (other than HM Treasury, if applicable) of Ordinary Resolution 2 set out in the notice convening the Lloyds TSB General Meeting, as described in paragraph 14 of Part I (“Letter from Sir Victor Blank, Chairman of Lloyds TSB Group Plc”) of this document, of the obligation to make a general offer to Lloyds TSB Shareholders under Rule 9 of the City Code that might otherwise arise on HM Treasury;
<b>“Scheme”</b>	means the proposed scheme of arrangement under sections 895 to 899 of the Companies Act between HBOS and the holders of the Scheme Shares, with or subject to any modification thereof or addition thereto or condition agreed by HBOS and Lloyds TSB and which the Court may think fit to approve or impose;
<b>“Scheme Court Hearing”</b>	means the hearing by the Court of the petition to sanction the Scheme under section 899 of the Companies Act;
<b>“Scheme Court Order”</b>	means the order of the Court sanctioning the Scheme under section 899 of the Companies Act;
<b>“Scheme Document”</b>	means the document to be posted to HBOS Shareholders and others containing, <i>inter alia</i> , the Scheme and the notice of the Court Meeting and HBOS General Meeting;
<b>“Scheme Record Time”</b>	means 6.00 p.m. on the Business Day immediately preceding the date of the Reduction Court Hearing;
<b>“Scheme Shareholders”</b>	means the holders of Scheme Shares and <b>“Scheme Shareholder”</b> means any one of them;
<b>“Scheme Shares”</b>	means the HBOS Shares (or any other shares in the capital of HBOS which may be included within the definition of Scheme Shares pursuant to the terms of the Scheme): <ul style="list-style-type: none"> <li>(i) in issue on the date of this document;</li> <li>(ii) (if any) issued after the date of this document and prior to the Voting Record Time; and</li> <li>(iii) (if any) issued at or after the Voting Record Time but before the Hearing Record Time either on terms that the original or any subsequent holder thereof shall be bound by the Scheme or, in the case of any such shares issued prior to the adoption of the amendment to the HBOS Articles to be adopted at the HBOS General Meeting, in respect of which the original or subsequent holder thereof is, or shall have agreed in writing to be, bound by the Scheme,</li> </ul> and <b>“Scheme Share”</b> means any one of them;
<b>“Scottish Widows”</b>	means Scottish Widows plc, registered in Scotland (no. 199549);

<b>“SDRT”</b>	means stamp duty reserve tax;
<b>“SEC”</b>	means the US Securities and Exchange Commission;
<b>“Securities Act” or “US Securities Act”</b>	means the United States Securities Act of 1933, as amended;
<b>“SME”</b>	means small and medium sized entities;
<b>“UBS”</b>	means UBS Limited;
<b>“UK” or “United Kingdom”</b>	means the United Kingdom of Great Britain and Northern Ireland and its dependent territories;
<b>“UK GAAP”</b>	means generally accepted accounting principles in the United Kingdom;
<b>“UK Listing Authority” or “UKLA”</b>	means the United Kingdom Financial Services Authority in its capacity as the competent authority for listing under Part VI of FSMA;
<b>“US” or “United States” or “United States of America”</b>	means the United States of America (including the states of the United States and the District of Columbia), its possessions and territories and all areas subject to its jurisdiction;
<b>“Voting Record Time”</b>	means the time fixed by the Court for determining the entitlement to vote at the Court Meeting, as set out in the notice thereof.

All references to legislation in this document are to the legislation of England and Wales unless the contrary is indicated. Any reference to any provision of any legislation shall include any amendment, modification, re-enactment or extension thereof.

Unless otherwise stated, all times referred to in this document are references to London time.

Words importing the singular shall include the plural and vice versa, and words importing the masculine gender shall include the feminine or neutral gender.

For the purpose of this document, **“subsidiary”**, **“subsidiary undertaking”**, **“undertaking”** and **“associated undertaking”** have the meanings given by the Companies Act.

# LLOYDS TSB GROUP PLC

## NOTICE OF GENERAL MEETING

### Notice of General Meeting

A general meeting (the "**Meeting**") of Lloyds TSB Group plc (the "**Company**") will be held at the Scottish Exhibition and Conference Centre, Glasgow G3 8YW, on 19 November 2008 at 11.00 a.m., for the following purposes:

1. To resolve as an ordinary resolution that conditional upon the approval of Ordinary Resolution 3 as set out in the notice of this Meeting that:

the proposed acquisition by the Company (or one or more of its subsidiaries) of HBOS plc ("**HBOS**") (the "**Acquisition**") to be effected pursuant to a scheme of arrangement (the "**Scheme**") under sections 895 to 899 of the Companies Act 2006 (the "**Act**") or takeover offer (the "**Offer**") made by or on behalf of the Company, substantially on the terms and subject to the conditions set out in the circular to shareholders of the Company dated 3 November 2008 (the "**Circular**") outlining the Acquisition (a copy of which is produced to the Meeting and signed for identification purposes by the chairman of the Meeting (the "**Chairman**")) be approved and the directors of the Company (or any duly constituted committee thereof) (the "**Board**") be authorised (1) to take all such steps as the Board considers to be necessary or desirable in connection with, and to implement, the Acquisition (including in respect of options granted in relation to HBOS securities); and (2) to agree such modifications, variations, revisions, waivers, extensions or amendments to any of the terms and conditions of the Acquisition, and/or to any documents relating thereto, as they may in their absolute discretion think fit.
2. To resolve as an ordinary resolution that:

subject to and conditional upon the Acquisition becoming unconditional (save for any conditions relating to (i) the delivery of the order of the Court of Session in Edinburgh confirming the reduction of capital in HBOS to the Registrar of Companies in Scotland (the "**Court Sanction**"), (ii) registration of such order by the Registrar of Companies in Scotland ("**Registration**"), and (iii) the admission of the ordinary shares of 25 pence each in the Company to be issued pursuant to the Acquisition becoming effective in accordance with the Listing Rules, or as appropriate, the UK Listing Authority and the London Stock Exchange agreeing to admit such shares to the Official List and to trading on the main market of the London Stock Exchange respectively ("**Admission**")), that the waiver granted by the Panel on Takeovers and Mergers as described in the Circular of the obligation that might otherwise arise under Rule 9 of the City Code on Takeovers and Mergers on The Commissioners of Her Majesty's Treasury or their nominee ("**HM Treasury**") to make a general offer to ordinary shareholders for all of the issued ordinary shares in the capital of the Company held by them as a result of the issue to HM Treasury of up to 7,123,501,794 ordinary shares in the Company pursuant to the Placing and Open Offer Agreement (as defined in Ordinary Resolution 2 as set out in the notice of this Meeting), and following completion of the Acquisition, be approved. This represents a maximum of 43.5 per cent. of the shares carrying voting rights in the Company.
3. To resolve as an ordinary resolution that:

subject to and conditional upon (1) the Acquisition becoming unconditional (save for any conditions relating to the Court Sanction, Registration or Admission) and (2) the placing and open offer agreement entered into among the Company, Citigroup Global Markets Limited, Citigroup Global Markets U.K. Equity Limited, Merrill Lynch International, UBS Limited and HM Treasury and effective as of 13 October 2008 (the "**Placing and Open Offer Agreement**") (a copy of which is produced to the Meeting and signed for identification purposes by the Chairman) not having been terminated in accordance with its terms before the delivery of the order of the Court of Session in Edinburgh sanctioning the Scheme:

  - (A) the authorised share capital of the Company be increased from an aggregate of £1,791,250,000, US\$40,000,000, €40,000,000 and ¥1,250,000,000 to £5,675,477,055, US\$40,000,000, €40,000,000 and ¥1,250,000,000 by the creation of 14,911,908,221 new ordinary shares of 25 pence each, such shares forming one class with the then existing ordinary shares and having attached thereto the respective rights and privileges and

being subject to the limitations and restrictions set out in the Company's articles of association (the "**Articles**") and the creation of 625,000,000 new preference shares of 25 pence each, such shares having attached thereto the respective rights and privileges and being subject to the limitations and restrictions as may be determined by the Board or otherwise in accordance with article 3.3 of the Articles; and

(B) the Board be generally and unconditionally authorised pursuant to and in accordance with section 80 of the Companies Act 1985 (the "**1985 Act**") (in substitution for the authority conferred on it on 8 May 2008) to exercise all powers of the Company as set out in article 9.2 of the Articles to allot the new relevant securities created pursuant to part (A) of this Ordinary Resolution 3, as set out in the notice of this Meeting, credited as fully paid, with authority to deal with fractional entitlements arising out of such allotment as it thinks fit and to take all such other steps as it may deem necessary, expedient or appropriate to implement such allotment, and which authority shall expire on the day of the Company's annual general meeting in 2009 or on 7 August 2009, whichever is the earlier (unless previously revoked or varied by the Company in general meeting) and for such period the relevant section 80 amount (for the purposes of articles 9.2 and 9.5 of the Articles) shall be an aggregate nominal amount of £3,884,227,055, US\$39,750,000, €40,000,000 and ¥1,250,000,000 save that the Company may before such expiry make an offer or agreement which would or might require relevant securities to be allotted after such expiry and the Board may allot relevant securities in pursuance of such an offer or agreement as if the authority conferred by part (B) of this Ordinary Resolution 3 had not expired.

4. To resolve as an ordinary resolution that conditional upon the passing of Ordinary Resolution 3 as set out in the notice of this Meeting that:

pursuant to article 122 of the Articles, upon the recommendation of the Board an amount out of the sums standing to the credit of any of the Company's share premium account, capital redemption reserve or other undistributable reserve of up to the maximum amount standing to the credit of such reserves, as the Board may at its discretion determine, be capitalised, being such amount as the Board may determine for the purposes of paying up new ordinary shares and that the Board be authorised to apply such amount in paying up the new ordinary shares and to take all such other steps as it may deem necessary, expedient or appropriate to implement such capitalisation.

5. To resolve as an ordinary resolution that:

for the purpose of article 76 of the Articles, the ordinary remuneration of the directors of the Company, to be divisible among them shall be a sum not exceeding £1,000,000 in any year.

6. To resolve as an ordinary resolution that:

subject to and conditional upon the Acquisition becoming unconditional (save for any conditions relating to the Court Sanction, Registration or Admission) the Company is hereby generally and unconditionally authorised for the purpose of section 166 of the 1985 Act to make market purchases (as defined in section 163(3) of the 1985 Act) of (i) the £1,000,000,000 Fixed to Floating Callable Non-Cumulative Preference Shares (the "**New Preference Shares**") to be issued by the Company to HM Treasury pursuant to the preference share subscription agreement entered into with effect from 13 October 2008 by the Company and HM Treasury and (ii) the preference shares to be issued by the Company in exchange for the £3,000,000,000 Fixed to Floating Callable Non-Cumulative Preference Shares to be issued by HBOS to HM Treasury pursuant to the preference share subscription agreement entered into with effect from 13 October 2008 by HBOS and HM Treasury pursuant to the proposed scheme of arrangement under sections 895 to 899 of the Act between HBOS and relevant classes of holders of preference shares in HBOS (together with the New Preference Shares, the "**Preference Shares**") on such terms and in such manner as the Board may from time to time determine provided that:

- (i) the maximum number of Preference Shares which may be purchased is 4,000,000;
- (ii) the minimum price which may be paid for each Preference Share is 25 pence (exclusive of expenses);
- (iii) the maximum price which may be paid for each Preference Share is an amount equal to 120 per cent. of the liquidation preference of the Preference Shares; and

- (iv) the authority hereby conferred shall expire on the day which is 18 months after the date on which this Ordinary Resolution 6 is passed (except in relation to the purchase of Preference Shares the contracts for which are concluded before such expiry and which are executed wholly or partly after such expiry) unless such authority is renewed prior to such time.
7. To resolve as a special resolution that:  
in place of all existing powers, the power conferred on the Board by article 9.3 of the Articles be renewed for the period ending on the day of the Company's annual general meeting in 2009 or on 7 August 2009, whichever is the earlier, and for that period the relevant section 89 amount (for the purposes of articles 9.3 and 9.5 of the Articles) shall be £205,577,100 if Ordinary Resolution 3 is passed (equivalent to 822,308,400 ordinary shares of 25 pence each in the capital of the Company), or £75,647,511 if Ordinary Resolution 3 is rejected (equivalent to 302,590,044 ordinary shares of 25 pence each in the capital of the Company).
8. To resolve as a special resolution that:  
subject to and conditional upon the Acquisition becoming unconditional (save for any conditions relating to the Court Sanction, Registration or Admission), the name of the Company be changed to "Lloyds Banking Group plc".

Dated: 3 November 2008

*Registered Office*  
Henry Duncan House  
120 George Street  
Edinburgh  
Midlothian EH2 4LH

*By Order of the Board*  
M.A. Coltman  
Company Secretary

#### Notes

- (1) Only shareholders, proxies and authorised representatives of corporations which are shareholders of the Company are entitled to attend and speak at the Meeting and shareholders' names must be entered in the register of members at 6.00 p.m. on 17 November 2008, so that such shareholders, proxies and authorised representatives of corporations may have the right to vote at the Meeting.
- In order to facilitate voting by corporate representatives at the Meeting, arrangements will be put in place at the Meeting so that (i) if a corporate shareholder has appointed the Chairman as its corporate representative to vote on a poll in accordance with the directions of all of the other corporate representatives for that shareholder at the Meeting, then on a poll those corporate representatives will give voting directions to the Chairman and the Chairman will vote (or withhold a vote) as corporate representative in accordance with those directions; and (ii) if more than one corporate representative for the same corporate shareholder attends the Meeting but the corporate shareholder has not appointed the Chairman as its corporate representative, a designated corporate representative will be nominated, from those corporate representatives who attend, who will vote on a poll and the other corporate representatives will give voting directions to that designated corporate representative. Corporate shareholders are referred to the guidance issued by the Institute of Chartered Secretaries and Administrators on proxies and corporate representatives ([www.icsa.org.uk](http://www.icsa.org.uk)) for further details of this procedure. The guidance includes a sample form of representation letter if the Chairman is being appointed as described in (i) above.
- (2) Shareholders are invited to complete and return the enclosed form of proxy to the registrar, Equiniti Limited, FREEPOST SEA 7111, Aspect House, Spencer Road, Lancing, West Sussex BN99 6US or register their appointment of proxy electronically on our registrar's website, [www.sharevote.co.uk](http://www.sharevote.co.uk). A proxy need not be a shareholder of the Company but must attend the Meeting to represent a shareholder. Appointment of a proxy will not prevent shareholders from attending and voting at the Meeting. The form of proxy and, if relevant, the power of attorney or other authority under which it is signed, or a certified copy of that power or authority, must be received by Equiniti Limited by 11.00 a.m. on 17 November 2008.
- The right to appoint a proxy does not apply to persons whose shares are held on their behalf by another person and who have been nominated to receive communications from the Company in accordance with section 146 of the Act ("**nominated persons**"). Nominated persons may have a right under an agreement with the registered shareholder who holds the shares on their behalf to be appointed (or to have someone else appointed) as a proxy. Alternatively, if nominated persons do not have such a right, or do not wish to exercise it, they may have a right under such an agreement to give instructions to the person holding the shares as to the exercise of voting rights.
- (3) CREST members who wish to appoint and/or give instructions to a proxy or proxies through the CREST electronic proxy appointment service may do so through Equiniti Limited (ID RA19) by 11.00 a.m. on 17 November 2008. The time of receipt by Equiniti Limited will be deemed to be the time (as determined by the time stamp applied to the message by the CREST "applications host") from which Equiniti Limited is able to retrieve the message by enquiry of Euroclear in the manner prescribed by Euroclear. Equiniti Limited may treat as invalid a Euroclear instruction in the circumstances set out in Regulation 35(5)(a) of the Uncertificated Securities Regulations 2001.
- (4) Proxy appointments may be revoked by written notice to Equiniti Limited, FREEPOST SEA 7111, Aspect House, Spencer Road, Lancing, West Sussex BN99 6US, which must be received by 11.00 a.m. on 19 November 2008. Proxy instructions may be amended by notice received by the Company in accordance with the provisions of the Act at any time up to the time of the relevant poll. CREST members may also give instructions to revoke or amend by CREST message but only if the message is received by Equiniti Limited by 10.00 a.m. on 19 November 2008.
- (5) It would be helpful if any shareholder intending to come to the Meeting would remove the attendance card from the form of proxy and bring it to the Meeting. The shareholder will then be asked to produce the attendance card to show that he or she

has the right to attend, speak and vote. The card is not transferable and may only be used by the shareholder attending in person. If you are using our website for the appointment of a proxy, you may also use the website to register your intention to attend the Meeting.

- (6) If any shareholder intending to come to the Meeting would like to ask a question, which should relate to the business of the Meeting, they are asked to register it at the question registration desk which will be located in the reception area at the Meeting. To assist with these arrangements shareholders may, if they wish, send us advance notice of their question to gmquestions@lloydstsb.co.uk. If you give us advance notice of your questions, please tell a member of staff at the question registration desk when you arrive at the Meeting.
- (7) Any electronic communication sent by a shareholder to the Company or the registrar that is found to contain a computer virus will not be accepted.
- (8) As at 29 October 2008 (the last practicable date prior to the date of this notice) the total number of shares issued by the Company with rights to vote which are exercisable in all circumstances at general meetings is 5,972,853,501 ordinary shares of 25 pence each, which includes shares represented by American Depositary Receipts.
- (9) In accordance with article 62.1 of the Articles, the Board has determined that holders of limited voting shares shall be entitled to vote in respect of such shares on Ordinary Resolution 1 as set out in the notice of this Meeting only.
- (10) Copies of this notice are available in large print. If you would like a copy in large print, please contact Equiniti Limited, Aspect House, Spencer Road, Lancing, West Sussex BN99 6DA; telephone 0845 600 3579; textphone 0845 602 9376.
- (11) Voting on all resolutions will be decided on a poll. This means that shareholders who attend the Meeting, as well as those who are not able to attend but have sent proxy forms may have their votes taken into account according to the number of shares they hold. Details of the results of the polls will be announced through the stock exchange information service and will appear on our website, [www.lloydstsb.com](http://www.lloydstsb.com).

This page is intentionally left blank

This page is intentionally left blank



This page is intentionally left blank





