Abbey National Treasury Services plc
2011 Annual Report

Contents

Forward-looking Statements

Abbey National Treasury Services plc (the 'Company') and its subsidiaries (together the 'Group') may from time to time make written or oral forward-looking statements. Examples of such forward-looking statements include, but are not limited to:

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

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

By their very nature, forward-looking statements cannot be objectively verified, are speculative and involve inherent risks and uncertainties, both general and specific, and risks exist that the predictions, forecasts, projections and other forward-looking statements will not be achieved. The Company cautions readers that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements made by the Group or on the Group's behalf. Some of these factors are considered in detail in the Financial Risks and Risk Management section in Note 44 and the Risk Factors section on page 121 and may include:

- the effects of UK economic conditions (e.g. housing market correction, rising unemployment, increased taxation and reduced consumer and public spending) and particularly the UK real estate market;
- the effects of conditions in global financial markets (e.g. increased market volatility, reduced credit availability and increased commercial and consumer loan delinquencies);
- the effects of the ongoing economic and sovereign debt crisis in the eurozone;
- the credit quality of borrowers and the soundness of other financial institutions;
- the Group's ability to access liquidity and funding on financial terms acceptable to it;
- the extent to which regulatory capital and liquidity requirements and any changes to these requirements may limit the Group's operations;
- the effects of any changes to the credit rating assigned to the Group, any member of the Group or any of their respective debt securities;
- the effects of fluctuations in interest rates, foreign exchange rates, basis spreads, bond and equity prices and other market factors;
- the extent to the Group may be required to record negative fair value adjustments for its financial assets due to changes in market conditions;
- the ability of the Group to manage any future growth effectively (e.g. efficiently managing the operations and employees of expanding businesses and maintaining or growing its existing customer base);
- the ability of the Group to realise the anticipated benefits of the Santander UK plc group's ('Santander UK') business combinations and the exposure, if any, of the Group to any unknown liabilities or goodwill impairments relating to the acquired businesses;
- the effects of competition, or intensification of such competition, in the financial services markets in which the Group conducts business and the impact of customer perception of the Company's customer service levels on existing or potential business;
- the extent which the Group may be exposed to operational losses (e.g. failed internal or external processes, people and systems);
- the ability of the Group to recruit, retain and develop appropriate senior management and skilled personnel;
- the effects of any changes to the reputation of the Group, any member of the Group or any affiliate operating under the Group's brands;
- the effects of the financial services laws, regulations, administrative actions and policies and any changes thereto in each location or market in which the Group operates;
- the effects of taxation requirements and any changes thereto in each location in which the Group operates;
- the effects of the proposed reform and reorganisation of the structure of the UK financial regulatory authorities and of the UK regulatory framework that applies to members of the Group;
- the effects of any new reforms to the UK mortgage lending market;
- the power of the UK Financial Services Authority (or any overseas regulator) to intervene in response to attempts by customers to seek redress from financial service institutions, including the Group, in case of industry-wide issues;
- the extent to which members of Santander UK may be responsible for contributing to compensation schemes in the UK in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers;
- the effects which the UK Banking Act 2009 may have, should the HM Treasury, the Bank of England and/or the FSA exercise their powers under this Act in the future against the Company;
- the Group's dependency on its information technology systems;
- the risk of third parties using the Group as a conduit for illegal activities without the Group's knowledge;
- the effects of any changes in the pension liabilities and obligations of Santander UK plc; and
- Santander UK's success at managing the risks to which the Group is exposed, including the above items.

Undue reliance should not be placed on forward-looking statements when making decisions with respect to the Group and/or its securities. Investors and others should take into account the inherent risks and uncertainties of forward-looking statements and should carefully consider the foregoing non-exhaustive list of important factors. Forward-looking statements speak only as of the date on which they are made and are based on the knowledge, information available and views taken on the date on which they are made; such knowledge, information and views may change at any time. The Company does not undertake any obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Written forward-looking statements may appear in documents filed with the US Securities and Exchange Commission, including this Annual Report and Accounts, reports to shareholders and other communications. The US Private Securities Litigation Reform Act of 1995 contains a safe harbour for forward-looking statements on which the Company relies in making such disclosures.

Directors' Report

Introduction

The Directors submit their report together with the financial statements for the Company and its subsidiaries (together the 'Group') for the year ended 31 December 2011.

The purpose of this report is to provide information to the members of the Company and as such it is only addressed to those members. The report may contain certain forward-looking statements with respect to the operations, performance and financial conditions of the Group. By their nature, these statements involve inherent risks and uncertainties since future events, circumstances and other factors can cause results and developments to differ materially from the plans, objectives, expectations and intentions expressed in such forward-looking statements. Members should consider this when relying on any forward-looking statements. The forward-looking statements reflect knowledge and information available at the date of preparation of this report and the Company undertakes no obligation to update any forward-looking statement during the year. Nothing in this report should be construed as a profit forecast.

Corporate structure

The Company is a wholly-owned subsidiary of Santander UK plc and the shares of the Company are not traded on the London Stock Exchange. The Company and its subsidiaries are part of Banco Santander, S.A. (together with its subsidiaries, 'Banco Santander'), a company incorporated in Spain which is the ultimate parent company. The Company is incorporated in England and has its registered office at 2 Triton Square, Regent's Place, London NW1 3AN.

Note 22 to the Consolidated Financial Statements provides a list of the principal subsidiaries of the Company and the nature of each subsidiary's business as well as details of overseas branches. As it does not have listed shares, the Company is exempt from the requirement to make certain disclosures that are normally part of the continuing obligations of listed companies in the UK. This exemption applies, among other things, to corporate governance and certain Directors' remuneration disclosures.

In October 2010, all of the existing activities of Cater Allen International Limited (a subsidiary of the Company) were transferred to the Company. The principal purpose of the transfer was to increase the efficiency of the Santander UK plc group. No gain or loss was recognised on the transfer.

Santander UK plc has given a full and unconditional guarantee in respect of the liabilities of the Company incurred prior to 31 July 2012. The Company has given a reciprocal guarantee in respect of the liabilities of Santander UK plc.

The Company contains parts of three divisions of the Santander UK plc group ('Santander UK').

- **Corporate Banking** - offers banking services principally to small and medium-sized ('SME') UK companies and also to mid and large corporate clients. It also contains certain legacy portfolios in run-off. This division is headed by Steve Pateman with the exception of banking services to large corporate clients where there is a global relationship, which is headed by Luis de Sousa.
- **Markets** – provides financial markets sales, trading and risk management services. This division is headed by Luis de Sousa.
- **Asset and Liability Management** – responsible for managing the Group's structural balance sheet. This division is headed by Justo Gómez.

Corporate Banking

Corporate Banking provides a range of banking services principally to UK companies, with a focus on services for SMEs, providing a broad range of banking products including loans, bank accounts, deposits, treasury services, invoice discounts, cash transmission and asset finance. In addition, Corporate Banking includes specialist teams servicing Real Estate, Social Housing and UK infrastructure clients.

Within Corporate Banking, the Large Corporates business is responsible for larger multinational corporate clients, including related activities principally comprising foreign exchange, money market and credit activities. These related activities are structured into two main product areas: Foreign exchange and money markets, and Credit. Foreign exchange offers a range of foreign exchange products and money markets runs the securities lending/borrowing and repo businesses. Credit originates loan and bond transactions in primary markets as well as their intermediation in secondary markets.

Markets

Markets is a financial markets business focused on providing value added financial services to financial institutions, as well as to the rest of Santander UK's business. It is structured into two main product areas: Fixed income and Equity. Fixed Income covers sales and trading activity for fixed income products. Equity covers equity derivatives including the manufacture of structured products sold to both the Group and other financial institutions who sell or distribute them on to their customers.

Directors' Report continued

Asset and Liability Management ('ALM')

ALM is responsible for managing the Santander UK structural balance sheet composition and, in conjunction with Santander UK's Risk Division, strategic and tactical liquidity risk management. This includes short-term and medium-term funding, covered bond and securitisation programmes. ALM's responsibilities also include management of Santander UK's banking products and structural exposure to interest rates and, in that role, is a link between Markets and all other Santander UK divisions. ALM recommends and helps to implement the Santander UK plc Board of Directors (the 'Santander UK Board'), Strategic Risk & Financial Management Committee, Asset and Liability Management Committee and Risk Committee policies for all aspects of balance sheet management - formulating guidance for, and monitoring, the overall balance sheet shape, including maturity profile.

Santander UK plc, as guarantor, and Abbey National Treasury Services plc, as issuer, have a shelf registration statement on file with the US Securities and Exchange Commission in relation to issuances of SEC-registered debt securities. Additionally, as part of its prudent contingent funding arrangements, ALM ensures that Santander UK has access to the central bank facilities made available by the Bank of England, the Swiss National Bank, and the US Federal Reserve.

Principal activity and business review

The principal activity of Abbey National Treasury Services plc, company number 2338548, is to provide treasury, corporate and wholesale banking services. The Group also provides Santander UK with these services as well as liquidity, funding, capital and risk management products. As part of this activity the Group provides a treasury function, incorporating liquidity, funding, capital and risk management products to Santander UK. It also provides treasury services, supplying products and risk management services for other financial services companies, and corporate banking services principally to small and medium sized UK companies.

Competitive environment, future trends and outlook

The economic environment in the UK in 2011 remained challenging, with UK GDP growing by 0.9%, a lower rate than in 2010. Inflation rose, however, in part due to the increase in value added tax at the start of the year. In the second half of the year the unemployment rate started to rise again, reaching 8.4% in December, up from 7.9% a year earlier. House prices were relatively stable, with the Halifax index showing them ending the year 1.3% lower than a year earlier.

2012 is expected to be another challenging year for the UK economy, but one in which lower inflation is expected to support the real earnings growth of households relative to the experience of 2011 as the year progresses. However, unemployment is predicted to remain high, resulting in continuing challenges for banks, homeowners and savers. The Bank of England's Base Rate has remained at a record low of 0.5% since March 2009 and, at the present time, markets expect interest rates to remain very low, and monetary policy to continue to be supportive of the economy, for a considerable period.

In terms of the competitive landscape, the Group's main competitors are investment banks and universal banks. The market remains competitive, driven largely by market incumbents but with new entrants emerging. Management expects that such competition will continue in response to consumer demand, technological changes, the impact of consolidation within the financial sector, regulatory developments and actions and other factors.

Abbey National Treasury Services plc continues to benefit from the strength of its parent company, Santander UK plc, and as part of the Santander UK plc group, management remains confident of the Group's strength despite continuing challenging conditions in some of its core financial services markets. A detailed description of management's basis for concluding that the Group remains a going concern is set out in Going Concern on page 7.

Review of the development and performance of the business during the year

The Company is required to set out in this report a fair review of the development and performance of the business of the Group during the year ended 31 December 2011 and the position of the Group at the end of the year.

Summarised consolidated statutory income statement

	2011 £m	2010 £m
Net interest income	**511**	403
Non-interest income	**311**	490
Total operating income	**822**	893
Administrative expenses	**(229)**	(209)
Depreciation and amortisation	**(7)**	(6)
Total operating expenses excluding provisions and charges	**(236)**	(215)
Impairment losses on loans and advances	**(54)**	(69)
Provisions for other liabilities and charges	**(20)**	-
Total operating provisions and charges	**(74)**	(69)
Profit before tax	**512**	609
Taxation expense	**(168)**	(149)
Profit for the year	**344**	460

2011 compared to 2010
Profit before tax decreased by £97m to £512m (2010: £609m). Material movements by line include:

> Total operating income decreased by £71m to £822m (2010: £893m), reflecting the full year impact of the cost of higher liquid asset balances in response to new UK regulatory requirements introduced in June 2010, higher cost of deposits and new wholesale medium-term funding, and the ongoing impact of a low interest rate environment. These decreases were partly offset by the favourable impact of improved lending margins on new business and growth in customer loans.

> Administrative expenses increased by £20m to £229m (2010: £209m), reflecting ongoing investment in the business, offset by further efficiencies. In Markets, investment related to new products, markets and customer segments. In Corporate Banking, investment focused on extending the product capability for customers. This increase was partly offset by a reduction in costs driven by further ongoing efficiency initiatives.

> Depreciation and amortisation increased slightly by £1m to £7m (2010: £6m).

> Impairment losses on loans and advances decreased by £15m to £54m (2010: £69m) principally due to the non-recurrence in 2011 of the default of a small number of large value transactions that occurred late in 2010.

> Provisions for other liabilities and charges increased by £20m to £20m (2010: £nil) due to the introduction of the UK Bank Levy.

Adjustments between the statutory basis and the trading basis

The Company's Board of Directors (the 'Board') reviews discrete financial information for each of its segments that includes measures of operating results and assets. The segments are managed primarily on the basis of their results, which are measured on a 'trading' basis. The trading basis differs from the statutory basis as a result of the application of an adjustment in respect of hedging and other variances, as presented below. Management considers that the trading basis provides the most appropriate way of reviewing the performance of the business. The nature of the adjustments is described in Note 2 to the Consolidated Financial Statements. For a detailed explanation of movements in the adjustments, see below.

Key performance indicators

Key performance indicators are set at the Santander UK level, rather than separately for the Group. Detailed information of the key performance indicators of Santander UK, of which the Group is a part, is set out in the Business Review – Summary in the Santander UK plc 2011 Annual Report, which is available on the Santander UK corporate website (www.aboutsantander.co.uk).

Profit before tax by segment

This section contains a summary of the results, and commentary thereon, on a trading basis for each segment within the business, together with reconciliations from the trading basis to the statutory basis. Commentary on the movements in the adjustments between the trading basis and the statutory basis are set out below.

	2011 £m	2010 £m
Corporate Banking	**233**	164
Markets	**45**	145
Asset and Liability Management	**254**	312
Trading profit before tax	**532**	621
Adjust for:		
- Hedging and other variances	**(20)**	(12)
Profit before tax	**512**	609

Trading profit before tax decreased by £89m to £532m (2010: £621m), reflecting a weaker trading environment in Markets and ALM partially offset by a stronger performance in income in Corporate Banking reflecting the increase in Corporate Banking's activities over the previous year and the continuing improvement in interest margins.

> Corporate Banking trading profit before tax increased by £69m to £233m (2010: £164m). Trading income increased, reflecting the increase in Corporate Banking's activities over the previous year and the continuing improvement in interest margins on loans as market pricing better reflected incremental higher funding and liquidity costs. This was partially offset by increased trading expenses reflecting investment focused on extending the product capability for customers. The Group only contains part of Santander UK's Corporate Banking activity.

Directors' Report continued

- Markets trading profit before tax decreased by £100m to £45m (2010: £145m). Trading income decreased largely due to reduced results in the market making desks and weak trading activities. A weaker trading environment reduced the results of the Rates derivatives and Equity business due to reduced volumes (linked to sale of retail structured products through the branch network). This was partially offset by growth with institutional clients. Trading expenses increased, reflecting ongoing investment in growth initiatives relating to new products, markets and customer segments. There was a 42% headcount increase across the customer transaction businesses compared to 31 December 2010.

- Asset and Liability Management trading profit before tax decreased by £58m to £254m (2010: £312m). The decrease was largely due to the increased cost of new term funding issuances, higher liquidity costs and lower interest rates. This was partially offset by the allocation of these impacts to other Santander UK companies in line with the ongoing customer repricing.

Other Material Items - Adjustments between the statutory basis and the trading basis

The Board reviews discrete financial information for each of its segments that includes measures of operating results and assets, which are measured on a 'trading' basis. The trading basis differs from the statutory basis (described in Note 1) as a result of the application of an adjustment in respect of hedging and other variances, as presented below, and described in Note 2 to the Consolidated Financial Statements. The trading adjustment consists of:

Hedging and other variances

	2011 **£m**	2010 £m
Losses	**20**	12

The Balance Sheet and Income Statement are subject to mark-to-market volatility including that arising from the accounting for elements of derivatives deemed under IFRS rules to be ineffective as hedges. Volatility also arises on certain assets previously managed on a fair value basis, and hence classified as fair value through profit or loss under IFRS, that are now managed on an accruals basis. Where appropriate, such volatility is separately identified to enable management to view the underlying performance of the business.

2011 compared to 2010
In 2011, hedging and other variance losses of £20m (2010: £12m) were excluded from the trading basis results, broadly in line with the previous year.

The position of the Group at the year end

Our balance sheet at 31 December 2011 is set out on page 14 of the Consolidated Financial Statements. Net assets increased by 10% to £3,707m (2010: £3,363m). The main movements in the balance sheet items were:

- Trading assets decreased by 38% to £21,891m (2010: £35,461m). The decrease principally reflected changes in holdings of UK and Organisation of Economic Co-operation and Development ('OECD') government securities as part of the Group's liquidity management activity, including the maturity of approximately half of the Group's holdings of government guaranteed fixed and floating rate notes.

- Derivative assets increased by 43% to £33,224m (2010: £23,237m). The increase was driven by an increase in the fair values of interest rate derivatives as a result of downward moves in yield curves. There was a corresponding increase in derivative liabilities.

- Loans and advances to banks decreased by 23% to £113,222m (2010: £146,412m). The decrease was principally driven by repayments of amounts due from Santander UK undertakings.

- Loans and advances to customers increased by 12% to £38,826m (2010: £34,550m). The increase was driven by an increase in lending to corporate customers.

- Deposits by banks decreased by 17% to £114,019m (2010: £136,753m). The decrease reflected repayments of amounts due to other Banco Santander group companies.

- Derivative liabilities increased by 41% to £35,417m (2010: £25,043m). The increase was driven by an increase in the fair values of interest rate derivatives as a result of downward moves in yield curves.

- Trading liabilities decreased by 40% to £25,745m (2010: £42,827m). The decrease reflected lower repo activity and the funding of lower holdings of UK and Organisation of Economic Co-operation and Development ('OECD') government securities as part of the Group's liquidity management activity.

> Debt securities in issue decreased by 20% to £26,980m (2010: £33,659m), principally reflecting a significant decrease in short-term funding in the US$20bn Commercial Paper Programme and Certificates of Deposit in issue as well as maturities of debt outstanding under the US$40bn EMTN programme. These decreases were partially offset by an increase in the level of medium-term funding through the issuance of debt under the Covered Bond programme.

Principal risks and uncertainties

The Group's principal risks and uncertainties together with the processes that are in place to monitor and mitigate those risks where possible can be found in the Risk Management section in Note 44 of the Consolidated Financial Statements for each segment of the business by type of risk and material risk factors are described in the Risk Factors section on pages 121 to 134.

Results and dividends

The results of the Group are discussed above. Interim dividends of £nil (2010: £600m) were paid during the year on the Company's ordinary shares. The Directors do not recommend the payment of a final dividend (2010: £nil) on the ordinary shares in issue.

Events after the balance sheet date

None.

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out above. The financial position of the Group, its cash flows, liquidity position and borrowing facilities are set out in the financial statements. The Group's objectives, policies and processes for managing its capital are described in Note 46 to the financial statements.

Details of the Group's financial risk management objectives, its financial instruments and hedging activities; and its exposures to credit risk, interest rate risk, liquidity risk, operational risk and other risks are set out in the Risk Management section in Note 44.

The Group is reliant on Santander UK plc and other companies in Santander UK for a significant proportion of its funding. The Santander UK Board has confirmed that Santander UK plc is a going concern, and that it will provide funding to the Group for the foreseeable future. In giving this commitment to provide funding to the Group, the Santander UK Board has considered the uncertainties within the Group when preparing the forecasts and budgets of the combined business of Santander UK.

The Company has given a full and unconditional guarantee in respect of the unsubordinated liabilities of Santander UK plc incurred prior to 31 July 2012 under a deed poll guarantee entered into by the Company on 29 January 2008. Santander UK plc has given a reciprocal guarantee in respect of the unsubordinated liabilities of the Company incurred prior to 31 July 2012.

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

Directors

The Directors who served throughout the year and to the date of this report were:

Mr L de Sousa
Mr D M Green
Mr B W Morrison
Mr S Pateman

Third party indemnities

Enhanced indemnities are provided to the Directors of the Company by Santander UK plc against liabilities and associated costs which they could incur in the course of their duties to the Company. All of the indemnities remain in force at the date of this Annual Report and Accounts. A copy of each of the indemnities is kept at the registered office address of Santander UK plc.

Directors' Report continued

Financial Instruments

The Group's risks are managed on a group level by the ultimate UK parent company, Santander UK plc. The financial risk management objectives of and policies of the Group; the policy for hedging each major type of forecasted transaction for which hedge accounting is used; and the exposure of the Company to price risk, market risk, credit risk, liquidity risk and cash flow risk are outlined in Note 44 to the Consolidated Financial Statements.

Employees

At 31 December 2011 the total number of employees calculated on a full time basis was 817 (2010: 679). Details of the related costs can be found in Note 6 to the Consolidated Financial Statements.

The Group is committed to equality of access and quality of service for disabled people and embraces the spirit of the Equality Act 2010 throughout its business operations. The Group has processes in place to help recruit, train, develop, retain and promote employees with disabilities and is committed to giving full and fair consideration to applications for employment made by disabled persons, and for continuing the employment of, and arranging appropriate training for, existing employees who have become disabled.

The Group participates in Santander UK's policies and wants to involve and inform employees on matters that affect them. Santander UK publishes a magazine every quarter for employees, and almost all employees have access to the Santander UK intranet. Santander UK also uses face-to-face communication, such as team meetings, regional roadshows and annual staff conventions. All these channels are designed to keep employees fully informed of news and developments which may have an impact on them, and also to keep them up to date on financial, economic and other factors which affect the Group's performance. Santander UK considers employees' opinions and asks for their views on a range of issues through regular company-wide surveys.

Donations

The Group supports a wide range of charitable projects, particularly through Santander UK Foundation Limited, details of which are reported in the Annual Report and Accounts of Santander UK plc. There were no direct donations by the Company or its subsidiaries in 2011 (2010: £nil). No contributions were made for political purposes and no political expenditure was incurred.

Suppliers

The Group has a clear Cost Management & Procurement Policy and process that is enforced across all significant purchases from suppliers to provide a consistent approach. Corporate and social responsibility is a key factor throughout the purchasing process. All new suppliers must adhere to the Group's Corporate & Social Responsibility Protocol, unless it is not relevant to the type of work being undertaken. The protocol covers human rights, labour standards, environment and anti-corruption, in line with the principles in the UN Global Compact.

Policy and practice on payment of creditors

It is the Group's policy to make payments in accordance with the terms and conditions agreed, except where the supplier fails to comply with those terms and conditions. The Group's practice on payment of creditors has been quantified under the terms of Schedule 7 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. Based on the ratio of the aggregate amounts owed to trade creditors at the end of the year to the aggregate amounts invoiced by suppliers during the year at 31 December 2011, trade creditor days for the Group were 26 days (2010: 25 days).

Corporate governance

As it does not have listed ordinary shares, the Company is exempt from the requirement to make certain disclosures that are normally part of the continuing obligations of listed companies in the UK. This exemption applies, amongst other things, to corporate governance and certain Directors' remuneration disclosures.

Independent Commission on Banking ('ICB')

In June 2010, the UK Chancellor of the Exchequer announced the creation of the ICB. The ICB was asked to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition, as well as conducting a review of a proposal to separate retail and investment banking (the 'retail ring fence'). The ICB published its final report in September 2011 which included a proposed retail ring fence (under which the UK and EEA retail banking activities of a UK bank or building society should be placed in a legally distinct, operationally separate and economically independent entity), increased capital requirements, a leverage requirement and improvements of competition and facilitation of easier account switching.

In December 2011, the UK Government published their response to the ICB report, broadly endorsing the ICB recommendations and indicated that primary and secondary legislation relating to the proposed ring-fence will be completed by May 2015, with UK banks and building societies expected to be compliant as soon as practicable thereafter. The UK Government has indicated that it may modify the recommendations in the report and is proposing to undertake extensive consultation in two stages during 2012. The Santander UK group is currently engaged in the assessment of the possible impact of the ICB's recommendations and any response that could be required.

Basel III

Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to: (i) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source (ii) improve risk management and governance, and (iii) strengthen banks' transparency and disclosures. The reforms target: (a) bank-level, or micro-prudential, regulation, with the aim of helping raise the resilience of individual banking institutions to periods of stress, and (b) macro-prudential, system-wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time. These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system-wide shocks. The European Commission published its proposed legislation for the CRD and the Capital Requirements Regulation, which together form the CRD IV package, in July 2011. As well as reflecting the Basel III capital proposals, the CRD IV package also includes new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. These changes are due to be implemented beginning in January 2013. The Group is currently engaged in the assessment of the impact of the Basel III measures.

Relevant Audit Information

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

> so far as the Director is aware, there is no relevant audit information of which the Company's Auditor is unaware; and

> the Director has taken all steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Company's Auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the UK Companies Act 2006.

Auditor

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

Statement of Directors' responsibilities

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

Company law requires the Directors to prepare financial statements for each financial year. The Directors are required by the International Accounting Standards ('IAS') Regulation to prepare the group financial statements under IFRS, as adopted by the European Union, and have also elected to prepare the parent company financial statements in accordance with IFRS, as adopted by the European Union. The financial statements are also required by law to be properly prepared in accordance with the UK Companies Act 2006 and Article 4 of the IAS Regulation. In addition, in order to meet certain US requirements, the Directors are required to prepare the Group financial statements in accordance with IFRS, as issued by the International Accounting Standards Board.

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

International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the preparation and presentation of financial statements'.

Directors' Report continued

In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS. However, the Directors are also required to:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRS are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- make an assessment of the Company's ability to continue as a going concern.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the UK Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

By Order of the Board

Karen M. Fortunato
Company Secretary
15 March 2012

Registered office address:
2 Triton Square
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NW1 3AN

Contents to Financial Statements

Financial Statements

Independent Auditor's Report to the Members of Abbey National Treasury Services plc

We have audited the financial statements of Abbey National Treasury Services plc (the "Company" and together with its subsidiaries the "Group" or "ANTS Group") for the year ended 31 December 2011 which comprise the Consolidated Income Statement, the Consolidated and Company Statement of Comprehensive Income, the Consolidated and Company Balance Sheets, the Consolidated and Company Cash Flow Statements, the Consolidated and Company Statements of Changes in Equity, the related notes 1 to 46. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor
As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements
An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements
In our opinion:

> the financial statements give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2011 and of the Group's profit for the year then ended;
> the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union (the "EU");
> the Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
> the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements Article 4 of the IAS Regulation.

Separate opinion in relation to IFRSs as issued by the IASB
As explained in the Accounting Policies section of the financial statements, the Group, in addition to applying IFRSs as adopted by the European Union, has also applied IFRSs as issued by the International Accounting Standards Board (IASB). In our opinion the Group financial statements comply with IFRSs as issued by the IASB.

Opinion on other matter prescribed by the Companies Act 2006
In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

> adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
> the Company financial statements are not in agreement with the accounting records and returns; or
> certain disclosures of directors' remuneration specified by law are not made; or
> we have not received all the information and explanations we require for our audit.

Matthew Perkins (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London United Kingdom
15 March 2012

Primary Financial Statements

CONSOLIDATED INCOME STATEMENT

For the years ended 31 December 2011 and 2010

	Notes	2011 £m	2010 £m
Interest and similar income		**3,667**	3,045
Interest expense and similar charges		**(3,156)**	(2,642)
Net interest income	3	**511**	403
Net fee and commission income	4	**113**	28
Net trading and other income	5	**198**	462
Total operating income		**822**	893
Administration expenses	6	**(229)**	(209)
Depreciation and amortisation	7	**(7)**	(6)
Total operating expenses excluding provisions and charges		**(236)**	(215)
Impairment losses on loans and advances	8	**(54)**	(69)
Provisions for other liabilities and charges	8	**(20)**	-
Total operating provisions and charges		**(74)**	(69)
Profit before tax		**512**	609
Taxation charge	11	**(168)**	(149)
Profit for the year		**344**	460
Attributable to:			
Equity holders of the parent		**344**	460

The notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

All profits during the year were generated from continuing operations.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the years ended 31 December 2011 and 2010

	2011 £m	2010 £m
Profit for the year	**344**	460
Other comprehensive income		
Exchange differences on translation of foreign operations	**-**	-
Tax on above items	**-**	-
Net gain/(loss) recognised directly in equity	**-**	-
Total comprehensive income for the year	**344**	460
Attributable to:		
Equity holders of the parent	**344**	460

The notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

Primary Financial Statements continued

CONSOLIDATED BALANCE SHEET

At 31 December 2011 and 2010

	Notes	**2011 £m**	2010 £m
Assets			
Cash and balances at central banks	13	**7,013**	5,088
Trading assets	14	**21,891**	35,461
Derivative financial instruments	15	**33,224**	23,237
Financial assets designated at fair value	16	**4,710**	6,468
Loans and advances to banks	17	**113,222**	146,412
Loans and advances to customers	18	**38,826**	34,550
Held-to-maturity securities	20	**-**	331
Loans and receivables securities	21	**278**	626
Macro hedge of interest rate risk		**1,141**	908
Intangible assets	23	**3**	26
Property, plant and equipment	24	**5**	22
Current tax assets		**-**	40
Deferred tax assets	25	**17**	26
Other assets	26	**43**	65
Total assets		**220,373**	253,260
Liabilities			
Deposits by banks	27	**114,019**	136,753
Deposits by customers	28	**7,114**	7,061
Derivative financial instruments	15	**35,417**	25,043
Trading liabilities	29	**25,745**	42,827
Financial liabilities designated at fair value	30	**6,836**	3,657
Debt securities in issue	31	**26,980**	33,659
Subordinated liabilities	32	**-**	331
Other liabilities	33	**142**	191
Provisions	34	**20**	-
Current tax liabilities		**393**	374
Deferred tax liabilities	25	**-**	1
Total liabilities		**216,666**	249,897
Equity			
Share capital	36	**2,549**	2,549
Retained earnings		**1,142**	798
Other reserves		**16**	16
Total shareholders' equity		**3,707**	3,363
Total liabilities and equity		**220,373**	253,260

The Notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 13 to 120 were approved and authorised for issue by the Board on 15 March 2012 and signed on its behalf by:

David Green
Director

Company Registered Number 2338548

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the years ended 31 December 2011 and 2010

	Notes	Share Capital £m	Foreign currency translation reserve £m	Retained earnings £m	Total £m
1 January 2010		2,549	16	938	3,503
- Profit for the year		-	-	460	460
- Other comprehensive income for the year before tax		-	-	-	-
- Tax on other comprehensive income		-	-	-	-
Total comprehensive income		-	-	460	460
Dividends declared and amounts representative of contractual obligations	37	-	-	(600)	(600)
31 December 2010		2,549	16	798	3,363
1 January 2011		**2,549**	**16**	**798**	**3,363**
- Profit for the year		**-**	**-**	**344**	**344**
- Other comprehensive income for the year before tax		**-**	**-**	**-**	**-**
- Tax on other comprehensive income		**-**	**-**	**-**	**-**
Total comprehensive income		**-**	**-**	**344**	**344**
31 December 2011		**2,549**	**16**	**1,142**	**3,707**

CONSOLIDATED CASH FLOW STATEMENT

For the years ended 31 December 2011 and 2010

	Notes	2011 £m	2010 £m
Net cash flow (used in)/from operating activities			
Profit for the year		**344**	460
Adjustments for:			
Non cash items included in net profit		**105**	125
Change in operating assets		**26,388**	38,039
Change in operating liabilities		**(30,962)**	(36,856)
Income taxes paid		**(13)**	(28)
Effect of exchange rate differences		**(417)**	399
Net cash flow (used in)/from operating activities	38	**(4,555)**	2,139
Net cash flow from/(used in) investing activities			
Purchase of property, plant and equipment and intangible assets	23, 24	**(9)**	(40)
Proceeds from sale of property, plant and equipment and intangible assets		**42**	-
Net cash flow from/(used in) investing activities		**33**	(40)
Net cash flow (used in)/from financing activities			
Issue of long-term debt		**38,603**	11,419
Repayments of long-term debt		**(40,607)**	(4,840)
Dividends paid		**-**	(600)
Net cash flow (used in)/from financing activities		**(2,004)**	5,979
Net (decrease)/increase in cash and cash equivalents		**(6,526)**	8,078
Cash and cash equivalents at beginning of the year		**86,729**	78,510
Effect of exchange rate changes on cash and cash equivalents		**(345)**	141
Cash and cash equivalents at the end of the year	38	**79,858**	86,729

The Notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

Primary Financial Statements continued

COMPANY BALANCE SHEET

At 31 December 2011 and 2010

	Notes	2011 £m	2010 £m
Assets			
Cash and balances at central banks	13	**7,013**	5,088
Trading assets	14	**21,564**	35,110
Derivative financial instruments	15	**33,242**	23,277
Financial assets designated at fair value	16	**4,710**	6,468
Loans and advances to banks	17	**113,211**	146,398
Loans and advances to customers	18	**38,926**	34,935
Loans and receivable securities	21	**278**	626
Macro hedge of interest rate risk		**1,141**	908
Investment in subsidiary undertakings	22	**2,187**	2,187
Intangible assets	23	**3**	26
Property, plant and equipment	24	**5**	22
Current tax assets		**-**	40
Deferred tax assets	25	**17**	25
Other assets	26	**43**	65
Total assets		**222,340**	255,175
Liabilities			
Deposits by banks	27	**114,018**	136,701
Deposits by customers	28	**12,276**	13,989
Derivative financial instruments	15	**35,417**	25,043
Trading liabilities	29	**25,745**	42,827
Financial liabilities designated at fair value	30	**6,780**	3,595
Debt securities in issue	31	**23,906**	29,226
Other liabilities	33	**137**	182
Provisions	34	**20**	-
Current tax liabilities		**384**	357
Total liabilities		**218,683**	251,920
Equity			
Share capital	36	**2,549**	2,549
Retained earnings		**1,094**	692
Other reserves		**14**	14
Total shareholders equity		**3,657**	3,255
Total liabilities and equity		**222,340**	255,175

The Notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 13 to 120 were approved and authorised for issue by the Board on 15 March 2012 and signed on its behalf by:

David Green
Director

Company Registered Number 2338548

COMPANY STATEMENT OF COMPREHENSIVE INCOME

For the years ended 31 December 2011 and 2010

	2011 £m	2010 £m
Profit for the year	**402**	670
Other comprehensive expense:		
Exchange differences on translation of foreign operations	**-**	(1)
Tax on items taken directly to equity	**-**	-
Net expense recognised directly in equity	**-**	(1)
Total comprehensive income for the year	**402**	669
Attributable to:		
Equity holders of the parent	**402**	669

COMPANY STATEMENT OF CHANGES IN EQUITY

For the years ended 31 December 2011 and 2010

	Notes	Share Capital £m	Foreign currency translation reserve £m	Retained earnings £m	Total £m
1 January 2010		2,549	15	622	3,186
- Profit for the year		-	-	670	670
- Other comprehensive expense for the year before tax		-	(1)	-	(1)
- Tax on other comprehensive expense		-	-	-	-
Total comprehensive income		-	(1)	670	669
Dividends	37	-	-	(600)	(600)
31 December 2010		2,549	14	692	3,255
1 January 2011		**2,549**	**14**	**692**	**3,255**
- Profit for the year		**-**	**-**	**402**	**402**
- Other comprehensive income for the year before tax		**-**	**-**	**-**	**-**
- Tax on other comprehensive income		**-**	**-**	**-**	**-**
Total comprehensive income		**-**	**-**	**402**	**402**
31 December 2011		**2,549**	**14**	**1,094**	**3,657**

The Notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

Primary Financial Statements continued

COMPANY CASH FLOW STATEMENT

For the years ended 31 December 2011 and 2010

	Notes	**2011 £m**	2010 £m
Net cash flow (used in)/from operating activities			
Profit for the year		**402**	670
Adjustments for:			
Non cash items included in net profit		**238**	157
Change in operating assets		**26,093**	33,019
Change in operating liabilities		**(31,385)**	(2,824)
Income taxes paid		**(13)**	(17)
Effects of exchange rate differences		**(685)**	154
Net cash flow (used in)/from operating activities	38	**(5,350)**	31,159
Net cash flow from/(used in) investing activities			
Purchase of property, plant and equipment and intangible assets	23, 24	**(9)**	(40)
Proceeds from sale of property, plant and equipment and intangible assets		**42**	-
Net cash flow from/(used in) investing activities		**33**	(40)
Net cash flow (used in)/from financing activities			
Issue of long term debt		**38,607**	11,419
Repayments of long term debt		**(40,307)**	(4,840)
Dividends paid		**-**	(600)
Net cash flow (used in)/from financing activities		**(1,700)**	5,979
Net (decrease)/increase in cash and cash equivalents		**(7,017)**	37,098
Cash and cash equivalents at beginning of the year		**86,712**	49,327
Effect of exchange rate changes on cash and cash equivalents		**52**	287
Cash and cash equivalents at the end of the year	38	**79,747**	86,712

The Notes on pages 19 to 120 are an integral part of these Consolidated Financial Statements.

Notes to the Financial Statements

1. ACCOUNTING POLICIES

These financial statements are prepared for Abbey National Treasury Services plc (the 'Company') and its subsidiaries (together, 'ANTS Group' or the 'Group') under the Companies Act 2006. The principal activity of the Group is to provide treasury, corporate and wholesale banking services.

Abbey National Treasury Services plc is a public limited company, incorporated in England and Wales, having a registered office in England and is the holding company of the Group.

BASIS OF PREPARATION

The Consolidated Financial Statements have been prepared under the historical cost convention, as modified by the revaluation of available for sale financial assets, financial assets and financial liabilities held at fair value through profit or loss and all derivative contracts, and on the going concern basis of accounting as set out below.

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

Recent accounting developments
In 2011, the Group adopted the following significant new or revised standards or amendments to standards:

a) IAS 24 "Related Party Disclosures"- In November 2009, the IASB issued amendments to IAS 24 which clarified the definition of a related party, introduced a partial exemption from some disclosure requirements for government-related entities and included an explicit requirement to disclose commitments involving related parties. IAS 24 (2009) was adopted with effect from 1 January 2011. Retrospective application is required. The adoption of IAS 24 (2009) did not affect the Group's disclosures.

b) There are a number of other changes to IFRS that were effective from 1 January 2011. Those changes did not have a significant impact on the Group's financial statements.

Future accounting developments
The Group has not yet adopted the following significant new or revised standards and interpretations, and amendments thereto, which have been issued but which are not yet effective for the Group:

a) IAS 1 'Presentation of Financial Statements' – In June 2011, the IASB issued amendments to IAS 1 that retain the option to present profit or loss and other comprehensive income in either a single statement or in two separate but consecutive statements. However, the amendments to IAS 1 require additional disclosures to be made in the other comprehensive income section such that items of other comprehensive income are grouped into two categories: (i) items that will not be reclassified subsequently to profit or loss; and (ii) items that will be reclassified subsequently to profit or loss when specific conditions are met. Income tax on items of other comprehensive income is required to be allocated on the same basis. The amendments to IAS 1 are effective for annual periods beginning on or after 1 July 2012.

   The Group anticipates that IAS 1 (2011) will be adopted in the Group's financial statements for the annual period beginning on 1 January 2013 and that the application of the new Standard will modify the presentation of items of other comprehensive income accordingly. Retrospective application is required. The Group does not anticipate that these amendments to IAS 1 will have a significant impact on the Group's disclosures.

b) IFRS 10 'Consolidated Financial Statements', IFRS 11 'Joint Arrangements', IFRS 12 'Disclosure of Interests in Other Entities', IAS 27 'Separate Financial Statements' and IAS 28 'Investments in Associates and Joint Ventures' – In May 2011, the IASB issued new and amended guidance on consolidated financial statements and joint arrangements. IFRS 10, IFRS 11 and IFRS 12 were new standards issued while IAS 27 and IAS 28 were amended. Each of the standards issued is effective for annual periods beginning on or after 1 January 2013 with earlier application permitted as long as each of the other standards is also early applied.

   > Under IFRS 10 'Consolidated Financial Statements', control is the single basis for consolidation, irrespective of the nature of the investee; this standard therefore eliminates the risks-and-rewards approach. IFRS 10 identifies the three elements of control as power over the investee, exposure, or rights, to variable returns from involvement with the investee and the ability to use power over the investee to affect the amount of the investor's returns. An investor must possess all three elements to conclude that it controls an investee. The assessment of control is based on all facts and circumstances, and the conclusion is reassessed if there are changes to at least one of the three elements. Retrospective application is required subject to certain transitional provisions.

Notes to the Financial Statements continued

> IFRS 11 applies to all entities that are parties to a joint arrangement. A joint arrangement is an arrangement of which two or more parties have joint control. IFRS 11 establishes two types of joint arrangements, joint operations and joint ventures, which are distinguished by the rights and obligations of the parties to the arrangement. In a joint operation, the parties to the joint arrangement (referred to as 'joint operators') have rights to the assets and obligations for the liabilities of the arrangement. By contrast, in a joint venture, the parties to the arrangement (referred to as 'joint venturers') have rights to the net assets of the arrangement. IFRS 11 requires that a joint operator recognise its share of the assets, liabilities, revenues, and expenses in accordance with applicable IFRSs; however, a joint venturer would account for its interest by using the equity method of accounting under IAS 28 (2011). Transitional provisions vary depending on how an interest is accounted for under IAS 31 and what its nature is under IFRS 11.

> IFRS 12 integrates the disclosure requirements on interests in other entities, currently included in several standards to make it easier to understand and apply the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities. The standard also contains additional requirements on a number of topics. Under IFRS 12, an entity should disclose information about significant judgments and assumptions (and any changes to those assumptions) made in determining whether it has control, joint control, or significant influence over another entity and the type of joint arrangement. IFRS 12 also requires additional disclosures to make it easier to understand and evaluate the nature, extent, and financial effects of the Group's transactions with its subsidiaries, joint arrangements, associates and unconsolidated structured entities as well as any changes in and risks associated with these entities or arrangements. Disclosures shall be aggregated or disaggregated so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics. The standard applies prospectively from the beginning of the annual period in which it is adopted.

The Group anticipates that IFRS 10, IFRS 11 and IFRS 12 will be adopted in the Group's financial statements for the annual period beginning on 1 January 2013 and that the application of the new standards may have a significant impact on the Group's disclosures and on amounts reported in respect of the Group's financial assets and financial liabilities. However, it is not practicable to provide a reasonable estimate of that effect until a detailed review has been completed.

> IAS 27 was amended for the issuance of IFRS 10 but retains the current guidance on separate financial statements.

> IAS 28 was amended for conforming changes on the basis of the issuance of IFRS 10 and IFRS 11.

The Group anticipates that IAS 27 (2011) and IAS 28 (2011) will be adopted in the Group's financial statements for the annual period beginning on 1 January 2013. The Group does not anticipate that these amendments to IAS 27 and IAS 28 will have a significant impact on the Group's disclosures and on amounts reported in respect of the Group's financial assets and financial liabilities. However, it is not practicable to provide a reasonable estimate of that effect until a detailed review has been completed.

c) IFRS 13 'Fair Value Measurement' - In May 2011, the IASB issued IFRS 13, which establishes a single source of guidance for fair value measurement. IFRS 13 defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. IFRS 13 applies to both financial instrument items and non-financial instrument items for which other IFRSs require or permit fair value measurements and disclosures about fair value measurements, except in specified circumstances. In general, the disclosure requirements in IFRS 13 are more extensive than those required in the current accounting standards. IFRS 13 is effective for annual periods beginning on or after 1 January 2013, with early adoption permitted, and applies prospectively from the beginning of the annual period in which it is adopted.

The Group anticipates that IFRS 13 will be adopted in the Group's financial statements for the annual period beginning on 1 January 2013 and that the application of the new Standard may affect the amounts reported in the financial statements and result in more extensive disclosures in the financial statements. However, it is not practicable to provide a reasonable estimate of that effect until a detailed review has been completed.

d) IFRS 7 'Financial Instruments: Disclosures' – In October 2010, the IASB issued amendments to IFRS 7 that increase the disclosure requirements for transactions involving transfers of financial assets. The amendments are intended to provide greater transparency around risk exposures when a financial asset is transferred but the transferor retains some level of continuing exposure in the asset. The amendments also require disclosures where transfers of financial assets are not evenly distributed throughout the period. The amendments to IFRS 7 are effective for annual periods beginning on or after 1 July 2011, with earlier application permitted. Disclosures are not required for comparative periods before the date of initial application of the amendments.

The Group anticipates that IFRS 7 (2010) will be adopted in the Group's financial statements for the annual period beginning on 1 January 2012. The Group does not anticipate that these amendments to IFRS 7 will have a significant impact on the Group's disclosures regarding transfers of financial assets. However, if the Group enters into other types of transfers of financial assets in the future, disclosures regarding those transfers may be affected.

e) IFRS 9 'Financial Instruments' – In November 2009, the IASB issued IFRS 9 and in October 2010, issued an amendment to IFRS 9 which introduce new requirements for the classification and measurement of financial assets and financial liabilities and for derecognition. In November 2011, the Board reached a tentative agreement to change the mandatory effective date of IFRS 9 to annual periods beginning on or after 1 January 2015 rather than being required to apply them for annual periods beginning on or after 1 January 2013 as is currently the case. Early application would continue to be permitted.

> IFRS 9 requires all recognised financial assets that are within the scope of IAS 39 'Financial Instruments: Recognition and Measurement' to be subsequently measured at amortised cost or fair value. Specifically, debt investments that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortised cost at the end of subsequent accounting periods. All other debt investments and equity investments are measured at their fair values at the end of subsequent accounting periods.

> The most significant effect of IFRS 9 regarding the classification and measurement of financial liabilities relates to the accounting for changes in fair value of a financial liability (designated at fair value through profit or loss) attributable to changes in the credit risk of that liability. Specifically, under IFRS 9, for financial liabilities that are designated at fair value through profit or loss, the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability is presented in other comprehensive income, unless the recognition of the effects of changes in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. Changes in fair value attributable to a financial liability's credit risk are not subsequently reclassified to profit or loss. Previously, under IAS 39, the entire amount of the change in the fair value of the financial liability designated at fair value through profit or loss was presented in profit or loss.

The Group anticipates that IFRS 9 will be adopted in the Group's financial statements for the annual period beginning on 1 January 2015 and that the application of the new Standard may have a significant impact on amounts reported in respect of the Group's financial assets and financial liabilities. However, it is not practicable to provide a reasonable estimate of that effect until a detailed review has been completed.

f) IAS 19 'Employee Benefits' – In June 2011, the IASB issued amendments to IAS 19 that change the accounting for defined benefit plans and termination benefits. The most significant change relates to the accounting for changes in defined benefit obligations and plan assets. The amendments require the recognition of changes in defined benefit obligations and in fair value of plan assets when they occur, and hence eliminate the 'corridor approach' permitted under the previous version of IAS 19 and accelerate the recognition of past service costs. The amendments require all actuarial gains and losses to be recognised immediately through other comprehensive income in order for the net pension asset or liability recognised in the consolidated statement of financial position to reflect the full value of the plan deficit or surplus. The amendments to IAS 19 are effective for annual periods beginning on or after 1 January 2013 and require retrospective application with certain exceptions.

The Group anticipates that IAS 19 (2011) will be adopted in the Group's financial statements for the annual period beginning on 1 January 2013. The Group does not anticipate that these amendments to IAS 19 will have a significant impact on the Group's profit or loss or financial position as the Group does not utilise the 'corridor approach'.

g) There are a number of other standards which have been issued or amended that are expected to be effective in future periods. However, it is not practicable to provide a reasonable estimate of their effects on the Group's financial statements until a detailed review has been completed.

GOING CONCERN

The Group's objectives, policies and processes for managing its capital are described in Note 46. Details of the Group's financial risk management objectives, its financial instruments and hedging activities; and its exposures to credit risk, interest rate risk, liquidity risk, operational risk and other risks are set out in Note 44.

The Group is reliant on Santander UK plc and other companies in the Santander UK group of companies ('Santander UK') for a significant proportion of its funding. The Santander UK Board has confirmed that Santander UK plc is a going concern, and that it will provide funding to the Group for the foreseeable future. In giving this commitment to provide funding to the Group, the Santander UK Board has considered the uncertainties within the Group when preparing the forecasts and budgets of the combined business of Santander UK.

The Company has given a full and unconditional guarantee in respect of the unsubordinated liabilities of Santander UK plc incurred prior to 31 July 2012 under a deed poll guarantee entered into by the Company on 29 January 2008. Santander UK plc has given a reciprocal guarantee in respect of the unsubordinated liabilities of the Company incurred prior to 31 July 2012.

After making enquiries, the Directors have a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis of accounting in preparing the financial statements.

Notes to the Financial Statements continued

CONSOLIDATION

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

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

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, the Group controls and consequently consolidates an SPE:

> the activities of the SPE are being conducted on behalf of the Group according to the Group's specific business needs so that it obtains benefits from the SPE's operation;
> the Group has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the Group has delegated those decision-making powers;
> the Group has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks arising from the activities of the SPE; or
> the Group retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

Assessments of control are made based on the initial arrangements in place, but these are reconsidered if there are subsequent changes to the substance of the arrangements, such as the nature of the Group's involvement, the contractual arrangements or the governing rules of the SPE.

Transactions between entities under common control are outside the scope of IFRS 3 – Business Combinations, and there is no other guidance for such situations under IFRS. The Group elects to account for transactions between entities under common control for cash consideration in a manner consistent with the approach under IFRS 3, unless the transaction represents a reorganisation of entities within the Group, in which case the transaction is accounted for at its historical cost.

FOREIGN CURRENCY TRANSLATION

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

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

Foreign currency transactions are translated into the functional currency of the entity involved at the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement unless recognised in other comprehensive income in connection with a cash flow hedge.

The amount of exchange rate differences recognised in profit or loss on items not at fair value through profit and loss was £526m income (2010: £128m income). This was offset by income/charges on items held at fair value.

REVENUE RECOGNITION

(a) Interest income and expense

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

In accordance with IFRS, the Group recognises interest income on assets after they have been written down as a result of an impairment loss. Interest continues to be accrued on all loans, and the element of interest that is not anticipated to be recovered is provided for.

(b) Fee and commission income

Fees and commissions that are not an integral part of the effective interest rate are recognised when the service is provided. Fee and commission income which forms an integral part of the effective interest rate of a financial instrument (for example, certain loan commitment fees) is recognised as an adjustment to the effective interest rate and recorded in 'Interest income' (See (a) above).

(c) Dividend income

Except for equity securities classified as trading assets or financial assets held at fair value through profit or loss, described below, dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

(d) Net trading and other income

Net trading and other income comprises all gains and losses from changes in the fair value of financial assets and liabilities held at fair value through profit or loss (including financial assets and financial liabilities held for trading and designated as fair value through profit or loss), together with related interest income, expense and dividends. It also includes income from operating lease assets, and profits/(losses) on the sales of property, plant and equipment and intangible assets and subsidiary undertakings. Changes in the fair value of financial assets and liabilities held for trading, including trading derivatives, are recognised in the income statement as net trading and other income together with dividends and interest receivable and payable. Changes in the fair value of assets and liabilities designated as fair value through profit or loss are recognised in net trading and other income together with dividends, interest receivable and payable and changes in fair value of derivatives managed in conjunction with these assets and liabilities. Changes in fair value of derivatives in a hedging relationship are recognised in net trading and other income along with the fair value of the hedged item if designated in a fair value hedge or macro hedging relationship.

BORROWING COSTS

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, including computer software, which are assets that necessarily take a substantial period of time to develop for their intended use, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use. All other borrowing costs are recognised in profit or loss in the period in which they occur.

PENSIONS AND OTHER POST RETIREMENT BENEFITS

The Group participates in various Santander UK plc group defined benefit and defined contribution pension schemes in operation. Details of the schemes are disclosed in the Annual Report and Accounts of Santander UK plc. There is no contractual agreement or stated policy for charging the net defined benefit cost of the Santander UK defined benefit schemes. Therefore in accordance with IAS 19 the defined benefit asset or liability has been recognised in the financial statements of the sponsoring employer of the scheme and the Group accounts for its contributions as a defined contribution scheme. The contribution to be paid by the Group is calculated as the contributions made by Santander UK plc to the schemes in respect of the Group's employees.

Notes to the Financial Statements continued

INTANGIBLE ASSETS

Software development costs are capitalised when they are direct costs associated with identifiable and unique software products that are expected to provide future economic benefits and the cost of these products can be measured reliably. These costs include payroll, the costs of materials and services, and directly attributable overheads. Internally developed software meeting these criteria and externally purchased software are classified in intangible assets on the balance sheet and amortised on a straight-line basis over their useful life of 3 years, unless the software is an integral part of the related computer hardware, in which case it is treated as property, plant and equipment as described below. Capitalisation of costs cease when the software is capable of operating as intended. Costs associated with maintaining software programmes are expensed as incurred.

PROPERTY, PLANT AND EQUIPMENT

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

Internally developed software meeting the criteria set out in "intangible assets" and externally purchased software are classified in property, plant and equipment on the balance sheet where the software is an integral part of the related computer hardware. Classes of property, plant and equipment are depreciated on a straight-line basis over their useful life as follows:

Owner-occupied properties	Not exceeding 50 years
Office fixtures and equipment	5 to 8 years
Computer software	3 years

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

FINANCIAL ASSETS

The Group classifies its financial assets as: financial assets at fair value through profit or loss, loans and receivables and held-to-maturity financial assets. Management determines the classification of its investments at initial recognition. Financial assets that are classified at fair value through profit or loss, which have not been designated as such or are not accounted for as derivatives, may subsequently in rare circumstances, be reclassified from the fair value through profit or loss category to the loans and receivables, available for sale or held to maturity categories.

In order to meet the criteria for reclassification, the asset must no longer be held for the purpose of selling or repurchasing in the near term and must also meet the definition of the category into which it is to be reclassified had it not been required to classify it at fair value through profit or loss at initial recognition. The reclassified value is the fair value of the asset at the date of reclassification. The Group has not utilised this option and therefore has not reclassified any assets from the fair value through profit or loss category that were classified as such at initial recognition.

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

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

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

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

(b) Loans and receivables

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

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

VALUATION OF FINANCIAL INSTRUMENTS

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

Changes in the valuation of such financial instruments, including derivatives, are included in the line item 'Net trading and other income' in the income statement.

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

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

The Group categorises assets and liabilities measured at fair value within the fair value hierarchy based on the inputs to the valuation techniques as follows:

Level 1:	Unadjusted quoted prices for identical assets or liabilities in an active market that the Group has the ability to access at the measurement date. Level 1 positions include debt securities, equity securities, exchange traded derivatives and short positions in securities.
Level 2:	Quoted prices in markets that are not active, quoted prices for similar assets or liabilities, recent market transactions, inputs other than quoted market prices for the asset or liability that are observable either directly or indirectly for substantially the full term, and inputs to valuation techniques that are derived principally from or corroborated by observable market data through correlation or other statistical means for substantially the full term of the asset or liability. Level 2 positions include loans and advances to banks, loans and advances to customers, equity securities, exchange rate derivatives, interest rate derivatives, equity and credit derivatives, debt securities, deposits by banks, deposits by customers and debt securities in issue.
Level 3:	Inputs to the pricing or valuation techniques that are significant to the overall fair value measurement of the asset or liability are unobservable. Level 3 positions include equity securities, exchange rate derivatives, equity and credit derivatives, loans and advances to customers, debt securities, and debt securities in issue.

The Group assesses active markets for equity instruments based on the average daily trading volume both in absolute terms and relative to the market capitalisation for the instrument. The Group assesses active markets for debt instruments based on both the average daily trading volume and the number of days with trading activity. The Group assesses active markets for exchange traded derivatives based on the average daily trading volume both in absolute terms and relative to the market capitalisation for the instrument.

Market activity and liquidity is discussed in the relevant monthly Risk Forum as well as being part of the daily update given by each business at the start of the trading day. This information, together with the observation of active trading and the magnitude of the bid/offer spreads allow consideration of the liquidity of a financial instrument. Underlying assets and liabilities are reviewed to consider the appropriate adjustment to mark the mid price reported in the trading systems to a realisable value. This process takes into account the liquidity of the position in the size of the adjustment required. These liquidity adjustments are presented and discussed at the monthly Risk Forum.

Notes to the Financial Statements continued

In determining the appropriate measurement levels, the Group performs regular analyses on the assets and liabilities. Underlying assets and liabilities are regularly reviewed to determine whether a position should be regarded as illiquid; the most important practical consideration being the observability of trading. Where the bid-offer spread is observable, this is tested against actual trades. Changes in the observability of significant valuation inputs during the reporting period may result in a reclassification of certain assets and liabilities within the fair value hierarchy.

Financial instruments valued using observable market prices
If a quoted market price in an active market is available for an instrument, the fair value is calculated as the current bid price multiplied by the number of units of the instrument held.

Financial instruments valued using a valuation technique
In the absence of a quoted market price in an active market, management uses internal models to make its best estimate of the price that the market would set for that financial instrument. In order to make these estimations, various techniques are employed, including extrapolation from observable market data and observation of similar financial instruments with similar characteristics. Wherever possible, valuation parameters for each product are based on prices directly observable in active markets or that can be derived from directly observable market prices. Valuation parameters for each type of financial instrument are discussed in Note 45.

Unrecognised gains as a result of the use of valuation models using unobservable inputs ("Day One profits")
The timing of recognition of deferred day one profit and loss is determined individually. It is deferred until either the instrument's fair value can be determined using market observable inputs or is realised through settlement. The financial instrument is subsequently measured at fair value adjusted for the deferred day one profit and loss. Subsequent changes in fair value are recognised immediately in the consolidated income statement without immediate reversal of deferred day one profits and losses.

"REGULAR WAY" PURCHASES OF FINANCIAL ASSETS AND ISSUES OF FINANCIAL LIABILITIES

A regular way purchase is a purchase of a financial asset under a contract whose terms require delivery of the asset within the timeframe established generally by regulation or convention in the market place concerned.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date; all other regular way purchases are recognised on trade date. The assets are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all the risks and rewards of ownership.

Issues of equity or financial liabilities measured at amortised cost are recognised on settlement date; all other regular way issues are recognised on trade date. The liabilities are derecognised when extinguished.

OFFSETTING FINANCIAL ASSETS AND LIABILITIES

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

The Group is party to a number of arrangements, including master netting arrangements under industry standard agreements which facilitate netting of transactions in jurisdictions where netting agreements are recognised and have legal force. The netting arrangements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis.

SALE AND REPURCHASE AGREEMENTS (INCLUDING STOCK BORROWING AND LENDING)

Securities sold subject to a commitment to repurchase them at a predetermined price ('repos') under which substantially all the risks and rewards of ownership are retained by the Group remain on the balance sheet as trading assets and a liability is recorded in trading liabilities in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in trading assets. The difference between the sale and repurchase price is treated as trading income in the income statement.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. Securities lent or borrowed are not reflected on the balance sheet. Collateral in the form of cash received or advanced is recorded as a deposit or a loan. Collateral in the form of securities is not recognised.

DERIVATIVE FINANCIAL INSTRUMENTS

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

Derivatives are held for trading or for risk management purposes. Derivatives are classified as held for trading unless they are designated as being in a hedge relationship. The Group chooses to designate certain derivatives as in a hedging relationship if they meet specific criteria, as further described within 'hedge accounting' below.

Derivatives are recognised initially (on the date on which a derivative contract is entered into), and are subsequently remeasured, at their fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow and option pricing models.

Derivatives may be embedded in other financial instruments, such as the conversion option in a convertible bond. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. Contracts containing embedded derivatives are not subsequently reassessed for separation unless either there has been a change in the terms of the contract which significantly modifies the cash flows (in which case the contract is reassessed at the time of modification) or the contract has been reclassified (in which case the contract is reassessed at the time of reclassification).

All derivatives are carried as assets when their fair value is positive and as liabilities when their fair value is negative, except where netting is permitted.

The method of recognising fair value gains and losses depends on whether derivatives are held for trading or are designated as hedging instruments and, if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement, and included within net trading and other income.

HEDGE ACCOUNTING

In certain circumstances, derivatives may be designated as hedges and classified as: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of a net investment in a foreign operation ('net investment hedges'). The Group enters into derivatives as fair value hedges, but not as cash flow hedges or net investment hedges. Hedge accounting is used for derivatives designated in this way provided certain criteria are met.

At the time a financial instrument is designated as a hedge (i.e., at the inception of the hedge), the Group formally documents the relationship between the hedging instrument(s) and hedged item(s), its risk management objective and strategy for undertaking the hedge. The documentation includes the identification of each hedging instrument and respective hedged item, the nature of the risk being hedged (including the benchmark interest rate being hedged in a hedge of interest rate risk) and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value attributable to the hedged risk is to be assessed. Accordingly, the Group formally assesses, both at the inception of the hedge and on an ongoing basis, whether the hedging derivatives have been and will be highly effective in offsetting changes in the fair value attributable to the hedged risk during the period that the hedge is designated. A hedge is normally regarded as highly effective if, at inception and throughout its life, the Group can expect, and actual results indicate, that changes in the fair value (determined by discounting the contractual cash flows by the current forward benchmark interest rate) of the hedged items are effectively offset by changes in the fair value of the hedging instrument.

The main derivatives held for risk management purposes are interest rate and cross-currency swaps, which are used to hedge fixed-rate lending and structured savings products and medium-term note issuances, capital issuances and other capital markets funding.

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

The hedge adjustment for fair value hedges is classified in the balance sheet in the same category as the hedged item, unless it relates to a macro hedging relationship where the hedge adjustment is recognised as a macro hedge on the face of the balance sheet. For fair value hedges, changes in the fair value of the hedging instrument and hedged item are recognised in net trading and other income. Hedge ineffectiveness represents the amount by which the changes in the fair value of the hedging derivative differ from changes in the fair value of the hedged item. Such gains and losses are recorded in current period earnings within net trading and other income.

Gains and losses on components of a hedging derivative that are not part of the hedging relationship and are therefore excluded from the hedge effectiveness assessment are also included in net trading and other income.

Notes to the Financial Statements continued

IMPAIRMENT OF FINANCIAL ASSETS

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition, there is objective evidence that a financial asset or group of financial assets classified as loans and receivables, available-for-sale or loan and receivable securities have become impaired. Evidence of impairment varies across different portfolios and may include indications that the borrower or group of borrowers have defaulted, are experiencing significant financial difficulty, or the debt has been restructured potentially reducing the burden to the borrower. Impairment losses are recorded as charges in the income statement and the carrying amount of the financial asset or group of financial assets is reduced by establishing an impairment loss allowance. Impairment loss allowances are maintained at the level that management deems sufficient to absorb probable incurred losses in the Group's loans. Losses expected from future events are not recognised.

Impairment losses are assessed individually for financial assets that are individually significant and individually or collectively for assets that are not individually significant. An impairment loss allowance for observed losses is established for all past due loans after a specified period of repayment default where it is probable that some of the capital or interest will not be repaid or recovered through enforcement of any applicable security. An allowance for inherent losses is established for loans for which no evidence of loss has been specifically identified on an individual basis because the loans are not yet past due (i.e. incurred but not observed ('IBNO')) but are known from past experience to have deteriorated since the initial decision to lend was made. An example of this situation is where a borrower has not yet missed a payment but is experiencing financial difficulties at the reporting date, e.g. due to loss of employment or divorce. In these circumstances, an inherent loss had been incurred at the reporting date.

Impairment loss allowances for loans and advances, less amounts released and recoveries of amounts written off are charged to the line item 'Impairment losses on loans and advances' in the income statement. The impairment loss allowances are deducted from the 'Loans and advances to banks', 'Loans and advances to customers' and 'Loans and receivables securities' line items on the balance sheet.

(i) Corporate assets

Corporate assets are assessed either individually or collectively for impairment. An impairment loss is incurred if there is objective evidence that a loss event has occurred since initial recognition of the assets that has an impact on the estimated future cash flows of the assets.

Potential indicators of loss events

Potential indicators of loss events which may be evidence of financial difficulty for a corporate borrower may include the borrower notifying the Group of current or likely financial distress; corporate results not meeting forecasts, missed repayments, requests for additional funding; breaches of covenants and changes in business plans.

Individual assessment

Impairment reviews are conducted monthly for those assets on the Group's 'Watchlist' of new, emerging and serious circumstances relating to the asset, with a particular focus on the following scenarios:

- where an asset has a payment default which has been outstanding for 90 days or more;
- where non-payment defaults have occurred and/or where it has become evident that a workout or rescheduling exercise is to be undertaken; or
- where it has become evident that the value of any security is no longer considered adequate.

In such situations the asset is transferred to the Corporate Banking Workouts and Collections team. As part of their impairment reviews, an assessment is undertaken of the expected future cash flows (including a revaluation of collateral held) in relation to the relevant asset, appropriately discounted. The result is compared to the current net book value of the asset. Any shortfall evidenced as a result of such a review results in an observed impairment loss allowance.

Collective assessment

Collective impairment assessment is used for portfolios classified as 'performing assets' where it is believed that market events are likely to have determined that losses are already inherent in a portfolio (i.e. IBNO) notwithstanding that these events may not have manifested themselves in specific defaults or other triggers that would lead to an individual impairment assessment. The amount of any such collective impairment loss allowance, for each portfolio concerned represents management's best estimate of likely loss levels and takes into account, amongst other factors, the total exposure and anticipated stressed levels in the relevant industry sector, estimates of probability of default and loss given default rates.

The level of IBNO for each portfolio is calculated, based on these factors, and is applied to the total value of unimpaired assets within the portfolio (i.e. excluding any assets for which an observed impairment loss allowance already exists). The impairment loss allowance assessment is regularly reviewed for any material change in the dynamics of the portfolio (e.g. volume, mix, observed losses) and market conditions (including comparison of the current IBNO impairment loss allowance level to the range of IBNO impairment loss allowances across similar loans in the industry).

Reversals of impairment

If in a subsequent period, the amount of an impairment loss reduces and the reduction can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the impairment loss allowance account accordingly. The write-back is recognised in the income statement.

Write-off

For secured loans, a write-off is made when all collection procedures have been exhausted and the security has been sold. For unsecured loans, a write-off is made when all avenues for collecting the debt have been exhausted. There may be occasions where a write-off occurs for other reasons, for example, following a consensual restructure of the debt or where the debt is sold for strategic reasons into the secondary market at a value lower than the face value of the debt. Write-offs are charged against previously established impairment loss allowances.

Recoveries

Recoveries of impairment losses are not included in the impairment loss allowance, but are taken to income and offset against impairment losses. Recoveries of impairment losses are classified in the income statement as 'Impairment losses on loans and advances'.

Impairment losses on restructured/renegotiated corporate assets (forbearance)

To support corporate customers that encounter actual or apparent financial difficulties, the Group may grant a concession, whether temporary or permanent, to accept less than contractual amounts where financial distress would otherwise prevent satisfactory repayment within the original terms and conditions of the contract. These arrangements are known as forbearance.

There are different risk characteristics associated with loans that are subject to forbearance as compared to loans that are not. A range of forbearance arrangements may be entered into by the Group, reflecting the different risk characteristics of such loans. The Group's forbearance programmes are described in the credit risk section in the Risk Management report.

For corporate borrowers, the main types of forbearance offered are payment arrangements, refinancing (principally, either a term extension or an interest only concession) and in limited circumstances other forms of restructuring policies (principally a debt for equity swap), subject to customer negotiation and vetting.

If such accounts were classified in the "non-performing" loan category prior to the restructuring, they continue to be classified as non-performing until evidence of compliance with the new terms is demonstrated (typically over a period of at least three months) before being reclassified as "substandard". If the account was not categorised as non-performing at the time the revised arrangements were agreed, the case is considered to be a renegotiation and is reclassified to "substandard" upon completion of the restructuring agreement.

Once a substandard asset has demonstrated continued compliance with the new terms and the risk profile is deemed to have improved it may be reclassified as a "performing asset". When such accounts are reclassified as performing assets, they continue to be assessed for impairment collectively for inherent losses under the Group's normal collective assessment methodology. Until then, impairment loss allowances for such restructured loans are assessed individually, taking into account the value of collateral held as confirmed by third party professional valuations and the available cashflow to service debt over the period of the restructuring. These impairment loss allowances are assessed and reviewed regularly. In the case of a debt for equity conversion, the converted debt is written off against the existing impairment loss allowance upon completion of the restructuring. The value of the equity acquired is reassessed periodically in light of subsequent performance of the restructured company.

Where an account is in forbearance, its additional risk characteristics are reflected by way of a management's best estimate as the only practical means of factoring recent conditions into impairment calculations until the Group's models can be recalibrated. As more comprehensive data on the performance of loans in forbearance is gathered, the Group's models will be recalibrated.

(ii) Loans and receivables securities

Loans and receivables securities are assessed individually for impairment. An impairment loss is incurred if there is objective evidence that a loss event has occurred since initial recognition of the assets that has an impact on the estimated future cash flows of the loans and receivables securities. Potential indicators of loss events include significant financial distress of the issuer and default or delinquency in interest and principal payments (breach of contractual terms).

Loans and receivables securities are monitored for potential impairment through a detailed expected cashflow analysis taking into account the structure and underlying assets of each individual security. Once specific events give rise to a reasonable expectation that future anticipated cash flows may not be received, the asset originating these doubtful cash flows will be deemed to be impaired.

Notes to the Financial Statements continued

IMPAIRMENT OF NON-FINANCIAL ASSETS

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

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

LEASES

The Group as lessor
Operating lease assets are recorded at deemed cost and depreciated over the life of the asset after taking into account anticipated residual values. Operating lease rental income and depreciation is recognised on a straight-line basis over the life of the asset.

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

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

INCOME TAXES, INCLUDING DEFERRED TAXES

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

Income tax payable on profits, based on the applicable tax law in each jurisdiction, is recognised as an expense in the period in which profits arise. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred income tax is the tax expected to be payable or recoverable on income tax losses available to carry forward and on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the Consolidated Financial Statements and is accounted for using the balance sheet liability method.

Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which the assets may be utilised as they reverse. Such deferred tax liabilities are not recognised if the temporary difference arises from the initial recognition of goodwill. Deferred tax assets and liabilities are not recognised if the temporary difference arises from the initial recognition of other assets (other than in a business combination) and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised based on rates enacted or substantively enacted at the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity or directly in equity. Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries except where the Group is able to control reversal of the temporary difference and it is probable that it will not reverse in the foreseeable future.

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

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

CASH AND CASH EQUIVALENTS

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

FINANCIAL LIABILITIES

Financial liabilities are initially recognised when the Group becomes contractually bound to the transfer of economic benefits in the future. Financial liabilities are derecognised when extinguished.

(a) Financial liabilities at fair value through profit or loss
Financial liabilities are classified as fair value through profit or loss if they are either held for trading or otherwise designated at fair value through profit or loss on initial recognition. A financial liability is classified as held for trading if it is a derivative or is incurred principally for the purpose of repurchasing or being unwound in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short term profit taking.

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

Derivative financial instruments, Trading liabilities and Financial liabilities designated at fair value are classified as fair value through profit or loss.

(b) Other financial liabilities
All other financial liabilities are initially recognised at fair value net of transaction costs incurred. They are subsequently stated at amortised cost and the redemption value recognised in the income statement over the period of the liability using the effective interest method.

Deposits by banks, Deposits by customers, Debt securities in issue (unless designated at fair value), and Subordinated liabilities are classified as amortised cost.

Equity index-linked deposits
Contracts involving the receipt of cash on which customers receive an index-linked return are accounted for as equity index-linked deposits, and classified as deposits by customers within trading liabilities. Equity index-linked deposits are managed within the equity derivatives trading book as an integral part of the equity derivatives portfolio. There are two principal product types.
(i) Capital at Risk
These products are designed to replicate the investment performance of an equity index, subject to a floor. In the event the index falls under a certain predetermined level, customers forfeit a predetermined percentage of principal up to a predetermined amount.
(ii) Capital Guaranteed/Protected
These products give the customers a limited participation in the upside growth of an equity index. In the event the index falls in price, a cash principal element is guaranteed/protected.

Equity index-linked deposits are remeasured at fair value at each reporting date with changes in fair values recognised in the income statement. The equity index-linked deposits contain embedded derivatives. These embedded derivatives, in combination with the principal cash deposit element, are designed to replicate the investment performance profile tailored to the return agreed in the contracts with customers. Other than new capital guaranteed products, which are treated as deposits by customers with any associated embedded derivatives bifurcated, embedded derivatives are not separated from the host instrument and are not separately accounted for as a derivative instrument, as the entire contract embodies both the embedded derivative and the host instrument and is remeasured at fair value at each reporting date. As such, there is no requirement to bifurcate the embedded derivatives in the equity index-linked deposits.

Notes to the Financial Statements continued

BORROWINGS

Borrowings (which include deposits by banks, deposits by customers, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds (fair value of consideration received) net of transaction costs incurred. Borrowings are subsequently stated at amortised cost or fair value dependent on designation at initial recognition.

PROVISIONS

Provisions are recognised for present obligations arising as consequences of past events where it is more likely than not that a transfer of economic benefits will be necessary to settle the obligation, and it can be reliably estimated.

Provision is made for the anticipated cost of restructuring, including redundancy costs, when an obligation exists. An obligation exists when the Group has a detailed formal plan for restructuring a business, has raised valid expectations in those affected by the restructuring, and has started to implement the plan or announce its main features.

When a leasehold property ceases to be used in the business, provision is made where the unavoidable costs of the future obligations relating to the lease are expected to exceed anticipated rental income. The net costs are discounted using market rates of interest to reflect the long-term nature of the cash flows.

Provision is made for loan commitments, other than those classified as held for trading, within impairment loss allowances if it is probable that the facility will be drawn and the resulting loan will be recognised at a value less than the cash advanced.

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

FINANCIAL GUARANTEE CONTRACTS

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due in accordance with the terms of a debt instrument. The Group accounts for guarantees that meet the definition of a financial guarantee contract at fair value on initial recognition. In subsequent periods, these guarantees are measured at the higher of the initial fair value less cumulative amortisation and the amount that would be recognised as an impairment loss allowance as described in the accounting policies above.

SHARE CAPITAL

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

DIVIDENDS

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

CRITICAL ACCOUNTING POLICIES AND AREAS OF SIGNIFICANT MANAGEMENT JUDGEMENT

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

The following accounting estimates and judgements are considered important to the portrayal of the Group's financial results and financial condition because: (i) they are highly susceptible to change from period to period as assumptions are made to calculate the estimates, and (ii) any significant difference between the Group's estimated amounts and actual amounts could have a material impact on the Group's future financial results and financial condition.

In calculating each estimate, a range of outcomes was calculated based principally on management's conclusions regarding the input assumptions relative to historic experience. The actual estimates were based on what management concluded to be the most probable assumptions within the range of reasonably possible assumptions.

(a) Impairment loss allowances for loans and advances

The Group estimates impairment losses for loans and advances to customers, loans and receivables securities, and loans and advances to banks as described in the accounting policy "Impairment of financial assets" on page 28. The Group's assumptions about estimated losses are based on past performance, past customer behaviour, the credit quality of recent underwritten business and general economic conditions, which are not necessarily an indication of future losses.

(i) Loans and advances to customers
The net impairment loss (i.e. after recoveries) for loans and advances to customers recognised in 2011 was £54m (2010: £69m). In calculating the impairment loss allowances, for each portfolio concerned the impairment loss allowance represents management's best estimate of likely loss levels and takes into account, amongst other factors, the total exposure and anticipated stressed levels in the relevant industry sector, estimates of probability of default and loss given default rates.

Had management used different assumptions, a larger or smaller impairment loss allowance would have resulted that could have had a material impact on the Group's reported profit before tax. Specifically, if management's conclusions as to the anticipated stressed levels, probability of default and loss given default rates were different, but within the range of what management deemed to be reasonably possible, the impairment loss for loans and advances could have decreased in 2011 from an actual impairment loss of £54m (2010: £69m) by up to £13m (2010: £27m), with a potential corresponding increase in the Group's profit before tax in 2011 of up to 3% (2010: 4%), or increased by up to £12m (2010: £23m), with a potential corresponding decrease in the Group's profit before tax in 2011 of up to 2% (2010: 4%).

(ii) Loans and receivables securities
The impairment loss for loans and receivables securities of £nil (2010: £nil) in 2011 was based on management's assessment of impairment of each individual asset based on data available at 31 December 2011. A detailed analysis of the loans and receivables securities is set out in Note 21.

(iii) Loans and advances to banks
In 2011and 2010, the Group did not incur any impairment losses in respect of loans and advances to banks. Based on the conditions at the balance sheet date, management determined that a reasonably possible change in any of its assumptions would not cause an impairment loss to be recognised.

(b) Valuation of financial instruments

The Group trades in a wide variety of financial instruments in the major financial markets. When estimating the value of its financial instruments, including derivatives where quoted market prices are not available, management therefore considers a range of interest rates, volatility, exchange rates, counterparty credit ratings, valuation adjustments and other similar inputs, all of which vary across maturity bands. These are chosen to best reflect the particular characteristics of each transaction.

Had management used different assumptions, a larger or smaller change in the valuation of financial instruments including derivatives where quoted market prices are not available would have resulted that could have had a material impact on the Group's reported profit before tax.

Detailed disclosures on financial instruments, including sensitivities, can be found in Note 45. Further information about sensitivities to market risk (including Value-at-Risk ('VaR')) arising from financial instrument trading activities can be found in the Financial Risks and Risk Management section in Note 44.

Notes to the Financial Statements continued

2. SEGMENTS

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

> Corporate Banking;
> Markets; and
> Asset and Liability Management ('ALM').

In 2011, as the Group moved towards becoming a full-service commercial bank, management wanted a fuller view in Corporate Banking of the results of the range of services offered to corporate customers. Large multinationals were managed and reported as part of Corporate Banking in 2011, rather than Global Banking & Markets as in 2010. As a result of the change, Global Banking & Markets was renamed Markets. Prior years' segmental analyses have been adjusted to reflect the fact that reportable segments have changed.

The Group's segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. The Group has three segments:

> **Corporate Banking** provides a range of banking services principally to UK companies, with a focus on services for SMEs, providing a broad range of banking products including loans, bank accounts, deposits, treasury services, invoice discounts, cash transmission and asset finance. In addition, Corporate Banking includes specialist teams servicing Real Estate, Social Housing and UK infrastructure clients.
Within Corporate Banking, the Large Corporates business is responsible for larger multinational corporate clients, including related activities principally comprising foreign exchange, money market and credit activities. These related activities are structured into two main product areas: Foreign exchange and money markets, and Credit. Foreign exchange offers a range of foreign exchange products and money markets runs the securities lending/borrowing and repo businesses. Credit originates loan and bond transactions in primary markets as well as their intermediation in secondary markets.
> **Markets** is a financial markets business focused on providing value added financial services to financial institutions, as well as to the rest of Santander UK's business. It is structured into two main product areas: Fixed income and Equity. Fixed Income covers sales and trading activity for fixed income products. Equity covers equity derivatives, property derivatives and commodities. Equity derivatives' activities include the manufacture of structured products sold to both the Group and other financial institutions who sell or distribute them on to their customers.
> **ALM** is responsible for managing the Santander UK structural balance sheet composition and, in conjunction with the Santander UK Risk Division, strategic and tactical liquidity risk management. This includes short-term and medium-term funding, covered bond and securitisation programmes. ALM's responsibilities also include management of Santander UK's banking products and structural exposure to interest rates and managing the run down of the Treasury asset portfolio.

The Company's board of directors (the 'Board') is the chief operating decision maker for the Group. The segment information below is presented on the basis used by the Board to evaluate performance and allocate resources. The Board reviews discrete financial information for each segment of the business, including measures of operating results, assets and liabilities.

The segments are managed primarily on the basis of their results, which are measured on a 'trading' basis. The trading basis differs from the statutory basis (described in Note 1) as a result of the application of an adjustment in respect of hedging and other variances as presented below. Management considers that the trading basis provides the most appropriate way of reviewing the performance of the business.

The adjustment consists of:

> **Hedging and other variances** - The Balance Sheet and Income Statement are subject to mark-to-market volatility including that arising from the accounting for elements of derivatives deemed under IFRS rules to be ineffective as hedges. Volatility also arises on certain assets previously managed on a fair value basis, and hence classified as fair value through profit or loss under IFRS, that are now managed on an accruals basis. Where appropriate, such volatility is separately identified to enable management to view the underlying performance of the business.

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

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

Notes to the Financial Statements continued

a) Segmental information

2011	Corporate Banking £m	Markets £m	ALM £m	Total £m	Adjustments £m	Group Total £m
Net interest income	92	(3)	422	511	-	511
Non-interest income	296	162	(127)	331	(20)	311
Total trading income	388	159	295	842	(20)	822
Administration expenses	(95)	(108)	(26)	(229)	-	(229)
Depreciation and amortisation	(3)	(3)	(1)	(7)	-	(7)
Total trading expenses	(98)	(111)	(27)	(236)	-	(236)
Impairment losses on loans and advances	(54)	-	-	(54)	-	(54)
Provisions for other liabilities and charges	(3)	(3)	(14)	(20)	-	(20)
Total operating provisions and charges	(57)	(3)	(14)	(74)	-	(74)
Trading profit before tax	233	45	254	532	(20)	512
Adjust for:						
- Hedging and other variances	-	-	(20)	(20)		
Profit before tax	233	45	234	512		
Average number of staff	404	260	97	761		
Total assets	36,175	28,652	155,546	220,373		

2010	Corporate Banking £m	Markets £m	ALM £m	Total £m	Adjustments £m	Group Total £m
Net interest income	87	-	316	403	-	403
Non-interest income	237	221	44	502	(12)	490
Total trading income	324	221	360	905	(12)	893
Administration expenses	(90)	(74)	(45)	(209)	-	(209)
Depreciation and amortisation	(1)	(2)	(3)	(6)	-	(6)
Total trading expenses	(91)	(76)	(48)	(215)	-	(215)
Impairment losses on loans and advances	(69)	-	-	(69)	-	(69)
Total operating provisions and charges	(69)	-	-	(69)	-	(69)
Trading profit before tax	164	145	312	621	(12)	609
Adjust for:						
- Hedging and other variances	-	-	(12)	(12)		
Profit before tax	164	145	300	609		
Average number of staff	184	346	91	621		
Total assets	35,988	22,070	195,202	253,260		

b) By geographical region

	Group	
Total operating income/(expenses)	**2011 £m**	2010 £m
United Kingdom	816	903
Other	6	(9)
	822	894
Total assets other than financial instruments and current and deferred tax assets		
United Kingdom	8	48
Other	-	-
	8	48

Revenue by products and services

Details of revenue by product and service are disclosed in Notes 3 to 5.

Notes to the Financial Statements continued

3. NET INTEREST INCOME

	Group	
	2011 £m	2010 £m
Interest and similar income:		
On loans and advances to Santander UK undertakings	**3,326**	2,796
On loans and advances to Banco Santander, S.A.	**12**	15
On loans and advances to other Banco Santander undertakings	**2**	24
Other interest earning financial assets	**327**	210
Total interest and similar income	**3,667**	3,045
Interest expense and similar charges:		
On deposits by Santander UK undertakings	**(2,474)**	(2,254)
On deposits by Banco Santander, S.A.	**(15)**	(2)
On deposits by other Banco Santander group undertakings	**(7)**	(7)
Other interest bearing financial liabilities	**(660)**	(379)
Total interest expense and similar charges	**(3,156)**	(2,642)
Net interest income	**511**	403

4. NET FEE AND COMMISSION INCOME

	Group	
	2011 £m	2010 £m
Fee and commission income:		
Corporate Products	**115**	28
Fee and commission expense:		
Other fees paid	**(2)**	-
Net fee and commission income	**113**	28

5. NET TRADING AND OTHER INCOME

	Group	
	2011 £m	2010 £m
Net trading and funding of other items by the trading book	**254**	378
Income on assets designated at fair value through profit or loss	**504**	246
Expense on liabilities designated at fair value through profit or loss	**(105)**	(111)
Losses on derivatives managed with assets/liabilities held at fair value through profit or loss	**(458)**	(150)
Hedge ineffectiveness and other	**3**	99
	198	462

6. ADMINISTRATION EXPENSES

	Group	
	2011 £m	2010 £m
Staff costs:		
Wages and salaries	**119**	91
Social security costs	**14**	11
Pensions costs:		
- defined contribution plans	**5**	41
Other personnel costs	**9**	4
	147	147
Property and equipment expenses	**5**	5
Information technology expenses	**43**	37
Other administrative expenses	**34**	20
	229	209

7. DEPRECIATION AND AMORTISATION

	Group	
	2011	2010
	£m	£m
Depreciation of property, plant and equipment	**3**	3
Amortisation of intangible assets	**4**	3
	7	6

8. IMPAIRMENT LOSSES AND PROVISIONS

	Group	
	2011	2010
	£m	£m
Impairment losses on loans and advances:		
- loans and advances to customers (Note 18)	**54**	80
Recoveries of loans and advances	**-**	(11)
	54	69
Provisions for other liabilities and charges		
- New and increased allowances (Note 34)	**20**	-
Total impairment losses and provisions charged to the income statement	**74**	69

9. AUDIT AND OTHER SERVICES

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

	Group	
	2011	2010
	£m	£m
Fees payable to the Company's auditor for the audit of the Group's annual accounts	**0.4**	0.4
Non-audit fees – Debt issuance	**0.6**	0.4
Total fees	**1.0**	0.8

10. DIRECTORS' REMUNERATION AND INTERESTS

The aggregate remuneration received by the Directors of the Group was:

	Group	
	2011	2010
	£	£
Salaries and fees	**638,567**	509,931
Performance-related payments	**865,293**	832,374
Total remuneration excluding pension contributions	**1,503,860**	1,342,305
Pension contributions	**75,298**	44,523
	1,579,158	1,386,828

The aggregate emoluments above exclude emoluments received by Directors in respect of their primary duties as Directors or officers of Banco Santander, S.A. and Santander UK plc. Salaries and performance-related payments comprise payments to three (2010: three) Directors serving during the year.

In accordance with the UK Financial Services Authority Revised Remuneration Code (the 'Code'), the Company operates a remuneration policy, designed to promote effective risk management, applicable to all employees including a number of senior staff whose professional activities have a material impact on the Company's risk profile (known as 'Code Staff'). In accordance with the Code, an element of the 2010 and 2011 variable remuneration of Code Staff was deferred. For Code Staff earning more than £500,000 in variable remuneration (comprising the annual bonus and Long Term Incentive Plan), at least 60% was deferred and for Code Staff earning less than £500,000 in variable remuneration, at least 40% was deferred, both for a period of three years.

Notes to the Financial Statements continued

Remuneration of highest paid Director

The remuneration, excluding pension contributions, of the highest paid Director was £1,023,956 (2010: £990,993) of which £625,000 (2010: £650,001) was performance-related. The amount paid with respect to a defined contribution scheme by the highest paid director was £nil (2010: £nil).

The accrued pension benefit for the highest paid Director was £nil (2010: £nil). The accrued lump sum of the highest paid director at 31 December 2011 was £nil (2010: £nil). Two Directors will be receiving benefits under a defined benefit scheme (2010: two) and no Director (2010: nil) will be receiving benefits under a defined contribution scheme.

Long-Term Incentive Plan

In 2011, no Directors (2010: three) were granted conditional awards of shares in Banco Santander, S.A. under the Santander Long-Term Incentive Plan (2010: £59,414 based on a share price on euro 5.57).

Under the Santander Long-Term Incentive Plans granted on 1 July 2010 and 2009, 21 June 2008 and 31 December 2007, certain Executive Directors, Key Management Personnel (as defined above) and other nominated individuals were granted conditional awards of shares in Banco Santander, S.A..

The number of shares participants will receive depends on the performance of Banco Santander, S.A. during this period. The vesting of awards under the Santander Long-Term Incentive Plan depends on Santander's Total Shareholder Return performance against a competitor benchmark group. Awards made prior to 2009 also depend on Santander's Earnings Per Share performance against a competitor benchmark group. 90.79% of the 40% of the 2007 conditional award of shares vested in July 2009 and 90.79% of the remaining 60% of the 2007 conditional award vested in July 2010. Subject to performance conditions being met, 100% of the 2008 conditional award will vest in July 2011, 100% of the 2009 conditional award will vest in July 2012 and 100% of the 2010 conditional award will vest in July 2013.

From 1 July 2011 the eligibility criteria of the LTIP changed. Under the LTIP granted on 1 July 2011, only individuals who were not classified as Code Staff under the FSA’s Remuneration Code were granted conditional awards of shares in Banco Santander, S.A.. Instead, for Code Staff, an amount equivalent to the target value of the LTIP for 2010 was included within the case bonus target level for 2011 and as such is subject to financial, non-financial and risk based performance measures and deferral as determined by the Code. This arrangement was devised in response to discussions between Banco Santander, S.A. and the Bank of Spain.

11. TAXATION EXPENSE

	Group	
	2011	2010
	£m	£m
Current tax:		
UK corporation tax on profit for the year	**127**	175
Adjustments in respect of prior years	**32**	(21)
Total current tax	**159**	154
Deferred tax (Note 25)		
Origination and reversal of temporary differences	**9**	(7)
Change in rate of UK corporation tax	**1**	1
Adjustments in respect of prior years	**(1)**	1
Total deferred tax	**9**	(5)
Tax on profit for the year	**168**	149

UK income tax is calculated at 26.5% (2010: 28%) of the estimated assessable profits for the year. The standard rate of UK corporation tax was reduced from 28% to 26% with effect from 1 April 2011. Taxation for other jurisdictions is calculated at the rates prevailing in the relevant jurisdictions.

The Finance Act 2011, which provides for a reduction in the main rate of UK corporation tax to 25% effective from 1 April 2012, was enacted on 19 July 2011. As this change in rate was substantively enacted prior to 31 December 2011, it has been reflected in the deferred tax asset at 31 December 2011. The effect of the rate reduction was to increase the corporation tax expense by £1m and to reduce the deferred tax asset by the same amount. The UK Government has also indicated that it intends to enact future reductions in the main rate of UK corporation tax of 1% each year down to 23% by 1 April 2014. These changes in the main rate have not been substantively enacted at the balance sheet date and, therefore, are not included in these financial statements. The estimated financial effect of these changes is insignificant.

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

	Group	
	2011	2010
	£m	£m
Profit before tax	**512**	609
Tax calculated at a tax rate of 26.5% (2010: 28%)	**136**	171
Non-taxable dividend income	**-**	(4)
Non-deductible UK Bank Levy	**5**	-
Other non-equalised items	**(5)**	1
Effect of change in tax rate on deferred tax provision	**1**	1
Adjustment in respect of prior periods	**31**	(20)
Tax expense	**168**	149

The effective tax rate for 2011 based on profit before tax was 32.8% (2010: 24.5%). The effective tax rate differed from the UK corporation tax rate of 26.5% (2010: 28%) principally because of the effect of adjustments to prior year provisions, the impact of the non-deductible UK Bank Levy and the reduction in the deferred tax asset as a result of the change in the tax rate.

Further information about deferred tax is presented in Note 25.

12. PROFIT ON ORDINARY ACTIVITIES AFTER TAX

The profit after tax of the Company attributable to the shareholders was £402m (2010: £670m). As permitted by Section 408 of the UK Companies Act 2006, the Company's individual income statement has not been presented in these Consolidated Financial Statements.

13. CASH AND BALANCES AT CENTRAL BANKS

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Balances with central banks	**7,013**	5,088	**7,013**	5,088

For regulatory purposes, certain minimum cash balances are required to be maintained with the Bank of England. At 31 December, these amounted to £18m (2010: £13m) for the Group and £18m (2010: £13m) for the Company.

Balances with central banks above represent amounts which are held with the US Federal Reserve and the Bank of England as part of the Group's policy of managing liquidity risk and maintaining core liquid assets as required by the UK Financial Services Authority.

14. TRADING ASSETS

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Loans and advances to banks – securities purchased under resale agreements	**3,056**	5,775	**3,056**	5,775
Loans and advances to banks - other(1)	**3,088**	2,506	**3,088**	2,506
Loans and advances to customers – securities purchased under resale agreements	**6,338**	8,652	**6,338**	8,652
Loans and advances to customers – other(2)	**349**	7	**348**	3
Debt securities	**8,711**	17,821	**8,711**	17,821
Equity securities	**349**	700	**23**	353
	21,891	35,461	**21,564**	35,110

(1) Comprises short-term loans of £84m (2010: £98m) and cash collateral of £3,004m (2010: £2,408m).
(2) Comprises short-term loans

Notes to the Financial Statements continued

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

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Issued by public bodies:				
- Government securities	**2,943**	6,630	**2,943**	6,630
Issued by other issuers:				
- Bank and building society certificates of deposit: Other	**-**	290	**-**	290
- Fixed and floating rate notes(1): Government guaranteed	**5,666**	10,586	**5,666**	10,586
- Fixed and floating rate notes(1): Other	**102**	315	**102**	315
	8,711	17,821	**8,711**	17,821

(1) The FRNs are all AAA rated.

Debt securities and equity securities can be analysed by listing status as follows:

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Debt securities:				
- Listed in the UK	**5,904**	11,392	**5,904**	11,392
- Listed elsewhere	**1,165**	1,467	**1,165**	1,467
- Unlisted	**1,642**	4,962	**1,642**	4,962
	8,711	17,821	**8,711**	17,821
Equity securities:				
- Listed in the UK	**335**	698	**11**	351
- Listed elsewhere	**14**	2	**12**	2
	349	700	**23**	353

15. DERIVATIVE FINANCIAL INSTRUMENTS

Derivatives are financial instruments whose value is derived from the price of one or more underlying items such as equities, equity indices, interest rates, foreign exchange rates, property indices, commodities and credit spreads. Derivatives enable users to manage exposure to credit or market risks. The Group sells derivatives to its customers and uses derivatives to manage its own exposure to credit and market risks.

Use of derivatives

The Group transacts derivatives for four primary purposes:

> to create risk management solutions for customers,
> to manage the portfolio risks arising from customer business,
> to manage and hedge the Group's own risks, and
> to generate profits through sales activities.

Under IAS 39, all derivatives are classified as "held for trading" (except for derivatives which are designated as effective hedging instruments in accordance with the detailed requirements of IAS 39) even if this is not the purpose of the transaction. The held for trading classification therefore includes two types of derivatives:

> those used in sales activities, and
> those used for risk management purposes but, for various reasons, either the Group does not elect to claim hedge accounting for or they do not meet the qualifying criteria for hedge accounting. These consist of:

> non-qualifying hedging derivatives (known as "economic hedges"), whose terms match other on-balance sheet instruments but do not meet the technical criteria for hedge accounting, or which use natural offsets within other on-balance sheet instruments containing the same risk features as part of an integrated approach to risk management, and hence do not require the application of hedge accounting to achieve a reduction in income statement volatility,
> derivatives managed in conjunction with financial instruments designated at fair value (known as the "fair value option"). The fair value option is described more fully in the Accounting Policy "Financial assets" and Notes 16 and 30. The Group's business model is primarily structured to maximise use of the fair value option, rather than electing to apply hedge accounting, in order to reduce the administrative burden on the Group associated with complying with the detailed hedge accounting requirements of IAS 39,
> derivatives that do not meet the qualifying criteria for hedge accounting, including ineffective hedging derivatives and any components of hedging derivatives that are excluded from assessing hedge effectiveness, and
> derivative contracts that represent the closing-out of existing positions through the use of matching deals.

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

Activity	Risk	Type of derivative
Management of the return on variable rate assets financed by shareholders' funds and net non-interest-bearing liabilities.	Reduced profitability due to falls in interest rates.	Receive fixed interest rate swaps.
Management of the basis between administered rate assets and liabilities and wholesale market rates.	Reduced profitability due to adverse changes in the basis spread.	Basis swaps.
Management of repricing profile of wholesale funding.	Reduced profitability due to adverse movement in wholesale interest rates when large volumes of wholesale funding are repriced.	Forward rate agreements.
Fixed rate lending and investments.	Sensitivity to increases in interest rates.	Pay fixed interest rate swaps.
Fixed rate retail and wholesale funding.	Sensitivity to falls in interest rates.	Receive fixed interest rate swaps.
Equity-linked retail funding.	Sensitivity to increases in equity market indices.	Receive equity swaps.
Management of other net interest income on retail activities.	Sensitivity of income to changes in interest rates.	Interest rate swaps.
Issuance of products with embedded equity options.	Sensitivity to changes in underlying index and index volatility causing option exercise.	Interest rate swaps combined with equity options.
Lending and investments.	Sensitivity to weakening credit quality.	Purchase credit default swaps and total return swaps.
Lending and issuance of products with embedded interest rate options.	Sensitivity to changes in underlying rate and rate volatility causing option exercise.	Interest rate swaps plus caps/floors.
Investment in, and issuance of, bonds with put/call features.	Sensitivity to changes in rates causing option exercise.	Interest rate swaps combined with swaptions(1) and other matched options.

(1) A swaption is an option on a swap that gives the holder the right but not the obligation to buy or sell a swap.

The Group's derivative activities do not give rise to significant open positions in portfolios of derivatives. Any residual position is managed to ensure that it remains within acceptable risk levels, with matching deals being utilised to achieve this where necessary. When entering into derivative transactions, the Group employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

The hedging classification consists of derivatives that the Group has chosen to designate as in a hedging relationship because they meet the specific criteria in IAS 39.

All derivatives are required to be held at fair value through profit or loss, and shown in the balance sheet as separate totals of assets and liabilities. A description of how the fair values of derivatives are derived is set out in Note 45. This is described in more detail in the accounting policies "Derivative financial instruments" and "Hedge accounting" on page 27. Derivative assets and liabilities on different transactions are only set off if the transactions are with the same counterparty, a legal right of set-off or netting exists and the cash flows are intended to be settled on a net basis.

Trading derivatives

Most of the Group's derivative transactions relate to sales activities and derivative contracts that represent the closing-out of existing positions through the use of matching deals. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Limited positions may be traded actively or be held over a period of time to benefit from expected changes in exchange rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

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

Corporate Banking deals with commercial customers who wish to enter into derivative contracts. Any market risk arising from such transactions is hedged by Markets. Markets is responsible for implementing Group derivative hedging with the external market together with its own trading activities. For trading activities, its objectives are to gain value by:

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

Notes to the Financial Statements continued

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives (economic hedges), ineffective hedging derivatives and any components of hedging derivatives that are excluded from assessing hedge effectiveness, derivatives managed in conjunction with financial instruments designated at fair value and derivative contracts that represent the closing-out of existing positions through the use of matching deals.

Hedging derivatives

The Group uses derivatives (principally interest rate swaps and cross-currency swaps) for hedging purposes in the management of its own asset and liability portfolios, including fixed-rate lending, fixed-rate asset purchases, medium-term note issues, capital issues, and structural positions. This enables the Group to optimise the overall cost to it of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The accounting for these derivatives is described in the accounting policy "Hedge accounting" on page 27. Such risks may also be managed using natural offsets within other on-balance sheet instruments as part of an integrated approach to risk management.

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

The fair values of derivative instruments classified as held for trading and hedging purposes are set out in the following tables. The tables show the contract or underlying principal amounts, and positive and negative fair values of derivatives analysed by contract. The contract/notional amounts of derivatives indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent actual exposures. The fair values represent the amount at which a contract could be exchanged in an arm's length transaction, calculated at market rates at the balance sheet date.

Derivatives classified as held for trading in the table below consist of those used in sales and trading activities, and those used for risk management purposes but which, for various reasons, either for which the Group does not elect to claim hedge accounting or which do not meet the qualifying criteria for hedge accounting. Derivatives classified as held for hedging in the table below consist of those that have been designated as in a hedging relationship in accordance with IAS 39.

			Group
2011 Derivatives held for trading	**Contract/notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Exchange rate contracts:			
- Cross-currency swaps	**104,519**	**1,507**	**2,839**
- Forward exchange swaps, options and forwards	**19,497**	**149**	**248**
	124,016	**1,656**	**3,087**
Interest rate contracts:			
- Interest rate swaps	**566,365**	**25,949**	**24,700**
- Caps, floors and swaptions(1)	**63,100**	**3,484**	**3,522**
- Futures	**32,503**	**54**	**41**
- Forward rate agreements	**78,090**	**21**	**31**
	740,058	**29,508**	**28,294**
Equity and credit contracts:			
- Equity index swaps and similar products	**32,330**	**1,237**	**1,527**
- Equity index options	**43,708**	**406**	**1,240**
- Credit default swaps and similar products	**1,565**	**45**	**21**
	77,603	**1,688**	**2,788**
Commodity contracts:			
- swaps	**542**	**12**	**11**
	542	**12**	**11**
Total derivative assets and liabilities held for trading	**942,219**	**32,864**	**34,180**

			Group
2011 Derivatives held for fair value hedging	**Contract/notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Exchange rate contracts:			
- Cross-currency swaps	**437**	**32**	**-**
Interest rate contracts:			
- Interest rate swaps	**35,848**	**328**	**1,237**
Total derivative assets and liabilities held for fair value hedging	**36,285**	**360**	**1,237**
Total recognised derivative assets and liabilities	**978,504**	**33,224**	**35,417**

Notes to the Financial Statements continued

2011 Derivatives held for trading	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Company
Exchange rate contracts:			
- Cross-currency swaps	**104,519**	**1,506**	**2,839**
- Forward exchange swaps, options and forwards	**19,497**	**149**	**248**
	124,016	**1,655**	**3,087**
Interest rate contracts:			
- Interest rate swaps	**566,365**	**25,951**	**24,700**
- Caps, floors and swaptions(1)	**63,100**	**3,484**	**3,522**
- Futures	**32,503**	**54**	**41**
- Forward rate agreements	**78,090**	**21**	**31**
	740,058	**29,510**	**28,294**
Equity and credit contracts:			
- Equity index swaps and similar products	**32,629**	**1,254**	**1,527**
- Equity index options	**43,708**	**406**	**1,240**
- Credit default swaps and similar products	**1,627**	**45**	**21**
	77,964	**1,705**	**2,788**
Commodity contracts:			
- swaps	**542**	**12**	**11**
	542	**12**	**11**
Total derivative assets and liabilities held for trading	**942,580**	**32,882**	**34,180**

2011 Derivatives held for fair value hedging	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Company
Exchange rate contracts:			
- Cross-currency swaps	**437**	**32**	
Interest rate contracts:			
- Interest rate swaps	**35,848**	**328**	**1,237**
Total derivative assets and liabilities held for fair value hedging	**36,285**	**360**	**1,237**
Total recognised derivative assets and liabilities	**978,865**	**33,242**	**35,417**

(1) A swaption is an option on a swap that gives the holder the right but not the obligation to buy or sell a swap.

2010 Derivatives held for trading	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Group
Exchange rate contracts:			
- Cross-currency swaps	57,499	1,160	1,727
- Forward exchange swaps, options and forwards	16,802	86	381
	74,301	1,246	2,108
Interest rate contracts:			
- Interest rate swaps	551,259	16,675	15,033
- Caps, floors and swaptions(1)	69,242	2,680	2,747
- Futures	39,840	3	10
- Forward rate agreements	37,479	8	18
	697,820	19,366	17,808
Equity and credit contracts:			
- Equity index swaps and similar products	41,397	1,214	2,814
- Equity index options	40,279	740	145
- Credit default swaps and similar products	3,314	385	293
	84,990	2,339	3,252
Total derivative assets and liabilities held for trading	857,111	22,951	23,168

2010 Derivatives held for fair value hedging	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Group
Interest rate contracts:			
- Interest rate swaps	39,083	286	1,875
Total derivative assets and liabilities held for fair value hedging	39,083	286	1,875
Total recognised derivative assets and liabilities	896,194	23,237	25,043

Notes to the Financial Statements continued

2010 Derivatives held for trading	Company Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
Exchange rate contracts:			
- Cross-currency swaps	57,499	1,160	1,727
- Forward exchange swaps, options and forwards	16,802	86	381
	74,301	1,246	2,108
Interest rate contracts:			
- Interest rate swaps	551,259	16,675	15,033
- Caps, floors and swaptions(1)	69,242	2,680	2,747
- Futures	39,840	3	10
- Forward rate agreements	37,479	8	18
	697,820	19,366	17,808
Equity and credit contracts:			
- Equity index swaps and similar products	41,998	1,254	2,814
- Equity index options	40,279	740	145
- Credit default swaps and similar products	3,377	385	293
	85,654	2,379	3,252
Total derivative assets and liabilities held for trading	857,775	22,991	23,168

2010 Derivatives held for fair value hedging	Company Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
Interest rate contracts:			
- Interest rate swaps	39,083	286	1,875
Total derivative assets and liabilities held for fair value hedging	39,083	286	1,875
Total recognised derivative assets and liabilities	896,858	23,277	25,043

(1) A swaption is an option on a swap that gives the holder the right but not the obligation to buy or sell a swap.

Net gains or losses arising from fair value hedges included in net trading and other income

	Group **2011 £m**	2010 £m
Net gains/(losses):		
- on hedging instruments	**31**	171
- on hedged items attributable to hedged risks	**(36)**	(169)
	(5)	2

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

In the ordinary course of business, the Group entered into long-term interest rate hedging contracts with five investment vehicles whose underlying assets comprise debt securities, bank loans and energy and infrastructure financings. Although the vehicles themselves are not externally rated, the counterparty exposure ranks super-senior to the most senior notes issued by the vehicles and these notes are rated AAA or AA. The total mark-to-market exposure at 31 December 2011 was £67m (31 December 2010: £81m).

16. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Loans and advances to customers	**4,331**	5,422	**4,331**	5,422
Debt securities	**379**	1,046	**379**	1,046
	4,710	6,468	**4,710**	6,468

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

The following assets have been designated at fair value through profit or loss:

- **Loans and advances to customers**, representing certain loans secured on residential property to housing associations. Since 2009 the Group's policy has been not to designate similar new loans at fair value through profit or loss. These would otherwise have been measured at amortised cost with the associated derivatives used to economically hedge the risk held for trading and measured at fair value through profit or loss.
- **Debt securities**, representing holdings of asset-backed securities of £379m (2010: £1,046m):
  - Mortgage-backed securities of £328m (2010: £859m) are managed and their performance evaluated on a fair value basis in accordance with a documented strategy, and information about them is provided on that basis to management.
  - Other asset-backed securities of £51m (2010: £187m) which, at the date of their acquisition, were managed, and their performance evaluated, on a fair value basis in accordance with a documented investment strategy, and information about them was provided on that basis to management. Almost all of these securities are now managed on an accrual basis, but are not eligible for reclassification under IAS 39. These securities were issued by Banco Santander entities in Spain.

The maximum exposure to credit risk on loans and advances designated as held at fair value through profit or loss at the balance sheet date was £4,331m (2010: £5,422m) for the Group and £4,332m (2010: £5,422m) for the Company. The maximum exposure was mitigated by the Group having a charge over residential properties in respect of lending to housing associations amounting to £4,687m (2010: £5,966m) for the Group and £4,687m (2010: £5,966m) for the Company.

The net loss during the year attributable to changes in credit risk for loans and advances designated at fair value was £26m (2010: net loss of £26m) for the Group. The cumulative net loss attributable to changes in credit risk for loans and advances designated at fair value at 31 December 2011 was £257m (2010: net loss of £231m).

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

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Mortgage-backed securities	**328**	859	**328**	859
Other asset-backed securities	**51**	187	**51**	187
	379	1,046	**379**	1,046

Debt securities can be analysed by listing status as follows:

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Listed UK	**-**	647	**-**	647
Listed elsewhere	**58**	75	**58**	75
Unlisted(1)	**321**	324	**321**	324
	379	1,046	**379**	1,046

(1) Comprises Social Housing.

Notes to the Financial Statements continued

Asset-backed securities can be analysed by the geographical location of the issuer or counterparty as follows:

	31 December 2011				31 December 2010				Income statement	
	Nominal value	**Book value**	**Fair value**	**Fair value as % of nominal**	Nominal value	Book value	Fair value	Fair value as % of nominal	**2011**	2010
Country	**£m**	**£m**	**£m**	**%**	£m	£m	£m	%	**£m**	£m
UK										
ABS	**-**	**-**	**-**	**-**	79	76	76	96	**-**	-
MBS	**187**	**263**	**263**	**141**	686	726	726	106	**26**	22
	187	**263**	**263**	**141**	765	802	802	105	**26**	22
US										
MBS	**8**	**9**	**9**	**113**	9	14	14	156	**(4)**	6
	8	**9**	**9**	**113**	9	14	14	156	**(4)**	6
Rest of Europe										
ABS	**80**	**51**	**51**	**64**	115	111	111	97	**1**	35
MBS	**35**	**56**	**56**	**160**	20	17	17	85	**11**	-
	115	**107**	**107**	**93**	135	128	128	95	**12**	35
Rest of world										
MBS	**-**	**-**	**-**	**-**	116	102	102	88	**-**	-
	-	**-**	**-**	**-**	116	102	102	88	**-**	-
Total	**310**	**379**	**379**	**122**	1,025	1,046	1,046	102	**34**	63

Asset-backed securities can be analysed by the credit rating of the issuer or counterparty as follows:

	31 December 2011				31 December 2010				Income statement	
	Nominal value	**Book value**	**Fair value**	**Fair value as % of nominal**	Nominal value	Book value	Fair value	Fair value as % of nominal	**2011**	2010
Credit rating	**£m**	**£m**	**£m**	**%**	£m	£m	£m	%	**£m**	£m
AAA										
ABS	**28**	**16**	**16**	**57**	114	104	104	91	**-**	27
MBS	**175**	**247**	**247**	**141**	685	725	725	106	**18**	26
	203	**263**	**263**	**130**	799	829	829	104	**18**	53
AA+										
ABS	**46**	**30**	**30**	**65**	80	83	83	104	**1**	7
MBS	**-**	**-**	**-**	**-**	146	134	134	92	**-**	3
	46	**30**	**30**	**65**	226	217	217	96	**1**	10
AA										
ABS	**3**	**3**	**3**	**100**	-	-	-	-	**-**	-
MBS	**46**	**76**	**76**	**165**	-	-	-	-	**15**	-
	49	**79**	**79**	**161**	-	-	-	-	**15**	-
A										
ABS	**3**	**2**	**2**	**67**	-	-	-	-	**-**	-
	3	**2**	**2**	**67**	-	-	-	-	**-**	-
Below BBB										
MBS	**9**	**5**	**5**	**56**	-	-	-	-	**-**	-
	9	**5**	**5**	**56**	-	-	-	-	**-**	-
Total	**310**	**379**	**379**	**122**	1,025	1,046	1,046	102	**34**	63

17. LOANS AND ADVANCES TO BANKS

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Amounts due from Santander UK group undertakings	**110,004**	143,789	**109,999**	143,783
Amounts due from Banco Santander S.A.	**2,082**	643	**2,082**	643
Other loans and advances	**1,136**	1,980	**1,130**	1,972
	113,222	146,412	**113,211**	146,398

During the year, £nil impairment losses were incurred (2010:£nil).

	Group		Company	
Repayable:	**2011 £m**	2010 £m	**2011 £m**	2010 £m
On demand	**18,507**	24,417	**18,500**	24,403
In not more than 3 months	**40,763**	40,806	**40,762**	40,806
In more than 3 months but not more than 1 year	**9,911**	28,825	**9,911**	28,825
In more than 1 year but not more than 5 years	**35,214**	41,697	**35,214**	41,697
In more than 5 years	**8,827**	10,667	**8,824**	10,667
	113,222	146,412	**113,211**	146,398

Loans and advances to banks can be analysed by the geographical location of the issuer or counterparty as follows:

	Group	
Country	**2011 £m**	2010 £m
UK	**110,531**	144,080
Spain	**2,082**	643
France	**-**	727
Rest of Europe	**89**	-
US	**245**	962
Rest of world	**275**	-
Total	**113,222**	146,412

Loans and advances to banks can be analysed by the credit rating of the issuer or counterparty as follows:

	Group	
Credit rating	**2011 £m**	2010 £m
AAA	**238**	-
AA	**-**	145,402
AA-	**112,087**	-
A+	**-**	90
A-	**897**	920
Total	**113,222**	146,412

18. LOANS AND ADVANCES TO CUSTOMERS

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Amounts due from Santander UK group undertakings	**27,831**	26,942	**27,938**	27,336
Amounts due from Banco Santander group undertakings	**5**	8	**5**	8
Other loans and advances	**11,120**	7,708	**11,113**	7,699
Loans and advances to customers	**38,956**	34,658	**39,056**	35,043
Less: impairment loss allowances	**(130)**	(108)	**(130)**	(108)
Loans and advances to customers, net of impairment loss allowances	**38,826**	34,550	**38,926**	34,935

	Group		Company	
Repayable:	**2011 £m**	2010 £m	**2011 £m**	2010 £m
On demand	**1,026**	81	**1,078**	424
In no more than 3 months	**6,692**	6,799	**6,736**	6,812
In more than 3 months but not more than a year	**2,110**	1,674	**2,112**	1,694
In more than 1 year but not more than 5 years	**15,970**	11,398	**15,965**	11,398
In more than 5 years	**13,158**	14,706	**13,165**	14,715
Loans and advances to customers	**38,956**	34,658	**39,056**	35,043
Less: impairment loss allowance	**(130)**	(108)	**(130)**	(108)
Loans and advances to customers, net of impairment loss allowances	**38,826**	34,550	**38,926**	34,935

Notes to the Financial Statements continued

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

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Fixed rate	**19,349**	12,815	**19,454**	12,900
Variable rate	**19,607**	21,843	**19,602**	22,143
Less: impairment loss allowances	**(130)**	(108)	**(130)**	(108)
	38,826	34,550	**38,926**	34,935

Movement in impairment loss allowances:

	Group
	£m
At 1 January 2011	**108**
Charge to the income statement:	
- Observed	**50**
- Incurred but not yet observed	**4**
	54
Write offs	**(32)**
At 31 December 2011	**130**
At 1 January 2010	77
Charge to the income statement:	
- Observed	65
- Incurred but not yet observed	15
	80
Write offs	(49)
At 31 December 2010	108

	Company
	£m
At 1 January 2011	**108**
Charge to the income statement	**55**
Write offs	**(33)**
At 31 December 2011	**130**
At 1 January 2010	77
Charge to the income statement	80
Write offs	(49)
At 31 December 2010	108

19. SPECIAL PURPOSE ENTITIES

Special Purpose Entities ('SPEs') are formed by the Group to accomplish specific and well-defined objectives. The Group consolidates these SPEs when the substance of the relationship indicates control, as described in Note 1.

Consolidated special purpose entities

The only SPEs sponsored and consolidated by the Group are described below. There are no third party assets held in the SPEs.

a) Guaranteed Investment Products 1 PCC
Guaranteed Investment Products 1 PCC Limited is a Guernsey-incorporated, closed-ended, protected cell company. The objective of each cell is to achieve capital growth. In order to achieve the investment objective, Guaranteed Investment Products 1 PCC Limited, on behalf of the respective cells, has entered into transactions with the Group. Santander Guarantee Company, a Santander UK group company, also guarantees the shareholders of cells a fixed return on their investment and/or the investment amount. Guaranteed Investment Products 1 PCC Limited has no third party assets.

b) Marylebone Road 3 CBO B.V.
Marylebone Road 3 CBO B.V. was established with the specific purpose of housing Collateralised Bond Obligation structures under which the Group raises funds, and transfers credit risk to third parties. This entity issues credit linked notes to third parties and issues repos and credit default swaps to other Group companies. Marylebone Road 3 CBO B.V. has no third party assets.

Off balance sheet special purpose entities

The only SPEs sponsored but not consolidated by the Group are SPEs which issue shares that back retail structured products. At 31 December 2011, the total value of products issued by these SPEs was £36m (2010: £111m). The Group's arrangements with these entities comprise the provision of equity derivatives and a secondary market-making service to those retail customers who wish to exit early from these products.

The maximum exposure to the SPEs sponsored but not consolidated by the Group is set out in the table below:

	Group	
	2011	2010
	£m	£m
Trading assets	**17**	39

20. HELD TO MATURITY SECURITIES

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
	-	331	**-**	-

The balance above primarily represented two issuances of £150m each of subordinated bonds in pounds sterling made by a subsidiary company. It also included accrued interest. The bonds were redeemed at par in 2011 as part of a restructuring of the Santander UK group of companies. The key terms of these subordinated bonds were:

- £150m issued on 30 December 1991 due on 4 January 2017. Interest is payable annually in arrears, at a rate of 11.5%.
- £150m issued on 4 February 1993, due on 4 January 2023. Interest is payable annually in arrears, at a rate of 10.125%.

21. LOANS AND RECEIVABLE SECURITIES

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Loans and receivable securities	**278**	626	**278**	626

These asset-backed securities were acquired as part of an alignment of portfolios across the Banco Santander group in 2010 and are being run down. Detailed analysis of these securities is set out below.

Asset-backed securities can be analysed by the geographic location of the issuer or counterparty as follows:

	31 December 2011				31 December 2010				Income statement	
	Nominal value	**Book value**	**Fair value**	**Fair value as % of nominal**	Nominal value	Book value	Fair value	Fair value as % of nominal	**2011**	2010
Country	**£m**	**£m**	**£m**	**%**	£m	£m	£m	%	**£m**	£m
UK										
MBS	**91**	**91**	**91**	**100**	409	408	419	102	**1**	-
	91	**91**	**91**	**100**	409	408	419	102	**1**	-
US										
ABS	**29**	**22**	**22**	**76**	37	29	29	78	**1**	-
	29	**22**	**22**	**76**	37	29	29	78	**1**	-
Rest of Europe										
ABS	**3**	**3**	**3**	**100**	10	8	8	80	**-**	-
MBS	**151**	**143**	**143**	**95**	155	146	146	94	**4**	1
	154	**146**	**146**	**95**	165	154	154	93	**4**	1
Rest of world										
ABS	**21**	**19**	**19**	**90**	43	35	35	81	**4**	-
	21	**19**	**19**	**90**	43	35	35	81	**4**	-
Total	**295**	**278**	**278**	**94**	654	626	637	97	**10**	1

Notes to the Financial Statements continued

Asset-backed securities can be analysed by the credit rating of the issuer or counterparty as follows:

	31 December 2011				31 December 2010				Income statement	
	Nominal value	Book value	Fair value	Fair value as % of nominal	Nominal value	Book value	Fair value	Fair value as % of nominal	2011	2010
Credit rating	£m	£m	£m	%	£m	£m	£m	%	£m	£m
AAA										
ABS	**19**	**16**	**16**	**84**	25	18	18	72	**2**	2
MBS	**147**	**143**	**143**	**97**	452	444	455	101	**3**	-
	166	**159**	**159**	**96**	477	462	473	99	**5**	2
AA+										
ABS	**-**	**-**	**-**	**-**	27	22	22	81	**-**	(1)
MBS	**84**	**80**	**80**	**95**	68	66	66	97	**2**	-
	84	**80**	**80**	**95**	95	88	88	93	**2**	-
AA										
MBS	**5**	**5**	**5**	**100**	-	-	-	-	**-**	-
	5	**5**	**5**	**100**	-	-	-	-	**-**	-
A										
ABS	**19**	**16**	**16**	**84**	22	19	19	86	**2**	-
MBS	**6**	**6**	**6**	**100**	4	4	4	100	**-**	-
	25	**22**	**22**	**88**	26	23	23	88	**2**	-
BBB										
MBS	**-**	**-**	**-**	**-**	40	40	40	100	**-**	-
	-	**-**	**-**	**-**	40	40	40	100	**-**	-
Below BBB										
ABS	**15**	**12**	**12**	**80**	16	13	13	81	**1**	-
	15	**12**	**12**	**80**	16	13	13	81	**1**	-
Total	**295**	**278**	**278**	**94**	654	626	637	97	**10**	1

Asset-backed securities above include the following:

> **ALT-A US asset-backed securities** – the Group holds no ALT-A US asset-backed securities.

> **Monoline insurer exposures** - The Group has a £44m (31 December 2010: £42m) exposure to corporate bonds and securitisations which are wrapped by monoline insurers. The principal risk exposures are recorded against the securitisations, with the monoline wraps being viewed as contingent exposures.

22. INVESTMENT IN SUBSIDIARY UNDERTAKINGS

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

	Company		
	Cost £m	Impairment £m	Net book value £m
At 1 January and 31 December 2011	**2,213**	**(26)**	**2,187**

	Company		
	Cost £m	Impairment £m	Net book value £m
At 1 January 2010	2,213	(28)	2,185
Additions	-	2	2
At 31 December 2010	2,213	(26)	2,187

The principal subsidiaries of the Company at 31 December 2011 are shown below, all of which are directly held, except where noted, and unlisted. The Directors consider that to give full particulars of all subsidiary undertakings would lead to a statement of excessive length. In accordance with Section 410(2) of the UK Companies Act 2006, the following information relates to those subsidiary undertakings whose results or financial position, in the opinion of the Directors, principally affect the results of the Group. Full particulars of all subsidiary undertakings will be annexed to the Company's next annual return in accordance with Section 410(3)(b) of the UK Companies Act 2006.

	Nature of business	% Interest held	Country of Incorporation or registration
Abbey National Treasury Services Overseas Holdings *	Investment	100	England & Wales
Abbey National North America LLC *	Commercial paper issue	100	United States
Abbey National Treasury Services Investments Limited	Investment	100	England & Wales
Abbey National (Holdings) Limited	Holding Company	100	England & Wales
Abbey National American Investments Limited	Investment	100	England & Wales
Abbey National Treasury Investments	Investment	100	England & Wales

* Held indirectly or partly indirectly through subsidiary companies.

All the above companies are included in the Consolidated Financial Statements. All companies operate principally in their country of incorporation or registration. The Company also has branch offices in the US and the Cayman Islands.

23. INTANGIBLE ASSETS

	Group 2011 £m	Company 2011 £m
Cost		
At 1 January 2011	**45**	**29**
Additions	**7**	**7**
Disposals	**(26)**	**(26)**
At 31 December 2011	**26**	**10**
Accumulated amortisation / impairment		
At 1 January 2011	**19**	**3**
Charge for the year	**4**	**4**
31 December 2011	**23**	**7**
Net book value	**3**	**3**

	Group 2010 £m	Company 2010 £m
Cost		
At 1 January 2010	24	8
Additions	21	21
At 31 December 2010	45	29
Accumulated amortisation / impairment		
At 1 January 2011	16	-
Charge for the year	3	3
31 December 2010	19	3
Net book value	26	26

The intangible assets of the Group and the Company consist of computer software.

24. PROPERTY, PLANT AND EQUIPMENT

				Group
	Property £m	Office fixtures and equipment £m	Computer software £m	Total £m
Cost				
At 1 January 2011	**1**	**29**	**66**	**96**
Additions	**-**	**2**	**-**	**2**
Disposals	**-**	**(11)**	**(5)**	**(16)**
At 31 December 2011	**1**	**20**	**61**	**82**
Accumulated depreciation				
At 1 January 2011	**1**	**13**	**60**	**74**
Charge for the year	**-**	**3**	**-**	**3**
At 31 December 2011	**1**	**16**	**60**	**77**
Net book value				
At 31 December 2011	**-**	**4**	**1**	**5**

				Group
	Property £m	Office fixtures and equipment £m	Computer software £m	Total £m
Cost				
At 1 January 2010	1	15	61	77
Additions	-	14	5	19
At 31 December 2010	1	29	66	96
Accumulated depreciation				
At 1 January 2010	1	10	60	71
Charge for the year	-	3	-	3
At 31 December 2010	1	13	60	74
Net book value				
At 31 December 2010	-	16	6	22

Notes to the Financial Statements continued

				Company
	Property	**Office fixtures and equipment**	**Computer software**	**Total**
	£m	**£m**	**£m**	**£m**
Cost				
At 1 January 2011	**-**	**27**	**65**	**92**
Additions	**-**	**2**	**-**	**2**
Disposals	**-**	**(11)**	**(5)**	**(16)**
At 31 December 2011	**-**	**18**	**60**	**78**
Accumulated depreciation	**-**			
At 1 January 2011	**-**	**11**	**59**	**70**
Charge for the year	**-**	**3**	**-**	**3**
At 31 December 2011	**-**	**14**	**59**	**73**
Net book value				
At 31 December 2011	**-**	**4**	**1**	**5**

				Company
	Property	Office fixtures and equipment	Computer software	Total
	£m	£m	£m	£m
Cost				
At 1 January 2010	-	13	60	73
Additions	-	14	5	19
At 31 December 2010	-	27	65	92
Accumulated depreciation				
At 1 January 2010	-	8	59	67
Charge for the year	-	3	-	3
At 31 December 2010	-	11	59	70
Net book value				
At 31 December 2010	-	16	6	22

At 31 December 2011, capital expenditure contracted, but not provided for was £1m (2010: £nil) in respect of property, plant and equipment. The disposal of £16m (2010: £nil) was made to Santander UK at book value.

25. DEFERRED TAX

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

The movement on the deferred tax account is as follows:

		Group		Company
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
At 1 January	**25**	20	**25**	21
Income statement (charge)/credit	**(9)**	5	**(8)**	4
Intra group transfer	**1**	-	**-**	-
At 31 December	**17**	25	**17**	25

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

		Group		Company
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Deferred income tax liabilities				
Other temporary differences	**-**	(1)	**-**	-
	-	(1)	**-**	-
Deferred income tax assets				
Accelerated book depreciation	**2**	2	**2**	2
IAS 32 and 39 transition adjustments	**7**	11	**7**	10
Other temporary differences	**8**	13	**8**	13
	17	26	**17**	25

The deferred tax assets scheduled above have been recognised in both the Company and the Group on the basis that sufficient future taxable profits are forecast within the foreseeable future, in excess of the profits arising from the reversal of existing taxable temporary differences, to allow for the utilisation of the assets as they reverse.

The deferred tax (charge)/credit in the income statement comprises the following temporary differences:

	Group	
	2011	2010
	£m	£m
Accelerated tax depreciation	**-**	-
IAS 32 and 39 transitional adjustments	**4**	(2)
Other temporary differences	**5**	7
	9	5

At 31 December 2011, the Group had UK capital losses carried forward of £59m (2010: £91m). These losses are available for offset against future UK chargeable gains and under current UK tax legislation do not time expire. No deferred tax asset has been recognised in respect of these capital losses on the basis that the timing of any benefit is uncertain.

26. OTHER ASSETS

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Trade and other receivables	**43**	65	**43**	65

27. DEPOSITS BY BANKS

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Amounts due to Santander UK undertakings	**105,713**	132,574	**105,713**	132,523
Amounts due to fellow Banco Santander subsidiaries (not with Banco Santander, S.A.)	**603**	359	**603**	359
Securities sold under agreements to repurchase	**4,955**	2,548	**4,955**	2,548
Amounts due to Banco Santander, S.A. - securities sold under agreements to repurchase	**2,517**	830	**2,517**	830
Time and demand deposits	**231**	442	**230**	441
Total deposits by banks	**114,019**	136,753	**114,018**	136,701

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Repayable:				
On demand	**4,784**	4,484	**4,783**	4,433
In not more than 3 months	**30,705**	48,374	**30,705**	48,394
In more than 3 months but not more than 1 year	**25,136**	29,022	**25,136**	29,004
In more than 1 year but not more than 5 years	**38,388**	39,792	**38,388**	39,792
In more than 5 years	**15,006**	15,081	**15,006**	15,078
	114,019	136,753	**114,018**	136,701

Notes to the Financial Statements continued

28. DEPOSITS BY CUSTOMERS

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Time deposits	**10**	8	**10**	8
Amounts due to Santander UK subsidiaries	**1,847**	1,758	**6,973**	8,686
Amounts due to Banco Santander group subsidiaries	**345**	346	**381**	346
Securities sold under agreements to repurchase	**418**	-	**418**	-
Wholesale funds and deposits	**4,494**	4,949	**4,494**	4,949
	7,114	7,061	**12,276**	13,989
Repayable:				
On demand	**101**	476	**247**	479
In no more than 3 months	**884**	609	**3,309**	4,715
In more than 3 months but no more than 1 year	**781**	252	**1,486**	3,009
In more than 1 year but no more than 5 years	**5,248**	5,524	**7,134**	5,586
In more than 5 years	**100**	200	**100**	200
	7,114	7,061	**12,276**	13,989

Wholesale deposits by customers are interest bearing.

29. TRADING LIABILITIES

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Deposits by banks - securities sold under repurchase agreements	**10,105**	21,411	**10,105**	21,411
- other(1)	**4,403**	4,327	**4,403**	4,327
Deposits by customers - securities sold under repurchase agreements	**5,519**	11,112	**5,519**	11,112
- other(2)	**4,963**	4,859	**4,963**	4,859
Short positions in securities and unsettled trades	**755**	1,118	**755**	1,118
	25,745	42,827	**25,745**	42,827

(1) Comprises cash collateral £2,401m (2010: £1,149) and short-term deposits £2,002m (2010: £3,178m).
(2) Comprises short-term deposits £3,662m (2010: £3,202m) and equity linked deposits £1,301m (2010: £1,657m).

30. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Debt securities in issue:				
- US$10bn Euro Commercial Paper Programme	**429**	898	**429**	898
- US$20bn Euro Medium Term Note Programme	**4,594**	1,758	**4,594**	1,758
- Euro 10bn Structured Notes	**1,744**	930	**1,744**	930
- Other bonds	**61**	62	**5**	-
Warrants	**8**	9	**8**	9
	6,836	3,657	**6,780**	3,595

Financial liabilities are designated at fair value through profit or loss where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring assets and liabilities or recognising the gains or losses on them on a different basis or where a contract contains one or more embedded derivatives that would otherwise require separate recognition. The ‘fair value option’ has been used where debt securities in issue and warrants would otherwise be measured at amortised cost and any embedded derivatives or associated derivatives used to economically hedge the risk are held at fair value.

Where the Group records its own debt securities in issue at fair value, the fair value is based on quoted prices in an active market for the specific instrument concerned, if available. When quoted market prices are unavailable, the own debt security in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the Group’s liabilities.

The change in fair value of issued debt securities attributable to the Group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer or credit default swaps. Each security is then valued using discounted cash flows, incorporating a LIBOR-based discount curve. The difference in the valuations is attributable to the Group's own credit spread. This methodology is applied consistently across all securities where it is believed that counterparties would consider the Group's creditworthiness when pricing trades.

Gains and losses arising from changes in the credit spread of liabilities issued by the Group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

The net gain during the year attributable to changes in the Group's own credit risk on the above debt securities in issue was £64m (2010: net gain of £2m) for the Group and £64m (2010: net gain of £2m) for the Company. The cumulative net gain attributable to changes in the Group's own credit risk on the above debt securities in issue at 31 December 2010 was £93m (2010: £29m) for the Group and £93m (2010: £29m) for the Company.

The amount that would be required to be contractually paid at maturity of the debt securities in issue above is £439m (2010: £141m) higher than the carrying value.

US$10bn Euro Commercial Paper Programme

The Company may from time to time issue the commercial paper under the US$10bn Euro Commercial Paper Programme that may be denominated in any currency as agreed between the Company and the relevant dealer. The commercial ranks at least pari passu with all other unsecured and unsubordinated obligations of the Company. The payments of all amounts due in respect of the commercial paper have been unconditionally and irrevocably guaranteed by Santander UK plc.

The commercial paper is issued in bearer form, subject to a minimum maturity of 1 day and a maximum maturity of 364 days. The commercial paper may be issued on a discounted basis or may bear fixed or floating rate interest or a coupon calculated by reference to an index or formula. The maximum aggregate nominal amount of all commercial paper outstanding from time to time under the Programme will not exceed US$10bn (or its equivalent in other currencies).

This was increased from US$4bn in January 2011. The commercial paper is not listed on any stock exchange.

US$20bn Euro Medium Term Note Programme

The Company may from time to time issue notes denominated in any currency as agreed between the relevant issuer and the relevant dealer under the US$20bn Euro Medium Term Note Programme. The payment of all amounts payable in respect of the senior notes is unconditionally and irrevocably guaranteed by Santander UK plc. The programme provides for issuance of fixed rate notes, floating rate notes, index linked notes, credit linked notes, equity linked notes and any other structured notes, and also dual currency notes, zero coupon/discount notes and non-interest bearing notes.

The maximum aggregate nominal amount of all notes outstanding under the programme may not exceed US$20bn (or its equivalent in other currencies) subject to any modifications in accordance with the terms of the programme agreement. Notes may be issued in bearer or registered form and can be listed on the London Stock Exchange or any other or further stock exchange(s) or may be unlisted, as agreed.

Euro 10bn structured notes

The Company may from time to time issue structured notes denominated in any currency as agreed between the Company and the relevant dealers under the euro 10bn Structured Note Programme. Structured notes are direct, unsecured and unconditional obligations of the Company that rank pari passu without preference among themselves and, subject as to any applicable statutory provisions or judicial order, at least equally with all other present and future unsecured and unsubordinated obligations of the Company. The payments of all amounts due in respect of the structured notes have been unconditionally and irrevocably guaranteed by Santander UK plc.

The structured note programme provides for the issuance of commodity linked notes, credit linked notes, currency linked notes, equity linked notes, equity index linked notes, fixed rate notes, floating rate notes, fund linked notes, inflation linked notes, property linked notes, zero coupon/discount notes and any other structured notes as agreed between the Company and the relevant dealers. Structured notes may be issued in bearer or registered (or inscribed) form and may be listed on the London Stock Exchange or any other or further stock exchange(s) or may be unlisted, as agreed between the Company and the relevant dealers. Structured notes issued in bearer form may also be issued in new global note form.

The maximum aggregate nominal amount of all structured notes from time to time outstanding under the Programme will not exceed euro 10bn (or its equivalent in other currencies). This was increased from euro 2bn in March 2011.

Warrants programme

The Company may from time to time issue warrants denominated in any currency as agreed between it and the relevant dealer under the warrant programme. Warrants are direct, unsecured and unconditional obligations of the Company that rank pari passu without preference among themselves and, subject as to any applicable statutory provisions or judicial order, rank at least equally with all other present and future unsecured and unsubordinated obligations of the Company. The payments of all amounts due in respect of the warrants have been unconditionally and irrevocably guaranteed by Santander UK plc.

The warrants programme provides for the issuance of commodity linked warrants, currency linked warrants, equity linked warrants, equity index linked warrants, fund linked warrants, inflation index linked warrants, property index linked warrants, debt linked warrants and any other warrants as agreed with the relevant dealer. Warrants are issued in global form and can be listed on the London Stock Exchange or any other or further stock exchange(s) as agreed with the relevant dealer.

Notes to the Financial Statements continued

31. DEBT SECURITIES IN ISSUE

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Euro 35bn Global Covered Bond Programme	**16,945**	15,408	**16,945**	15,408
US$20bn Euro Medium Term Note Programme (see Note 30)	**4,295**	4,893	**4,290**	4,893
US$20bn Commercial Paper Programme	**3,069**	4,433	**-**	-
Certificates of deposit in issue	**2,671**	8,925	**2,671**	8,925
	26,980	33,659	**23,906**	29,226

Euro 35bn Global Covered Bond Programme

The Company issues the covered bonds under the euro 35bn Global Covered Bond Programme that may be denominated in any currency as agreed between the Company and the relevant dealers under the programme. The programme provides that covered bonds may be listed or admitted to trading, on the official list of the UK Listing Authority and on the London Stock Exchange or any other stock exchanges or regulated or unregulated markets. The Company may also issue unlisted covered bonds and/or covered bonds not admitted to trading on any regulated or unregulated market.

The payments of all amounts due in respect of the covered bonds have been unconditionally guaranteed by Santander UK plc. Abbey Covered Bonds LLP ("LLP"), together with Santander UK plc has guaranteed payments of interest and principal under the covered bonds pursuant to a guarantee which is secured over the LLP's portfolio of mortgages and its other assets. Recourse against the LLP under its guarantee is limited to its portfolio of mortgages and such assets.

Covered bonds may be issued in bearer or registered form. The maximum aggregate nominal amount of all covered bonds from time to time outstanding under the programme will not exceed euro 35bn (or its equivalent in other currencies), subject to increase in accordance with the programme. This was increased from euro 25bn in September 2011. On 8 July 2008, the Group issued a series of covered bonds totalling approximately £13bn. All notes were denominated in sterling and were subscribed for by Santander UK plc.

On 11 November 2008, the Company was admitted to the register of issuers and the programme and the covered bonds issued previously under the programme were admitted to the register of regulated covered bonds, pursuant to Regulation 14 of the Regulated Covered Bonds Regulations 2008 (SI 2008/346).

US$20bn Commercial Paper Programme

Abbey National North America LLC may from time to time issue unsecured notes denominated in United States dollars as agreed between Abbey National North America LLC and the relevant dealers under the US$20bn US commercial paper programme. The Notes will rank at least pari passu with all other unsecured and unsubordinated indebtedness of Abbey National North America LLC and Santander UK plc. The payments of all amounts due in respect of the Notes have been unconditionally and irrevocably guaranteed by Santander UK plc. The Notes are not redeemable prior to maturity or subject to voluntary prepayment. The maximum aggregate nominal amount of all Notes from time to time outstanding under the Programme will not exceed US$20bn (or its equivalent in other currencies).

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

			Group		Company	
			2011	2010	**2011**	2010
	Interest Rate	Maturity	**£m**	£m	**£m**	£m
Euro	0.00% - 3.99%	Up to 2011	**-**	1,230	**-**	1,230
		2011 - 2012	**741**	-	**736**	-
		2013 - 2019	**10,075**	7,350	**10,075**	7,350
		2020 - 2029	**211**	83	**211**	83
		2030 - 2039	**-**	103	**-**	103
	4.00% - 4.99%	2020 - 2029	**2,606**	1,316	**2,606**	1,316
		2030 - 2039	**101**	-	**101**	-
US dollar	0.00% - 3.99%	Up to 2011	**-**	11,145	**-**	6,712
		2011 - 2012	**3,628**	1,200	**559**	1,200
		2013 - 2019	**1,940**	966	**1,940**	966
	4.00% - 5.99%	2013 - 2019	**676**	-	**676**	-
Pounds sterling	0.00% - 3.99%	Up to 2011	**-**	1,532	**-**	1,532
		2011 - 2012	**1,850**	1,110	**1,850**	1,110
		2013 - 2019	**1,191**	1,164	**1,191**	1,164
		2020 - 2029	**-**	5,013	**-**	5,013
	4.00% - 5.99%	2013 - 2019	**1,013**	999	**1,013**	999
		2020 - 2029	**2,330**	-	**2,330**	-
Other currencies	0.00% - 5.99%	Up to 2011	**-**	9	**-**	9
		2013 - 2019	**445**	249	**445**	249
		2020 - 2029	**173**	177	**173**	177
	6.00% - 6.99%	Up to 2011	**-**	8	**-**	8
		Up to 2012	**-**	5	**-**	5
			26,980	33,659	**23,906**	29,226

32. SUBORDINATED LIABILITIES

	Group	
	2011	2010
	£m	£m
Dated subordinated liabilities:		
11.50% Subordinated guaranteed bond 2017	**-**	166
10.125% Subordinated guaranteed bond 2023	**-**	165
	-	331

On 25 May 2011, all of the outstanding liabilities were redeemed at a redemption price equal to 100% of the principal amount thereof, together with the accrued interest thereon as part of a restructuring of Santander UK. In common with other debt securities issued by Group companies, the subordinated liabilities were redeemable in whole at the option of the respective Group companies, on any interest payment date, in the event of certain tax changes affecting the treatment of payments of interest on the subordinated liabilities in the UK, at their principal amount together with any accrued interest. The subordinated liabilities were guaranteed by Santander UK plc.

The securities in this Note would, in the event of the winding-up of the issuer, be subordinated to the claims of all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities was determined in respect of the issuer and any guarantors of that liability.

The Group did not have any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2010: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the UK Financial Services Authority.

Subordinated liabilities were repayable:

	Group	
	2011	2010
	£m	£m
In more than 5 years	**-**	331

The Company did not hold any subordinated liabilities during the year (2010: £nil)

33. OTHER LIABILITIES

	Group		Company	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Trade and other payables	**39**	91	**34**	82
Accrued expense	**103**	100	**103**	100
	142	191	**137**	182

34. PROVISIONS

	Group
	Total
	£m
At 1 January 2011	**-**
Additional provisions	**20**
Used during the year	**-**
At 31 December 2011	**20**
To be settled:	
Within 12 months	**20**
In more than 12 months	**-**
	20

Notes to the Financial Statements continued

	Company Total £m
At 1 January 2011	**-**
Additional provisions	**20**
Used during the year	**-**
At 31 December 2011	**20**
To be settled:	
Within 12 months	**20**
In more than 12 months	**-**
	20

The charge disclosed in the income statement in respect of provisions for other liabilities and charges of £20m (2010: £nil), comprises the additional provisions of £20m (2010: £nil), relating to the UK Bank Levy. There were no provisions at 1 January or 31 December 2010.

UK Bank Levy

The Finance Act 2011 introduced an annual bank levy in the UK. The levy is collected through the existing quarterly Corporation Tax collection mechanism starting with payment dates on or after 19 July 2011.

The levy is based on the total aggregated chargeable equity and liabilities as reported in the balance sheet of a Relevant Group at the end of a chargeable period. The Relevant Group for this purpose is a Foreign Banking Group whose ultimate parent is Banco Santander, S.A.. The Bank Levy is calculated principally on the aggregation of the consolidated balance sheet of the UK sub-group parented by Santander UK plc, of which this Company is a part.

The first chargeable period for the Group was the year ended 31 December 2011. In determining the chargeable equity and liabilities the following amounts are excluded: adjusted Tier 1 capital; certain "protected deposits" (for example those protected under the Financial Services Compensation Scheme); liabilities that arise from certain insurance business within banking groups; liabilities in respect of currency notes in circulation; Financial Services Compensation Scheme liabilities; liabilities representing segregated client money; and deferred tax liabilities, current tax liabilities, liabilities in respect of the levy, revaluation of property liabilities, liabilities representing the revaluation of business premises and defined benefit retirement liabilities. It is also permitted in specified circumstances to reduce certain liabilities: by netting them against certain assets; offsetting assets on the relevant balance sheets that would qualify as high quality liquid assets (in accordance with the FSA definition); and repo liabilities secured against sovereign and supranational debt.

The levy will be set at a rate of 0.088% from 2012. Three different rates applied during 2011, these average to 0.075%. Certain liabilities are subject to only a half rate, namely any deposits not otherwise excluded (except for those from financial institutions and financial traders) and liabilities with a maturity greater than one year at the balance sheet date. The levy is not charged on the first £20bn of chargeable liabilities of the Relevant Group.

The cost of the levy to the Group for 2011 was £20m for which there is a provision of liability at 31 December 2011 as the payments are made by Santander UK plc on behalf of the UK subgroup and no recharge of the payment to the Company has yet been made.

35. CONTINGENT LIABILITIES AND COMMITMENTS

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

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Guarantees given on behalf of the Company's UK parent, fellow subsidiaries and subsidiaries	**150,742**	151,558	**153,811**	155,993
Guarantees given to third parties	**457**	112	**457**	112
Formal standby facilities, credit lines and other commitments:				
– Original term to maturity of one year or less	**678**	684	**678**	684
– Original term to maturity of more than one year	**8,601**	6,983	**8,601**	6,983
	160,478	159,337	**163,547**	163,772

Guarantees given on behalf of the Company's parent

The Company has fully and unconditionally guaranteed the obligations of Santander UK plc, its immediate parent company, that have been, or will be incurred before 31 July 2012. A copy of this guarantee in included on pages 135 to 137.

Guarantees given to fellow subsidiaries and subsidiaries
Via the guarantee given to the Company's parent described above, the Company has also indirectly guaranteed the obligations of Cater Allen Limited, Abbey National International Limited, Alliance & Leicester International Limited, A&L Services Limited (formerly Bradford & Bingley International Limited) and Abbey National North America LLC, that have been or will be incurred before 31 July 2012.

Formal standby facilities, credit lines and other commitments
Standby facilities, credit lines and other commitments are granted by Corporate Banking. Corporate facilities comprise standby facilities which are subject to the ongoing compliance with covenants and the provision of agreed security, failure to comply with these terms can result in the withdrawal of the unutilised facility headroom.

Overseas tax claim
A claim was filed against the Company by tax authorities abroad in relation to the refund of certain tax credits and other associated amounts. Following modifications to the demand, its nominal amount stands at £69m at the balance sheet exchange rate (2010: £71m). At 31 December 2011, additional interest in relation to the demand could amount to £37m at the balance sheet exchange rate (2010: £35m). A favourable judgement for the Company was handed down at first instance in September 2006 which was appealed against by the tax authorities in January 2007. In June 2010, the Court ruled in favour of the tax authorities. Abbey National Treasury Services plc appealed against the ruling and in December 2011 the tax authorities confirmed their intention to contest the appeal. Although this matter remains in dispute, in January 2012 £67m was paid in respect of this matter further to a demand from the tax authorities, which had previously been provided.

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

Other
As part of the sale of subsidiaries, and as is normal in such circumstances, the Group has given warranties and indemnities to the purchasers.

Obligations under stock borrowing and lending agreements
Obligations under stock borrowing and lending agreements represent contractual commitments to return stock borrowed. These obligations totalled £10,850m at 31 December 2011 (2010: £9,751m) and are offset by a contractual right to receive stock under other contractual agreements.

Other off-balance sheet commitments
The Group has commitments to lend at fixed interest rates which expose it to interest rate risk.

Operating lease commitments

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Rental commitments under non-cancellable operating leases expiring:				
- No later than 1 year	**5**	5	**5**	5
- Later than 1 year but no later than 5 years	**17**	16	**17**	16
- Later than 5 years	**19**	21	**19**	21
	41	42	**41**	42

Group rental expense comprises:

	Group	
	2011 £m	2010 £m
In respect of minimum rentals	**5**	5
Less: sub-lease rentals	**-**	-
	5	5

Included in the above Group rental expense was £nil (2010: £nil) relating to contingent rent expense.

Appropriate provisions are maintained to cover the above matters.

Notes to the Financial Statements continued

36. SHARE CAPITAL

	Ordinary shares of £1 each £m	Tracker shares of £1 each £m	B Tracker shares of £1 each £m	Total £m
Issued and fully paid share capital:				
At 1 January and 31 December 2011 and 2010	**2,549**	**-**	**-**	**2,549**

In 2008, the Company issued 1,000 Tracker Shares of £1 each at par to its parent company for £1,000. The Tracker Shares entitled the holders to dividends related to certain cashflows that were received by the Company in the period up to 7 April 2010. The Tracker Shares were not redeemable and did not confer any rights to participate in the assets of the company on winding up (beyond the amount subscribed). The Tracker Shares carried no voting rights.

During 2009, the Company entered into contractual arrangements relating to a proposed issue of B Tracker Shares. On 5 January 2010, the Company issued 1,000 B Tracker Shares of £1 each at par to its parent company for £1,000. The B Tracker Shares entitle the holders to dividends related to certain cashflows expected to be received by the Company in the period up to 31 December 2011. The B Tracker Shares are not redeemable and do not confer any rights to participate in the assets of the company on a winding up (beyond the amount subscribed). The B Tracker Shares carry no voting rights.

37. DIVIDENDS

Analysis of dividends declared is as follows:

	Group and Company		Group and Company	
	2011 Pence per share	2010 Pence per share	**2011 £m**	2010 £m
Ordinary shares (equity):				
Interim dividend	**-**	23.54	**-**	600
	-	23.54	**-**	600

In addition, the terms of the Tracker Shares and the B Tracker Shares are such that the issue of those shares (or in the case of the B Tracker Shares entry by the Company into contractual arrangements relating to the future issue of such shares) caused a derecognition of certain cashflows expected to be received by the Company. The amounts derecognised equate to the fair value of the cashflows involved and are shown in the Statement of Changes to Equity as amounts representative of contractual obligations for the year in which the derecognition occurs. Subsequent declaration and payment of dividends in respect of these cashflows is not further reflected in the Company's financial statements.

38. CONSOLIDATED CASH FLOW STATEMENT

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

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Profit for the year	**344**	460	**402**	670
Non-cash items included in net profit				
Depreciation and amortisation	**7**	6	**7**	6
Decrease/(increase) in prepayments and accrued income	**86**	(191)	**85**	(205)
(Decrease)/increase in accruals and deferred income	**(56)**	197	**(23)**	252
Impairment losses	**54**	80	**54**	80
Provisions for liabilities and charges	**20**	-	**20**	-
Corporation tax charge	**168**	149	**180**	138
Other non-cash items	**(174)**	(116)	**(85)**	(114)
Net cash flow (used in)/from trading activities	**449**	585	**640**	827
Changes in operating assets and liabilities				
Net increase in cash and balances held at central banks	**(5)**	-	**(5)**	-
Net decrease/(increase) in trading assets	**11,008**	(1,453)	**10,773**	(4,711)
Net decrease/(increase) in financial assets designated at fair value	**1,756**	5,560	**1,756**	5,560
Net (increase)/decrease in derivative assets	**(9,987)**	(36)	**(9,965)**	(148)
Net decrease/(increase) in loans and advances to banks and customers	**23,254**	34,002	**23,504**	32,320
Net decrease/(increase) in other assets	**362**	(34)	**30**	(2)
Net (decrease)/increase in deposits by banks and customers	**(22,660)**	(32,097)	**(24,375)**	(33,265)
Net increase/(decrease) in derivative liabilities	**10,374**	588	**10,374**	713
Net (decrease)/increase in trading liabilities	**(17,068)**	(3,310)	**(17,068)**	29,500
Net decrease in financial liabilities designated at fair value	**(185)**	(669)	**(184)**	(673)
Net (decrease)/increase in debt issued	**(1,291)**	(1,413)	**-**	761
Net (decrease)/increase in other liabilities	**(132)**	45	**(132)**	140
Effects of exchange rate differences	**(417)**	399	**(685)**	154
Net cash flow (used in)/from operating activities before tax	**(4,542)**	2,167	**(5,337)**	31,176
Income tax paid	**(13)**	(28)	**(13)**	(17)
Net cash flow (used in)/from operating activities	**(4,555)**	2,139	**(5,350)**	31,159

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

	Group		Company	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Cash and balances at central banks	**7,013**	5,088	**7,013**	5,088
Less: regulatory minimum cash balances (See Note 13)	**(18)**	(13)	**(18)**	(13)
	6,995	5,075	**6,995**	5,075
Debt securities - Trading	**4,093**	2,604	**4,093**	2,604
Loans and advances to banks - Trading	**3,140**	5,171	**3,140**	5,171
Loans and advances to customers - Trading	**6,360**	8,656	**6,360**	8,653
Net trading other cash equivalents	**13,593**	16,431	**13,593**	16,428
Loans and advances to banks - Non trading	**59,270**	65,223	**59,159**	65,209
Net non-trading other cash equivalents	**59,270**	65,223	**59,159**	65,209
Cash and cash equivalents at year end	**79,858**	86,729	**79,747**	86,712

Notes to the Financial Statements continued

39. ASSETS CHARGED AS SECURITY FOR LIABILITIES AND COLLATERAL ACCEPTED AS SECURITY FOR ASSETS

The following transactions are conducted under terms that are usual and customary to collateralised transactions, including, where relevant, standard securities lending and repurchase agreements.

a) Financial assets pledged to secure liabilities

The financial assets below are analysed between those assets accounted for on the balance sheet and off-balance sheet in accordance with IFRS.

	Group	
	2011 £m	2010 £m
On balance sheet:		
Treasury bills and other eligible securities	**6,141**	11,800
Cash	**3,004**	2,409
Debt securities	**129**	157
Equity securities	**321**	427
	9,595	14,793
Off balance sheet:		
Treasury bills and other eligible securities	**14,046**	24,344
Debt securities	**17,217**	11,408
Equity securities	**196**	116
	31,459	35,868

The Group provides assets as collateral in the following areas of the business.

Sale and repurchase agreements
The Company and certain of its subsidiaries enter into sale and repurchase agreements and similar transactions of equity and debt securities, which are accounted for as secured borrowings. Upon entering into such transactions, the Company and subsidiaries provide collateral equal to 100%-131% of the borrowed amount. The carrying amount of assets that were so provided at 31 December 2011 was £26,232m (2010: £39,637m).

Stock borrowing and lending agreements
Asset balances under stock borrowing and lending agreements represent stock lent by the Group. These balances amounted to £12,180m at 31 December 2011 (2010: £9,192m) and are offset by contractual commitments to return stock borrowed or cash received.

Derivatives business
In addition to the arrangements described above, collateral is also provided in the normal course of derivative business to counterparties. At 31 December 2011, £2,642m (2010: £1,832m) of such collateral in the form of cash had been provided by the Group and is included in the table above.

b) Collateral held as security for assets:

	Group	
	2011 £m	2010 £m
On balance sheet:		
Trading liabilities	**3,004**	1,149
	3,004	1,149
Off balance sheet:		
Trading liabilities	**20,078**	48,706
Deposits by banks	**2,054**	1,660
	22,132	50,366

Purchase and resale agreements
The Company and certain of its subsidiaries also enter into purchase and resale agreements and similar transactions of equity and debt securities, which are accounted for as collateralised loans. Upon entering into such transactions, the Company and subsidiaries receive collateral equal to 100%-105% of the loan amount. The level of collateral held is monitored daily and if required, further calls are made to ensure the market values of collateral remains at least equal to the loan balance. The Company and subsidiaries are permitted to sell or repledge the collateral held in the absence of default. At 31 December 2011, the fair value of such collateral received was £11,776m (2010: £40,860m), almost all of which was sold or repledged. The Company and its subsidiaries have an obligation to return collateral that they have sold or pledged.

Structured transactions
As part of structured transactions entered into by the Company and certain subsidiaries, assets are received as collateral. At 31 December 2011, the fair value of such collateral received was £526m (2010: £1,003m). Of the collateral received £526m (2010: £1,003m) was sold or repledged, which the subsidiaries have an obligation to return.

Stock borrowing and lending agreements
Obligations under stock borrowing and lending agreements represent contractual commitments to return stock borrowed. These obligations totalling £9,830m at 31 December 2011 (2010: £8,503m) and are offset by a contractual right to receive stock lent by the Group.

Derivatives business
In addition to the arrangements described above, collateral is also received in the normal course of derivative business from counterparties. At 31 December 2011, £2,642m (2010: £1,149m) of such collateral in the form of cash had been received by the Group and is included in the table above.

Lending activities
In addition to the above collateral held as security for assets, the Group may obtain a charge over a customer's property in connection with its lending activities. Details of these arrangements are set out in the "Credit Risk" section of Note 44.

40. PENSIONS AND OTHER POST-RETIREMENT BENEFITS

The Group participates in various Santander UK defined benefit and defined contribution pension schemes in operation. Details of the schemes are disclosed in the Annual Report and Accounts of Santander UK plc. There is no contractual agreement of stated policy for charging the net defined benefit cost of the Santander UK defined benefit schemes. Therefore, in accordance with IAS 19, the defined benefit asset or liability has been recognised in the financial statements of the sponsoring employer of the scheme and the Group accounts for its contributions as a defined contribution scheme. The contribution to be paid by the Group is calculated as the contributions made by Santander UK plc to the schemes in respect of the Group's employees. An amount of £5m (2010: £41m) was recognised as an expense for these contributions and is included in staff costs within administration expenses in the income statement.

41. RELATED PARTY DISCLOSURES

Transactions with Directors, Key Management Personnel and their connected persons
There were no other related party transactions during the year, or existing at the balance sheet date other than those disclosed below with the Company or parent company's Key Management Personnel. Key Management Personnel are defined as the Directors of the Company.

Remuneration of Key Management Personnel
The remuneration of the Directors is set out in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. Further information about the aggregate remuneration of the Directors is provided in Note 10.

Key management compensation	**2011** **£**	2010 £
Short-term employee benefits	**1,503,860**	1,342,305
Post employment benefits	**75,298**	44,523
Share-based payments	**68,075**	116,711
Total key management compensation	**1,647,233**	1,503,539

Of the Directors that served during the year, three were remunerated in relation to their services as directors of this Company and the amounts included above are based on an estimated time allocation basis.

Santander Long-Term Incentive Plan
Information about the Santander Long-Term Incentive Plan is provided in Note 10.

Notes to the Financial Statements continued

Parent undertaking and controlling party

The Company's immediate parent is Santander UK plc. The ultimate parent and controlling party is Banco Santander, S.A., a company incorporated in Spain. The smallest and largest groups into which the Company's results are included are the group accounts of Santander UK plc and Banco Santander, S.A. respectively. A copy of the accounts of Santander UK plc may be obtained from Secretariat, Santander UK plc, 2 Triton Square, Regent's Place, London NW1 3AN. A copy of the accounts of Banco Santander, S.A. may be obtained from Santander Shareholder Relations, 2 Triton Square, Regent's Place, London NW1 3AN or on the Santander UK corporate website (www.aboutsantander.co.uk).

Transactions with related parties

Transactions with related parties during the year and balances outstanding at the year end:

								Group
	Interest, fees and other income received		Interest, fees and other expense paid		Amounts owed by related parties		Amounts owed to related parties	
	2011 £m	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m
Ultimate parent company	**(163)**	(322)	**12**	12	**4,991**	2,539	**(5,364)**	(2,326)
Immediate parent	**(3,169)**	(3,280)	**2,118**	1,998	**110,848**	144,799	**(94,801)**	(122,054)
Fellow subsidiaries	**(833)**	(499)	**448**	349	**31,644**	28,623	**(20,296)**	(20,921)
	(4,165)	(4,101)	**2,578**	2,359	**147,483**	175,961	**(120,461)**	(145,301)

								Company
	Interest, fees and other income received		Interest, fees and other expense paid		Amounts owed by related parties		Amounts owed to related parties	
	2011 £m	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m
Ultimate parent company	**(107)**	(313)	**12**	11	**4,991**	2,539	**(5,360)**	(2,326)
Immediate parent	**(3,156)**	(3,188)	**2,118**	1,998	**110,848**	144,467	**(94,800)**	(122,003)
Subsidiaries	**(88)**	(323)	**30**	29	**126**	433	**(5,163)**	(6,928)
Fellow subsidiaries	**(832)**	(496)	**448**	346	**31,638**	28,619	**(20,296)**	(20,910)
	(4,183)	(4,320)	**2,608**	2,384	**147,603**	176,058	**(125,619)**	(152,167)

The above transactions were made in the ordinary course of business and substantially on the same terms as for comparable transactions with third-party counterparties and within limits acceptable to the UK Financial Services Authority. Such transactions do not involve more than the normal risk of collectability or present any unfavourable features.

During 2010, euro 3,265m of the Group's holdings of AAA-rated prime mortgage-backed securities were sold to Banco Santander, S.A.. Although Banco Santander, S.A. is a related party of the Group, the transaction is considered to be a commercial deal, with a normal sharing of profits.

In October 2010, all of the existing activities of Cater Allen International Limited (a subsidiary of the Company) were transferred to the Company. In accordance with the Company's accounting policy of accounting for internal reorganisations, the assets and liabilities of Cater Allen International Limited were transferred to the Company at their book values in Cater Allen International Limited (after adjusting for inter-company balances) as described in Note 43.

In November 2010, the Group acquired a portfolio of loans to banks, asset-backed securities and related credit derivatives, as part of an alignment of portfolios across the Banco Santander group, this is described further in Note 44.

In December 2010, the Group acquired a £2.2bn portfolio of loan facilities, consisting of £0.5bn drawn balances and £1.7bn of undrawn facilities, from Banco Santander, S.A., as part of an alignment of portfolios across the Banco Santander group.

42. EVENTS AFTER THE BALANCE SHEET DATE

None.

43. TRANSFER OF THE ACTIVITIES OF CATER ALLEN INTERNATIONAL LTD TO ABBEY NATIONAL TREASURY SERVICES PLC IN 2010

In October 2010, all of the existing activities of Cater Allen International Limited (a subsidiary of the Company) were transferred to the Company. In accordance with the Company's accounting policy of accounting for internal reorganisations, the assets and liabilities of Cater Allen International Limited were transferred to the Company at their book values in Cater Allen International Limited.

	Company 2010
Net assets transferred:	£m
Assets	
Cash and balances at central banks	103
Trading assets	281
Liabilities	
Trading liabilities	(384)
Net assets	-

44. FINANCIAL RISKS AND RISK MANAGEMENT

This Note contains audited financial information except for the discussion of Operational Risk and Other Risks on pages 98 to 103.

Summary

The Group's risks are managed at a Santander UK level. This Risk Management section describes Santander UK's Risk Governance Framework, and includes more detail on the Company and the Group's key risks, on a segmental basis or aggregated where relevant. It is divided into the following sections:

Introduction - A description of the principles of risk management and Santander UK's Risk Governance Framework, including the three tiers of Risk Governance structure.

Economic capital - including analyses of the global risk profile, Return on Risk Adjusted Capital ('RORAC') and value creation.

Principal Risks and Risk Management - Definitions and key features of the principal risks facing the Group, together with responsibility for risk management, control and assurance are described on pages 72 and 74, consisting of:

> **Credit Risk**
> **Market Risk**
> **Funding and Liquidity Risk**
> **Operational Risk,** and
> **Other Risks**

Credit Risk - Disclosures about credit risk are described on pages 74 to 92, consisting of Group-wide disclosures followed by additional segmental disclosures:

> **Total credit risk exposures and maximum exposure to credit risk** - including discussions of measurement tools, the credit risk cycle, and credit risk from other standpoints, particularly significant concentrations.
> **Segmental disclosures about credit risk:**
  > **Corporate Banking**, including forbearance
  > **Markets**, and
  > **Asset and Liability Management**

Market Risk - Segmental disclosures about market risk are described on pages 92 to 96, consisting of:

> **Corporate Banking**
> **Markets**, and
> **Asset and Liability Management**

Funding and Liquidity Risk - A description of the funding and liquidity risk the Group faces, along with their management and activity can be found on pages 97 to 98.

Operational Risk - Descriptions of operational risk management and key operational risk activity, as well as regulatory, legal and compliance risk can be found on page 98 to 102.

Other Risks - Descriptions of how business/strategic risk and reputational risk are managed can be found on pages 102 to 103.

Financial Instruments of Special Interest - Detailed disclosures can be found on page 104, including a description of the Group's exposures to certain classes of financial assets and off-balance sheet entities.

Notes to the Financial Statements continued

Introduction

The Group follows the same risk management structure as Santander UK. The Group is driven by the core Santander UK Markets and Corporate Banking businesses. In addition the ALM business is booked in the Company. In terms of governance, authority for risk management flows from the Santander UK Board to the Board of Directors of the Company.

In addition, Santander UK plc has given a full and unconditional guarantee in respect of the liabilities of the Group incurred prior to 31 July 2012. The Group has given a reciprocal guarantee in respect of the liabilities of Santander UK plc. As a consequence of this cross guarantee the Group is exposed to the same risk factors as Santander UK.

The Group accepts that risk arises from its full range of activities and actively manages and controls it. The management of risk is an integral part of the Group's activities. Risk is defined as the uncertainty around the Group's ability to achieve its business objectives and execute its strategy effectively. Risk constitutes the Group's exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse impacts on profitability arising from different sources of uncertainty. The key risks the Group is exposed to are credit (including residual credit and concentration), market (including trading and non-traded), funding and liquidity, operational and other risks (including business/strategic and reputational). Risk measurement is used to capture the source of the uncertainty and the magnitude of its potential effect on the profitability and solvency of the Group. Effective risk management and control is therefore of fundamental importance to the Group's long-term success.

Understanding and controlling risk is critical for the effective management of the business. Santander UK's Risk Framework aims to ensure that risk is managed and controlled on behalf of shareholders, customers, depositors, employees and the Group's regulators. Effective and efficient risk governance and oversight provide management with assurance that the Group's business activities will not be adversely impacted by risks that could have been reasonably foreseen. This in turn reduces the uncertainty of achieving the Group's strategic objectives.

Principles of Risk Management

Risk management at Santander UK is based on the following principles:

> **Independence of the risk function with respect to the business areas.** The segregation of functions between the business areas (which assume risk) and the risk areas responsible for risk measurement, analysis, control and reporting provides sufficient independence and autonomy for proper risk control.

> **Involvement of senior management.** Santander UK's risk committee and senior management committees are structured so as to involve senior management in the overall risk oversight process. This risk oversight process by the Santander UK Risk division supports the Santander UK Board's overall provision of risk oversight.

> **Risk division as a decision maker.** Decisions on credit transactions jointly reviewed by the risk and commercial areas. However, as the Santander UK Risk division is independent, it is ultimately the decision maker.

> **Definition of powers.** The type of activities to be performed, segments, risks to be assumed and risk decisions to be made are clearly defined for each risk taking unit and, if appropriate, for each risk management unit, based on their delegated powers. How transactions and products should be structured, arranged, managed and where they should be accounted for is also defined.

> **Risk measurement.** Risk measurement takes into account all risk exposures assumed across the business spectrum. It uses measures based on risk components and dimensions, over the entire risk cycle, for the management of risk at any given time. From a qualitative standpoint, this integrated vision translates into the use of certain integrating measures, which are mainly the risk capital requirement and return on risk-adjusted capital ('RORAC').

> **Limitation of risk.** The limitation of risk is intended to limit, in an efficient and comprehensive manner, the maximum levels of risk for the various risk measures. It is based on a knowledge of the risks incurred and supported by the necessary infrastructure for risk management, control and reporting. It also ensures that no undesired risks are assumed and that the risk-based-capital charge, risk exposures and losses do not exceed, in any case, the approved maximum levels.

> **Establishment of risk policies and procedures.** The risk policies and procedures represent the basic regulatory framework, consisting of frameworks, policies and operating rules, through which risk activities and processes are regulated.

> **Definition and assessment of risk methodologies.** Risk methodologies provide the definitions of the internal risk models applicable to Santander UK and, therefore, stipulate the risk measures, product valuation methods, yield curve and market data series building methods, calculation of risk-based capital requirements and other risk analysis methods, together with the respective calibration and testing processes.

Phases of risk management

The risk management and control process at Santander UK is structured into the following phases:

> Establishment of risk management frameworks and policies that reflect the principles and standards governing the general modus operandi of Santander UK's risk activities. These are based on a corporate risk management framework, which comprises the organisational model and the management model, and on a series of more specific corporate frameworks of the functions reporting to the Santander UK Risk Division. The Santander UK Risk Division transposes corporate risk regulations into its internal policies and develops the procedures required to implement them.

> Definition of Santander UK's risk appetite by setting overall and specific limits for the various types of risks, products, customers, groups, sectors and geographical locations.

> Identification of risks, through the constant review and monitoring of exposures, the assessment of new products, businesses and the specific analysis of singular transactions, or events.

> Measurement of risks using methodologies and models implemented subject to a validation and approval process.

Key techniques and tools

For many years, Santander UK has managed risk using a number of techniques and tools which are described in detail in various sections of this report. The key techniques and tools used are as follows:

> Internal ratings and scorings-based models which, by assessing the various qualitative and quantitative risk components by customer and transaction or product, make it possible to estimate, initially, the probability of default and, subsequently, the expected loss, based on estimates of loss given default. For operational risk, risks are assessed by self-assessments, supplemented by use of loss data and subjected to review at least annually.

> Economic capital, as a homogeneous measure of the risk assumed and a basis for the measurement of the management performed.

> Return on risk-adjusted capital ('RORAC'), which is used both as a transaction and product pricing tool (bottom-up approach) and in the analysis of portfolios and units (top-down approach).

> Value at Risk ('VaR'), which is used for controlling market risk and setting the market risk limits for the various trading portfolios.

> Scenario analysis and stress testing to supplement market, credit and operational risk analyses in order to assess the impact of alternative scenarios, even on impairment loss allowances and capital.

Risk Governance Framework

Santander UK adopts a three-tier risk governance framework that establishes responsibilities for:

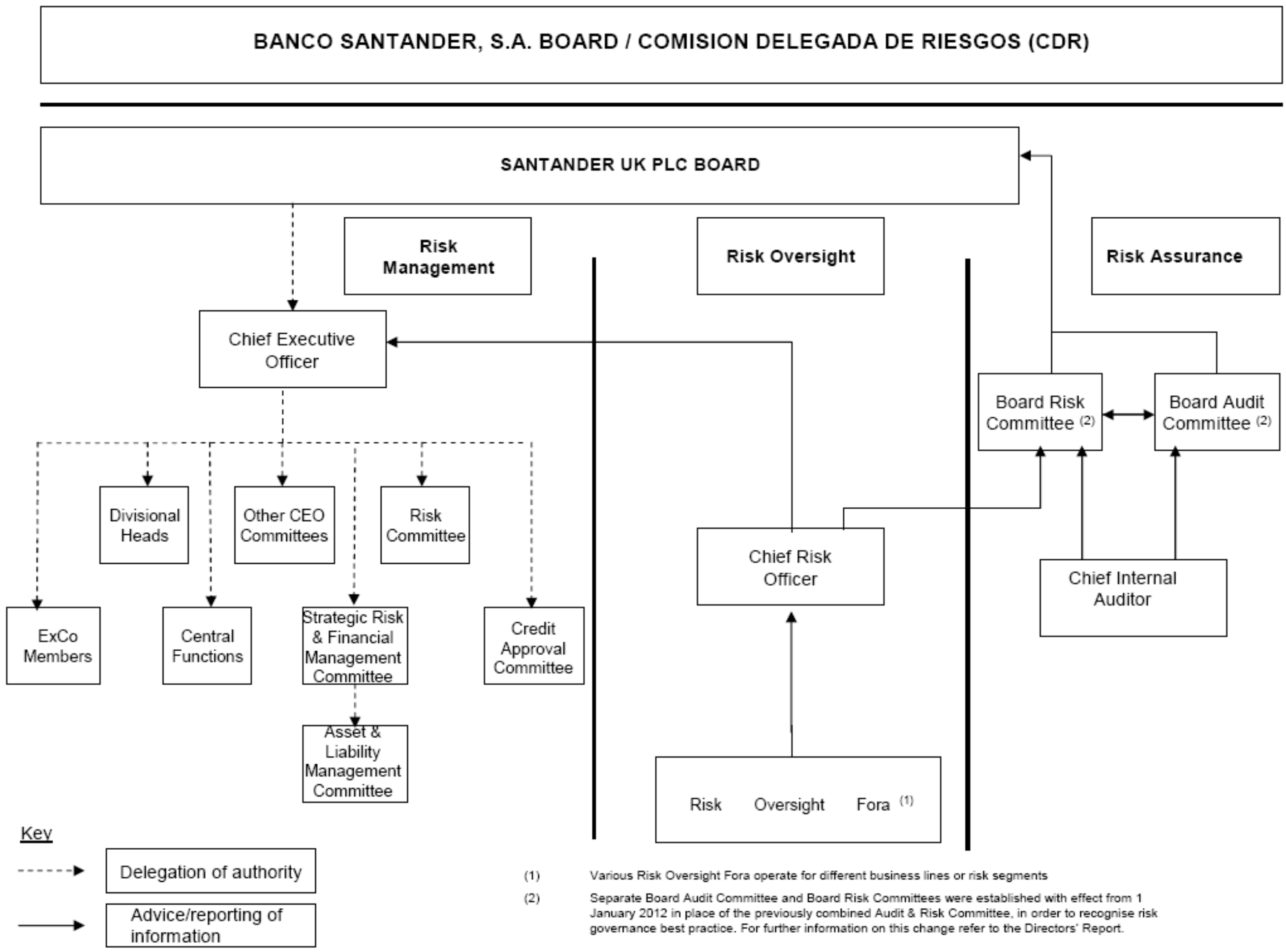
> Risk management;
> Risk oversight; and
> Risk assurance.

This ensures segregation of duties between those who take on risk, those who control risk and those who provide assurance. The framework is based on the following five principles:

> Clearly allocating accountability for risk;
> Embedded risk culture, starting at the highest levels of the organisation;
> Creating shareholder value;
> Independent risk assurance and transparency; and
> Embedding UK Financial Services Authority 'Treating Customers Fairly' principles into policies and processes.

Notes to the Financial Statements continued

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



(1) Various Risk Oversight Fora operate for different business lines or risk segments

(2) Separate Board Audit Committee and Board Risk Committees were established with effect from 1 January 2012 in place of the previously combined Audit & Risk Committee, in order to recognise risk governance best practice. For further information on this change refer to the Directors' Report.

Authority for Risk Management flows from the Santander UK plc Board of Directors (the 'Santander UK Board') to the Chief Executive Officer and from her to specific individuals. Formal standing committees are maintained for effective management or oversight. Their authority is derived from the person they are intended to assist.

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

The future of the framework

A new framework was approved in principle by the Santander UK Board in November 2011 and the detailed operational structure is in the process of finalisation. This revised framework will further strengthen the risk management controls. Once finalised, implementation will be undertaken throughout 2012.

The main elements of risk governance within Santander UK are as follows:

First tier of risk governance in Santander UK

Leadership in risk management is provided by the Santander UK Board. It approves Santander UK's Risk Appetite Statement which is set principally through economic capital measures for each risk type in consultation with Banco Santander, S.A. as appropriate. The Santander UK Board also approves the strategy for managing risk and is responsible for Santander UK's system of internal control. The Santander UK Board is supported by the Chief Executive Officer and Executive Committee members who have primary responsibility for understanding, identifying, and owning the risks generated by their lines of business and establishing a framework for managing those risks within the Board-approved risk appetite of Santander UK. In addition, understanding, identifying and owning the risks generated by Santander UK's operations are the responsibility of the Divisional Heads and central functions. These functions provide technical support and advice to assist in the management and control of risk. Within this tier, there is a process for transaction review and approval within certain thresholds, discharged by the Credit Approvals Committee ('CAC'), a specific committee established under the authority of the Chief Executive Officer. Transactions which exceed the threshold limits set are reviewed by Banco Santander, S.A.'s Risk Division before final approval by the CAC.

Santander UK Risk Committee

The Santander UK Risk Committee is a management committee, established under the authority of and chaired by the Chief Executive Officer.

The Santander UK Risk Committee is responsible for a more detailed allocation of Santander UK's risk appetite, proposing Santander UK's risk policy for approval by the Chief Executive Officer, the Executive Committee and the Santander UK Board. It makes decisions on risk issues within its governing and supervisory powers. Furthermore, the Santander UK Risk Committee ensures that Santander UK's activities are consistent with its risk tolerance level and establishes limits for the main risk exposures, which it reviews systematically.

The Chief Risk Officer advises the Santander UK Risk Committee in connection with its work on the following matters:

a) Review
The Santander UK Risk Committee reviews:

> the Risk Report on a monthly basis. The Risk Report is prepared by the Santander UK Risk Division and highlights all significant risk issues affecting Santander UK;
> recommendations made by the Chief Risk Officer and the Risk Oversight Fora ('ROF'), and escalates them to the Executive Committee or the Santander UK Board as appropriate;
> risk mandates, where appropriate, on an annual basis;
> changes in risk policy or appetite that may be recommended by relevant parties from time to time; and
> developments and changes in legal and regulatory requirements and the implications for risk management and control.

b) Advise and recommend
The Santander UK Risk Committee gives advice and recommends action relating to all risk issues to Executive Committee members (individually and collectively). After review, it recommends approval of the:

> Risk Framework;
> Risk Appetite; and
> Escalation of risk policy issues that lie outside its authority to approve.

c) Approve
The Santander UK Risk Committee approves:

> risk delegations;
> risk policy changes that do not require Santander UK Board approval; and
> risk mandates, where appropriate.

In addition, with respect to the Basel II Internal Rating Based ('IRB') approach, the Santander UK Risk Committee:

> Approves all material aspects of the rating and estimation process, where an IRB model has been developed locally and is therefore subject to local validation and local supervisory review;
> Reviews the roles and responsibilities of the relevant risk functions and the internal/external audit functions; and
> Reviews the associated management reports.

Where an IRB model has been developed and approved by Banco Santander, S.A. and therefore has been approved by the Banco de España (the Bank of Spain, the Spanish central bank), the responsibility of the Santander UK Risk Committee is to ratify the model, noting its applicability and relevance to the local environment. With the emergence of the up and coming milestones for the implementation of Basel III, there will be implications on the risk management processes relating to capital requirements, leverage ratios and liquidity requirements. New and updated processes are being constructed to ensure Santander UK's risk management structure fully complies with the new standards.

Second tier of risk governance in Santander UK

Risk control is provided by the Santander UK Board independently supported by the Santander UK Risk Division. The roles of the Chief Risk Officer, the Deputy Chief Risk Officer and the Santander UK Risk Division include development of risk measurement methodologies, risk approval, risk monitoring, risk reporting and escalation of risk issues in line with the relevant risk policy for all risks across the Group's lines of Corporate Banking, Markets and ALM businesses.

Dedicated Business ROFs advise and support the Chief Risk Officer in fulfilling his risk control responsibilities and help to ensure that risks are suitably understood.

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

Notes to the Financial Statements continued

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

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

Third tier of risk governance in Santander UK

Risk assurance provides independent objective assurance on the effectiveness of the management and control of risk across Santander UK. This is provided through the Santander UK Non-Executive Directors, Santander UK Board Risk Committee, Santander UK Board Audit Committee and the Internal Audit function. The Santander UK Risk Committee will also receive advice from the Santander UK Board Audit Committee on any matters within its remit which impact on Santander UK's risk management, including the effectiveness of the Internal Audit function in the context of the overall risk management system.

Non-Executive Directors

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

Santander UK Board Risk Committee

The Santander UK Board Risk Committee is made up of independent Non-Executive Directors, and is a formally constituted committee of the Board. The Santander UK Board Risk Committee has responsibility primarily for:

> Oversight and advice to the Santander UK Board on the overall risk appetite, tolerance and risk strategy of Santander UK;
> Reviewing and advising the Santander UK Board on the risk governance framework;
> Review the effectiveness of the risk management systems and internal controls;
> Advising the Santander UK Board on the current risk exposures and future risk strategy;
> Reviewing Santander UK's capability to identify and manage new risk types; and
> Ensuring a supportive risk awareness culture is embedded throughout Santander UK.

Internal Audit

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

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

Santander UK Board Audit Committee

The Santander UK Board Audit Committee consists of independent Non-Executive Directors of Santander UK, and is a committee of the Santander UK Board. In addition to the responsibilities shown in the Director's Report of the Santander UK plc 2011 Annual Report, the Santander UK Board Audit Committee provides advice to the Santander UK Board Risk Committee on matters within its remit which impact on Santander UK's risk management including the effectiveness of the Internal Audit function in the context of the overall risk management system.

Economic capital

Economic capital is an internal measure of the minimum equity and preference capital required for Santander UK to maintain its credit rating based upon its risk profile. The concept of economic capital differs from that of regulatory capital, the latter being the capital required by capital adequacy regulations. Economic capital is calculated using the Banco Santander, S.A. economic capital model and is managed by Santander UK.

The economic capital model enables Santander UK to quantify the consolidated risk profile taking into account the significant risks of the business, as well as the diversification effect inherent in a multi-business group such as Santander UK. Santander UK uses this model to prepare the economic capital forecasts as part of its internal capital adequacy assessment report in accordance with the UK Financial Services Authority regulations within the framework of Pillar 2 of Basel II. Santander UK monitors the economic capital utilisation and its sufficiency on a monthly basis at the Santander UK Risk Committee.

The concept of diversification is fundamental to the proper measurement of the risk profile of a multi-business group. Diversification can be explained in terms of the imperfect correlation between the various risks, which means that the largest loss events do not occur simultaneously in all portfolios or for all types of risk. Consequently, the sum of the economic capital of the various portfolios and types of risk, taken separately, is higher than Santander UK's total economic capital. In other words, the risk borne by Santander UK as a whole is less than the risk arising from the sum of its various components considered separately.

The economic capital model also considers the concentration risk for corporate and markets portfolios, in terms of both the size of their exposure and their sector or geographic concentration. Product concentration in retail portfolios is captured through the application of an appropriate correlation model.

Risk appetite

The risk appetite is principally set by defining the economic capital limits by risk types. The Santander UK Board agrees on high level limits for each principal risk type. The authority for managing and monitoring the risk appetite then flows to the Chief Executive Officer and from her to specific individuals. The Chief Risk Officer is responsible for setting other limits to support the monitoring of Board-approved limits, which is in turn supported by the Santander UK Risk Division and the Risk Oversight Fora.

The Risk Appetite Statement is recommended by the Chief Executive Officer and approved by the Santander UK Board, under advice from the Santander UK Board Risk Committee. The Risk Appetite Statement is reviewed by the Santander UK Board at least annually or more frequently if necessary (e.g. in the case of significant methodological change). This ensures that the risk appetite continues to be consistent with Santander UK's current and planned business activities. The Chief Executive Officer under advice from the Santander UK Risk Committee approves the detailed allocation of risk appetite to different businesses or portfolios. The Chief Risk Officer, supported by the Santander UK Risk Division, is responsible for the ongoing maintenance of the Risk Appetite Statement.

Living will

The Santander UK Board is responsible for Santander UK's Recovery and Resolution Plan ('RRP'). The RRP is required to be filed with the FSA and the Bank of England by 30 June 2012. In 2010, Santander UK was requested to be part of a pilot exercise and to prepare a draft RRP, following draft guidance issued by the FSA. The draft RRP was submitted to the FSA and the Bank of England in instalments during 2010 and early 2011.

Following new guidance issued by the FSA as part of a consultation paper in August 2011, the initial draft has been revised and re-submitted to the FSA and the Bank of England for their review. The Board will be asked to formally approve the final version, in advance of the filing deadline.

Return on risk-adjusted capital and value creation

Santander UK uses the RORAC methodology in its credit risk management, with the following activities and objectives:

- Calculation of economic capital requirement and of the return thereon for Santander UK's business units and for business segments and portfolios in order to facilitate an optimal allocation of economic capital.
- Budgeting of capital requirement and RORAC of Santander UK's business units.
- Analysis and setting of prices in the decision-making process for transactions or products, such as loan approval.

The RORAC methodology facilitates the comparison, on a consistent basis, of the performance of transactions, customers, portfolios and businesses. It also identifies those which achieve a risk-adjusted return higher than Santander UK's cost of capital, thus aligning risk management and business management with the aim of maximising value creation.

Notes to the Financial Statements continued

Principal Risks and Risk Management

The principal risks affecting Santander UK are discussed below. Risks are generally managed through tailored management policies within the business division or operating segment in which they are originated. Within Santander UK, these risks are divided into two populations:

> **Population 1**: Risks that are deemed to be material and are mitigated by a combination of internal controls and allocation of capital (both regulatory and economic).
> **Population 2**: Risks that are deemed to be material but where Santander UK seeks to mitigate its exposure primarily by its internal control arrangements rather than by allocation of capital.

All risks are classified as population 1 except for Funding and Liquidity risk and Reputational risk which are classified as population 2 risks.

Principal risks

The principal risks are:

Risk type	Definition
Credit Risk (including residual credit and concentration)	**Credit risk** is the risk of financial loss arising from the default of a customer or counterparty to which the Group has directly provided credit, or for which the Group has assumed a financial obligation, after realising collateral held. Credit risk includes residual credit risk, which arises when credit risk measurement and mitigation techniques prove less effective than expected. In addition, concentration risk, which is part of credit risk, includes large (connected) individual exposures, and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location or instrument type. Wholesale credit risk is managed through the assignment of dedicated credit analysts with responsibility over a portfolio of customers, a thorough understanding of the client's financial strengths and weaknesses, the utilisation of market standard documentation, the implementation of all risk mitigation available to the bank (i.e. collateral in the form of cash or securities, assignment of assets, general covenants) and the monitoring of trends in the portfolio quality through regular management reports.
Market Risk (including trading and non-traded)	**Market risk** is the risk of a reduction in economic value or reported income resulting from a change in the variables of financial instruments including interest rate, equity, credit spread, property and foreign currency risks. Market risk consists of trading and non-traded market risks. Trading market risk includes risks on exposures held with the intention of benefiting from short term price differences in interest rate variations and other market price shifts. Non-traded market risk includes interest rate risk in investment portfolios. The Group aims to actively manage and control market risk by limiting the adverse impact of market movements whilst seeking to enhance earnings within clearly defined parameters. The Market Risk Manual, which is reviewed and approved by the Chief Risk Officer (supported by the Deputy Chief Risk Officer) on an annual basis, sets the framework under which market risks are managed and controlled. Business area policies, risk limits and mandates are established within the context of the Market Risk Manual.
Funding and Liquidity Risk	**Funding risk** is the risk that the Group does not have sufficiently stable and diverse sources of funding, that funding structures are inefficient or that a funding programme such as debt issuance subsequently fails. For example, a securitisation arrangement may fail to operate as anticipated or the values of the assets transferred to a funding vehicle do not emerge as expected creating additional risks for the Group and its depositors. Risks arising from the encumbrance of assets are also included within this definition. **Liquidity risk** is the risk that the Group, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure them only at excessive cost In order to mitigate funding risk the Group utilises stable sources of funding such as longer term corporate deposits to fund its commercial balance sheet – consisting primarily of corporate lending. In addition a range of wholesale funding sources are used to supplement customer deposits and provide diversity of tenor, size and market. Liquidity risk is also mitigated through maintenance of a buffer of highly liquid securities and cash that may be realised at short notice and with minimal cost. Other marketable but less liquid securities are also held from which cash may be realised over longer time periods. A series of management actions are identified that can be taken in times of stress in order to further mitigate and manage liquidity risk.
Operational Risk	**Operational risk** is the risk of loss to the Group resulting from inadequate or failed internal processes, people and systems, or from external events. This includes regulatory, legal and compliance risk, financial crime risk, people risk and customer risk. Business areas use risk control assessments and risk indicators to monitor the likelihood of risks and give early warning signs of potential risk events. Control frameworks are reworked where preset risk thresholds are breached. Operational Risk events which do materialise are investigated to ensure the most appropriate actions are taken. All loss events are recorded and events above certain thresholds are mitigated. Rapid escalation to the most senior staff is mandatory for major incidents. Summaries of operational loss events are routinely reported to business committees, risk committees, and quarterly to the Executive Committee, with commentary on all the key mitigations being undertaken.

Other Risks	Other risks consist of business/strategic risk and reputational risk.
	Business/strategic risk is the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment. This includes pro-cyclicality and capital planning risk. The internal component is the risk related to implementing the strategy. The external component is the risk of the business environment change on the Group's strategy. Economically driven risks are assessed through management's stress testing programme of the Group and mitigation measures are implemented based on the resulting information. Other business/strategic risks are managed through the operational risk programme and the Risk Committee.
	Reputational risk is the risk of financial loss or reputational damage arising from treating customers unfairly, a failure to manage risk, a breakdown in internal controls or poor communication with stakeholders. This includes the risk of decline in the value of the Group's franchise potentially arising from reduced market share, complexity, tenor and performance of products and distribution mechanisms. The reputational risk arising from operational risk events is managed within the operational risk framework. The principal areas of reputational risk are managed through attention to customer and client interests, and through ensuring adherence to laws and regulations.

Responsibility for risk management, oversight and assurance

Responsibility for supporting the Santander UK Board in risk management, oversight and risk assurance may be summarised by principal risk as follows:

	Risk Management	Risk Oversight	Risk Assurance
	Board		
Credit (including residual credit and concentration)	Corporate Banking, Markets and ALM	Risk Division - Credit Risk Department	Board Risk Committee Board Audit Committee Internal Audit
Market (including trading and non-traded)	Corporate Banking, Markets and ALM	Risk Division - Market Risk Department	
Funding and Liquidity			
- Funding	ALM	Risk Division – Market Risk Department	
- Liquidity	ALM	Risk Division - Market Risk Department	
Operational			
- Non-regulatory	All	Risk Division - Operational Risk Department(1)	
- Regulatory	All	Finance Department Compliance Department	
Other			
- Business/strategic	CEO supported by Executive Committee	Chief Risk Officer	
- Reputational	CEO supported by Executive Committee	Chief Risk Officer	

(1) Known as Enterprise and Operational Risk Department, prior to a restructuring in July 2011.

Use of outsourcing

Following the outsourcing of key IT and operations processes (including information technology support, maintenance and consultancy services in connection with Partenon, the global banking informational technology platform utilised by Banco Santander, S.A. to which the Group transitioned in 2008) to Banco Santander, S.A. group companies, risk governance of these entities is crucial. The Group uses written service level agreements with these entities that include key service performance metrics to support this governance. The high-level governance processes include relationship management, service delivery management and contract management. Across these, there are a number of more detailed processes including:

> Policy processes acceptance, development and implementation,
> Compliance,
> Dispensation,
> Performance management,
> Business control,
> Change control,
> Environment management, and
> Billing analysis and review

Notes to the Financial Statements continued

The Group works closely, and continues to enhance its interaction, with outsourced service providers via the application of appropriate risk frameworks. These frameworks include processes and procedures designed to ensure that, with appropriate periodicity, arrangements are in place to ensure continuity of critical services up to and including disaster scenarios and that these plans are regularly validated through testing.

Credit Risk

Definition

Credit risk is the risk of financial loss arising from the default of a customer or counterparty to which the Group has directly provided credit or for which the Group has assumed a financial obligation after realising collateral held. Credit risk includes residual credit risk which arises when credit risk measurement and mitigation techniques prove less effective than expected. In addition concentration risk which is part of credit risk includes large (connected) individual exposures and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors e.g. sector, economy, geographical location or instrument type.

Treatment of credit risk

The specialisation of Santander UK's risk division is based on the type of customer and, accordingly, a distinction is made between non-standardised customers and standardised customers in the risk management process:

> Non-standardised customers are defined as those to which a risk analyst has been assigned. This category includes medium and large corporate customers and financial institutions. Risk management is performed through expert analysis supplemented by decision-making support tools based on internal risk assessment models.

> Standardised customers are those which have not been expressly assigned a risk analyst. This category generally includes individuals and small businesses not classified as non-standardised customers. Management of these risks is based on internal risk assessment and automatic decision-making models, and supported by teams of analysts specialising in this type of risk.

Total credit risk exposures

The Group's exposures to credit risk arise in the following businesses:

> Corporate exposures consist of loans, bank accounts, treasury services, asset finance, cash transmission, trade finance and invoice discounting to large corporates, small and medium-sized ('SME') UK companies and specialist businesses. Corporate exposures are managed by the Corporate Banking division.

> Sovereign exposures consist of deposits with central banks, loans and debt securities issued or guaranteed by central and local governments. Sovereign exposures are managed and monitored by the Strategic Risk and Financial Management Committee ('SRFM') in the Asset and Liability Management area of the Group Infrastructure division and by the Short Term Markets desk in the Corporate Banking division.

Other exposures arise in connection with a variety of purposes:

> As part of the Group's treasury trading activities, which are managed by the Corporate Banking and Markets divisions;

> For yield and liquidity purposes, including ALM; and

> In the Treasury asset portfolio which is being run down. This is managed by ALM.

Maximum exposure to credit risk

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

	2011 £m	2010 £m
Balances with central banks	**7,013**	5,088
Trading assets	**12,497**	21,034
Securities purchased under resale agreements	**11,464**	15,081
Derivative financial instruments	**33,224**	21,393
Financial assets designated at fair value	**4,710**	6,468
Loans and receivables securities	**278**	221
Loans and advances to customers	**38,826**	7,608
Loans and advances to banks	**111,152**	2,000
Other	**60**	131
Total exposure(1)	**219,224**	79,024

(1) In addition the Group is exposed to credit risk in respect of guarantees granted, loan commitments and stock borrowing and lending agreements. The estimated maximum exposure to credit risk is described in Note 35 to the Consolidated Financial Statements

Measures and measurement tools

Rating tools

The Group uses proprietary internal rating models to measure the credit quality of a given customer or transaction. Each rating relates to a certain probability of default or non-payment, determined on the basis of the Company's historical experience, with the exception of certain portfolios classified as "low default portfolios", where the probability is assigned using external sources, as described below.

Banco Santander, S.A. global rating tools are applied to the sovereign risk, financial institution and large corporates segments. Management of the rating tools for these segments is centralised at Banco Santander, S.A. group level, with rating calculation and risk monitoring purposes devolved to the Group under Banco Santander, S.A. group supervision. These tools assign a rating to each customer, which is obtained from a quantitative or automatic module, based on balance sheet ratios or macroeconomic variables, supplemented by the analyst's expert judgement. The ratings are reviewed at least annually or more frequently in the case of watchlist counterparts.

For non-standardised corporates and financial institutions, Banco Santander, S.A. has defined a single methodology for the construction of a rating in each country, based on an automatic module which includes an initial participation of the analyst that can be supplemented subsequently if required. The automatic module determines the rating in two phases, a quantitative phase and a qualitative phase. The latter is based on a corrective questionnaire which enables the analyst to modify the automatic score up or down in a controlled manner. The quantitative rating is determined by analysing the credit performance of a sample of customers and the correlation with their financial statements. Ratings assigned to customers are reviewed at least annually to include any new financial information available and the Group's experience in its banking relationship with the customer. The frequency of the reviews is increased when customers reach certain levels in the automatic warning systems or are classified as requiring special monitoring. The rating tools are also reviewed in order to progressively fine-tune the ratings they provide.

For standardised customers, both legal entities and individuals, the Group has scoring tools that automatically assign a score to the proposed transactions. The ratings are reviewed and updated periodically, depending on performance.

Credit risk parameters

The assessment of customers or transactions using rating or scoring systems constitutes a judgement of their credit quality, which is quantified through the probability of default ('PD'), in accordance with Basel II terminology. In addition to PD, the quantification of credit risk requires the estimation of other parameters, such as exposure at default ('EAD') and the percentage of EAD that will not be recovered (loss given default or 'LGD'). In estimating the risk involved in transactions, other factors such as any off-balance sheet exposure and collateral valuations are also taken into account.

The combination of these risk parameters (i.e. PD, LGD and EAD) enables calculation of the probable loss or expected loss ('EL'). The risk parameters also make it possible to calculate the Basel II regulatory capital.

For portfolios with limited internal default experience (e.g. banks) parameter estimates are based on alternative sources, such as market prices or studies conducted by external agencies gathering the shared experience of a sufficient number of entities. These portfolios are known as low default portfolios.

For all other portfolios, parameter estimates are based on internal risk models. The PD is calculated by observing the cases of new defaults in relation to the final rating assigned to customers or to the scoring assigned to the related transactions. The LGD is calculated by observing the recoveries of defaulted loans, taking into account not only the income and expenses associated with the recovery process, but also the timing thereof and the indirect costs arising from the recovery process. EAD is calculated by comparing the use of committed facilities at the time of default and their use under normal (i.e. performing) circumstances, so as to estimate the eventual extent of use of the facilities in the event of default.

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The parameters estimated for global portfolios (e.g. banks) are the same throughout the Banco Santander group. Therefore, a financial institution will have the same PD for a specific rating, regardless of the Banco Santander group entity in which the exposure is booked. By contrast, local portfolios (e.g. corporate loans) have specific score and rating systems. PDs are assessed specifically for each local portfolio.

Master scale of global ratings

The following tables are used to calculate regulatory capital. They assign a PD on the basis of the internal rating, with a minimum value of 0.03%. These PDs are applied uniformly throughout the Group in accordance with the global management of these portfolios. As can be seen, the PD assigned to the internal rating is not exactly equal for a same rating in both portfolios, although it is very similar in the tranches where most of the exposure is concentrated (i.e. in tranches of rating of more than six).

Probability of default

Large Corporate		Banks	
Internal Rating	Probability of default %	Internal Rating	Probability of default %
8.5 to 9.3	0.030	8.5 to 9.3	0.030
8.0 to 8.5	0.033	8.0 to 8.5	0.039
7.5 to 8.0	0.056	7.5 to 8.0	0.066
7.0 to 7.5	0.095	7.0 to 7.5	0.111
6.5 to 7.0	0.161	6.5 to 7.0	0.186
6.0 to 6.5	0.271	6.0 to 6.5	0.311
5.5 to 6.0	0.458	5.5 to 6.0	0.521
5.0 to 5.5	1.104	5.0 to 5.5	0.874
4.5 to 5.0	2.126	4.5 to 5.0	1.465
4.0 to 4.5	3.407	4.0 to 4.5	2.456
3.5 to 4.0	5.462	3.5 to 4.0	4.117
3.0 to 3.5	8.757	3.0 to 3.5	6.901
2.5 to 3.0	14.038	2.5 to 3.0	11.569
2.0 to 2.5	22.504	2.0 to 2.5	19.393
1.5 to 2.0	36.077	1.5 to 2.0	32.509
< 1.5	57.834	< 1.5	54.496

Credit risk cycle

The risk management process consists of identifying, measuring, analysing, controlling, negotiating and deciding on, as appropriate, the risks incurred in the Group's operations. The parties involved in this process are the risk-taking areas, senior management and the risk units.

The process begins at senior management level, through the Board of Directors, the Executive Committee and the Risk Committee, which establishes the risk policies and procedures, and the limits and delegations of authorities, and approves and supervises the scope of action of the risk function.

The risk cycle comprises three different phases:

> **Pre-sale:** this phase includes the risk planning and target setting processes, determination of the Group's risk appetite, approval of new products, risk analysis and credit rating process, and limit setting per counterparty. Limits can be established either through the framework of pre-approved or pre-classified limits or by the granting of a specific approval.

> **Sale:** this is the decision-making phase for both transactions under pre-classified limits and those which have received specific approval.

> **Post-sale:** this phase comprises the risk monitoring, measurement and control processes and the recovery process.

Risk limit planning and setting

Risk limit setting is the first of the pre-sale risk management procedures and is a dynamic process that identifies the Group's risk appetite through the discussion of business proposals and the attitude to risk. This process is defined in the global risk limit plan, a comprehensive document for the integrated management of the balance sheet and its inherent risks, which establishes risk appetite on the basis of the various factors involved. The risk limits are founded on two basic structures: customers/segments and products.

For non-standardised risks, a top-level risk limit is approved if the quantum of risk required to support the customer is material when compared to its overall financing needs. These limits cover a variety of products (such as lending, trade finance or derivatives) enabling the Group to define a total risk appetite with that customer based on its current and expected financial needs. For global corporate groups, a pre-classification model based on an economic capital measurement and monitoring system is used. For the large corporate customers, a simplified pre-classification model is applied for customers meeting certain requirements.

For standardised risks, the risk limits are planned and set using the credit management programme, a document agreed upon by the business areas and the Santander UK Risk Division and approved by the Santander UK Risk Committee, which contains the expected results of transactions in terms of risk and return, as well as the limits applicable to the activity and the related risk management.

Risk analysis and credit rating process

Risk analysis is another key pre-sale procedure and is a pre-requisite for the approval of credit to customers by the Group. This analysis consists of examining the customer's ability to meet its contractual obligations to the Group, which involves analysing the customer's credit quality, its risk transactions, its solvency and the return to be obtained in view of the risk assumed.

The risk analysis is conducted when a new customer or transaction arises or with a pre-established frequency, depending on the segment involved. Additionally, the credit rating is examined and reviewed whenever a warning is triggered or an event affecting the credit risk of the customer or transaction occurs.

Transaction decision-making

The purpose of the transaction decision-making process is to analyse transactions and then make a decision, taking into account the risk appetite and any transaction elements that are important in achieving a balance between risk and return. The Group uses, among others, the RORAC methodology for risk analysis and pricing in the decision-making process on transactions and deals.

Risk monitoring and control

In order to ensure adequate credit quality control in addition to the tasks performed by the internal audit division, the Risk Division has a specific risk monitoring function that covers all non-standardised portfolios and to which specific resources and persons in charge have been assigned.

This monitoring function is based on an ongoing process of observation to enable early detection of any incidents that might arise in the evolution of the risk, the transactions, the customers and their environment, with a view to adopting mitigating actions. The risk monitoring function is specialised by customer segment.

For this purpose a system called "companies under special watch" (FEVE, using the Spanish acronym) has been designed that distinguishes four categories, three of which are considered as 'proactive' (extinguish, secure and reduce) and one of which is considered 'enhanced monitoring' (monitor). The inclusion of a customer in the FEVE system does not mean that there has been a default, but rather that it is deemed advisable to adopt a specific policy for this customer, to place a person in charge and to set the policy implementation period. Customers classified as FEVE are reviewed monthly and the assigned rating is reviewed at least every six months, or every three months for those classified in the proactive categories. A customer can be classified as FEVE as a result of the monitoring process itself, a review performed by internal audit, a decision made by the sales manager responsible for that company or the triggering of the automatic warning system.

For exposures to standardised customers, the key indicators are monitored in order to detect any variance in the performance of the loan portfolio with respect to the forecasts contained in the credit management programmes.

Risk control function

Supplementing the management process, the risk control function obtains a global view of the Group's loan portfolio, through the various phases of the risk cycle, with a sufficient level of detail to permit the assessment of the current risk position and any changes therein. Changes in the Group's risk position are controlled on an ongoing and systematic basis against budgets, limits and benchmarks, and the impacts of these changes in future situations, both of an external nature and those arising from strategic decisions, are assessed in order to establish measures that place the profile and amount of the loan portfolio within the parameters set by the Group.

The risk control function assesses risks from various complementary perspectives, including geographical location, business area, management model and product and process, thus facilitating the detection of specific areas of action requiring management actions to control the risk profile of the group.

Within the corporate framework established in the wider Banco Santander group for compliance with the US 2002 Sarbanes-Oxley Act, a corporate tool is used for the documentation and certification of all the sub-processes, operational risks and related mitigating controls. The Santander UK Risk Division assesses annually the efficiency of the internal control of its activities.

Scenario analysis

As part of the ongoing risk management and oversight process, the Group performs simulations of the portfolio performance in different adverse and stress scenarios (stress testing) which enable it to assess the Group's capital adequacy in certain future situations. These simulations cover the Group's main portfolios and are conducted systematically using a corporate methodology which:

- Determines the sensitivity of risk factors (PD, LGD) to macroeconomic variables.
- Characterises benchmark scenarios.
- Identifies "break-off scenarios" (the levels above which the sensitivity of the risk factors to macroeconomic variables is more accentuated) and the distance of these break-off scenarios from the current situation and the benchmark scenarios.
- Estimates the expected loss associated with each scenario and the changes in the risk profile of each portfolio arising from variations in macroeconomic variables.

The simulation models used by the Group use data of a full business cycle to calibrate the performance of risk factors, given certain movements in macroeconomic variables. In the corporate banking area, since low-default portfolios are involved, there is insufficient historical default data available to perform the calibration and, therefore, expert judgment is used.

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The main macroeconomic variables contained in the Group's scenarios are as follows:

> Unemployment rate;
> Gross domestic product;
> Interest rates; and
> Inflation rate.

The scenario analysis enables management to better understand the expected performance of the portfolio given certain changing market conditions and situations. The analyses performed, both in base and in stressed scenarios, with a time horizon of five years, show the strength of the balance sheet against the various market and macroeconomic situations simulated.

Recovery management

Recovery management is defined as a strategic, integrated business activity. Banco Santander, S.A. has a global model which is applied and implemented locally by Santander UK, considering the specific features of the business in each area of activity.

The objectives of the recovery process are as follows:

> To collect payments in arrears so that accounts return to performing status. If this is not possible within a reasonable time period, the aim is to fully or partially recover debts, regardless of their status for accounting or management purposes.
> To maintain and strengthen the relationship with customers, paying attention to customer payment behaviour. Specifically to ensure that individual circumstances and reason for arrears are carefully considered when agreeing solutions with customers to ensure that arrangements are affordable and support repayment of arrears in a timely and sustainable manner.

Credit risk: concentration & mitigation

Certain areas and/or specific views of credit risk deserve specialist attention, complementary to global risk management.

Significant concentrations of credit risk

The management of risk concentration is a key part of risk management. The Group tracks the degree of concentration of its credit risk portfolios using various criteria, including geographic areas and countries, economic sectors, products and groups of customers.

During 2011, the Group's most significant exposures to credit risk derived from:

> derivatives exposure to financial institutions in Markets;
> secured lending and derivatives exposures to companies, real estate entities and social housing associations in Corporate Banking; and
> the Treasury asset portfolio in run down within ALM.

In Corporate Banking, the business consists of a relatively small number of high value balances where a problem with one customer may cause a relatively large impact.

The corporate and SME portfolios in Corporate Banking are largely unsecured, and the real estate and social housing portfolios in Corporate Banking comprise loans and associated derivatives secured on UK property. The total committed facilities exposure to these portfolios was £36bn at 31 December 2011 (31 December 2010: £38bn).

The derivatives exposures in Markets are mitigated by collateralisation as described in the section on Markets – Derivatives.

The holdings in the Treasury asset portfolio benefit from senior positions in the creditor cascade or are covered by derivatives with well rated market counterparties with additional protection given by daily collateralisation under standard market documentation.

Although the operations of Markets are based mainly in the UK, they have built up exposures to various entities around the world and are therefore exposed to concentrations of risk related to geographic area. These are further analysed below:

	2011		2010	
	Corporate	**Markets**	Corporate	Markets
Country	**%**	**%**	%	%
UK	**85**	**24**	88	39
Rest of Europe	**10**	**41**	11	38
US	**2**	**28**	-	5
Other, including non-OECD	**3**	**7**	1	18
	100	**100**	100	100

Details of credit ratings and additional geographical analysis of Corporate Banking disclosures can be found on pages 80 and 81 Details of credit ratings and additional geographic analysis of the Treasury asset portfolio in ALM can be found on pages 90 and 91.

Geographical exposures are governed by country limits set by Banco Santander, S.A. centrally and determined according to the classification of the country (whether it is a developed Organisation for Economic Co-operation and Development ('OECD') country or not), the rating of the country, its gross domestic product and the type of business activities and products the Group wishes to engage in within that country. The Group is constrained in its country risk exposure, within the group limits, and by its capital base.

Credit risk mitigation

In managing its gross exposures, the Group uses the policies and processes described in the Credit Risk sections below. Collateral, when received, can be held in the form of debentures over a company's assets and through market-standard collateral agreements (cash or highly liquid securities).

Group loan collections, including forbearance

The Workouts and Collections Department ('Workouts & Collections') is responsible for debt management activities. Debt management strategies, which include affordability assessment, use of collection tools, negotiation of appropriate repayment arrangements and debt counselling, can start prior to actual payment default or as early as the day after a repayment is past due and can continue until legal action. Different collection strategies are applied to different segments of the portfolio subject to the perceived levels of risk.

Forbearance

To support customers that encounter actual or apparent financial difficulties, the Group may grant a concession whether temporary or permanent to accept less than contractual amounts where financial distress would otherwise prevent satisfactory repayment within the original terms and conditions of the contract. These arrangements are known as forbearance. A range of forbearance strategies are employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. The Group's policies and practices are based on criteria which, in the judgement of management, indicate that repayment is likely to continue.

The Group also aims to ensure that after the initial period of financial difficulties the customer can revert to the previous terms, with appropriate support where necessary. These agreements may be initiated by the customer, the Group or by a third party.

> **Corporate -** In the corporate portfolios, forbearance strategies can include term extensions, interest only concessions, provision of additional security or guarantees, resetting of covenants, seeking additional equity and debt for equity swaps. For further information, refer to the discussions of forbearance and restructured loans in "Credit Risk - Corporate Banking".

Group restructured loans

At 31 December 2011, there were no financial assets that would otherwise be past due or impaired whose terms have been renegotiated (2010: £nil).

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CREDIT RISK - CORPORATE BANKING

Definition

Credit risk is the risk of financial loss arising from the default of a customer or counterparty to which the Group has directly provided credit, or for which the Group has assumed a financial obligation, after realising collateral held. Credit risk arises by Corporate Banking making loans, investing in other financial instruments or entering into financing transactions or derivatives.

Managing credit risk

Corporate Banking aims to minimise and controls credit risk. The Santander UK Board has approved a set of risk appetite limits to cover different types of risk, including credit risk, arising in Corporate Banking. Santander UK's credit risk appetite is measured and controlled by a maximum Economic Capital value, which is defined as the maximum level of unexpected loss that Santander UK is willing to sustain over a one-year period. Within these limits, credit mandates and policies are approved to cover detailed industry, sector and product limits. All transactions falling within these mandates and policies are accommodated under credit limits approved by the appropriate credit authority. Specific approval is usually required by the senior Credit Approvals Committee (CAC) for any transaction that falls outside the mandates. Transactions or exposures above this local limit will be referred by the CAC to the relevant approval authorities in Banco Santander, S.A.. The Credit Risk Department is responsible for controlling credit risk in the portfolios.

Analysis of credit exposures and credit risk trends on a Santander UK basis are provided each month to Risk Oversight Fora, with key issues escalated to the Risk Committee as required. Large Exposures (as defined by the UK Financial Services Authority) are reported quarterly to the Risk Committee and the UK Financial Services Authority. Credit risk on derivative instruments is calculated using the potential future mark-to-market exposure of the instruments at a 97.5% statistical confidence level and adding this value to the current value. The resulting "loan equivalent" or credit risk is then included against credit limits, along with other non-derivative exposures. In addition, there is a policy framework to enable the collateralisation of derivative instruments including swaps. If collateral is deemed necessary to reduce credit risk, any unsecured risk threshold, and the nature of any collateral to be accepted, is determined by management's credit evaluation of the counterparty.

Corporate and Business Banking is an area where the Group aims to achieve controlled growth, mainly through the expansion of a regional business centre network supporting lending to the Mid Corporate SME and Real Estate sectors as well as within the large corporate market. Focus is continuing to be given to the control of credit risks within this expansion based on robust Credit Policy Mandates and models covering both risk appetite and ratings.

In Corporate Banking, credit risk arises on assets and off-balance sheet transactions. Consequently, the credit risk exposure below arises from on balance sheet assets, and off-balance sheet transactions such as committed and undrawn credit facilities or guarantees.

Corporate Banking committed facilities exposure by credit rating of the issuer or counterparty (1) (2) (3)

2011	Sovereign £m	Large Corporate £m	Mid Corporate and SME £m	Real Estate £m	Social Housing £m	Total £m
AAA	**6,965**	**63**	**42**	**-**	**-**	**7,070**
AA	**819**	**511**	**147**	**218**	**2,651**	**4,346**
A	**25**	**3,248**	**1,061**	**1,395**	**5,990**	**11,719**
BBB	**-**	**4,529**	**2,996**	**2,555**	**1,300**	**11,380**
BB	**-**	**52**	**267**	**773**	**-**	**1,092**
B	**-**	**-**	**9**	**159**	**-**	**168**
CCC	**-**	**-**	**11**	**-**	**-**	**11**
D	**-**	**-**	**43**	**216**	**-**	**259**
Total(3)	**7,809**	**8,403**	**4,576**	**5,316**	**9,941**	**36,045**

2010	Sovereign £m	Large Corporate £m	Mid Corporate and SME £m	Real Estate £m	Social Housing £m	Total £m
AAA	15,510	9	26	92	-	15,637
AA	86	315	162	-	1,865	2,428
A	-	2,152	808	799	6,153	9,912
BBB	-	3,343	1,715	2,311	1,206	8,575
BB	-	-	285	780	10	1,075
B	-	-	9	72	-	81
CCC	-	-	5	-	-	5
D	-	-	4	57	-	61
Total(3)	15,596	5,819	3,014	4,111	9,234	37,774

(1) The committed facilities exposure includes OTC derivatives.
(2) All exposures are internally rated. External ratings are taken into consideration in the rating process, where available.
(3) Of the total exposure £2,539m (2010: £1,240m) are off-balance sheet transactions. Large Corporates represent 52% of this with the remaining 48% occurring in the Mid Corporate and Real Estate portfolios.

Corporate Banking committed facilities exposure by geographical area

2011	Sovereign £m	Large Corporate £m	Mid Corporate and SME £m	Real Estate £m	Social Housing £m	Total £m
UK	**5,476**	**5,672**	**4,225**	**5,316**	**9,941**	**30,630**
Rest of Europe	**1,591**	**1,485**	**320**	**-**	**-**	**3,396**
US	**-**	**807**	**-**	**-**	**-**	**807**
Other, including non-OECD	**742**	**439**	**31**	**-**	**-**	**1,212**
Total	**7,809**	**8,403**	**4,576**	**5,316**	**9,941**	**36,045**

2010	Sovereign £m	Large Corporate £m	Mid Corporate and SME £m	Real Estate £m	Social Housing £m	Total £m
UK	11,997	5,146	2,860	4,111	9,234	33,348
Rest of Europe	3,484	585	125	-	-	4,194
US	-	9	-	-	-	9
Other, including non-OECD	115	79	29	-	-	223
Total	15,596	5,819	3,014	4,111	9,234	37,774

The increase in SME, Large Corporate and Real Estate exposures in 2011 arose from the continued development of a UK corporate banking franchise and was partially offset by a reduction in sovereign exposures principally reflecting changes in holdings of UK and Organisation of Economic Co-operation and Development ('OECD') government securities as part of the Group's liquidity management activity.

Credit risk mitigation

Collateralisation

Corporate Banking provides a range of banking services principally to SME UK companies via a broad range of banking products including loans, bank accounts, deposits, treasury services, asset finance, cash transmission, trade finance and invoice discounting. The specialist businesses within Corporate Banking service customers in various business sectors including Real Estate and Social Housing.

Corporate Banking lends to these different types of business after undertaking a credit risk assessment of the borrower, including consideration of the customer's capacity to repay, and an assessment, where collateral is taken, of its likely realisable value. At 31 December 2011, the Group held collateral against impaired loans amounting to 58% (31 December 2010: 58%) of the carrying amount of impaired loan balances. These impaired loans for 2011 arise within the Mid Corporate and SME portfolio (5%) the Real Estate portfolio (95%).

a) Sovereigns
Assets held with Sovereign counterparties are mainly with issuers or counterparties with a AAA rating. It is normal market practice that there is no collateral associated with these financial assets.

b) Large Corporates
The Large Corporate portfolio is primarily unsecured but credit agreements are underpinned by both financial and non-financial covenants. Typically for this type of business the initial, and ongoing, lending decision is based upon factors relating to the financial strength of the client, its position within its industry, its management strengths and other factors as evaluated by the specialised analyst assigned to each customer.

There is also a small number of acquisition or project finance transactions with a total value at 31 December 2011 of £292m (2010: £1,072m) where collateral is held in the form of a charge over the assets being acquired. This type of assignment of all assets is combined with other covenants to provide security to the lenders.

c) Mid Corporate and SME
The Mid corporate and SME portfolio typically incorporates guarantee structures underpinned by both financial and non-financial covenants and debenture security. Typically for this type of business these guarantees are not classified as collateral and value is not attributed to them unless supported by tangible security. Lending decisions to these businesses are assessed against trading cash flows and in the event of a default the Group does not typically take possession of the assets of the business, although an Administrator may be appointed in more severe cases.

In addition the portfolio includes commercial mortgage lending where collateral is taken in the form of a charge over the property being mortgaged. A professional valuation of the real estate security is undertaken at the point of lending but no contractual right of revaluation exists. However, revaluations are undertaken in the event that cases become distressed. Collateral is rarely taken into possession. The Group seeks to ensure the disposal of the collateral either consensually or via an insolvency process, as early as practical in order to minimise the loss to the Group.

The corporate bank also provides asset as well as invoice finance to certain UK corporate clients. The assets financed (typically vehicles, and equipment) are reviewed prior to lending and their value assessed. In the case of invoice finance, the companies' debtors are subject to periodic reviews with funding provided against eligible debtors meeting pre-agreed criteria. In the event of a default these assets and debtors will be repossessed and sold or collected out respectively.

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d) Social Housing

The Social Housing portfolio is secured on residential real estate owned and let by UK Housing Associations. This collateral is revalued at least every five years and the valuation is based on standard housing methodologies, which generally involve the properties' continued use as social housing, if the valuation were based upon normal residential use the value would be considerably higher. To date, Santander UK has suffered no defaults or losses on this type of lending and has not had to take possession of any collateral. Of the Social Housing portfolio of £10bn, the value of the collateral is in all cases in excess of the loan balance. Typically, the loan balance represents between 25% and 50% of the implied market value of collateral using the Group's approved LGD methodology.

e) Real Estate

In the real estate portfolio, collateral is in the form of commercial real estate assets. Lending to commercial real estate is undertaken against an approved mandate setting minimum criteria including such aspects as the quality (e.g. condition and age) and location of the property, the quality of the tenant, the terms and length of the lease, and the experience and creditworthiness of the sponsors. Properties are viewed by the Group prior to lending and annually thereafter. An independent professional valuation is obtained prior to lending, providing both a value and an assessment of the property, the tenant and future demand for the property (e.g. market rent compared to the current rent). Loan agreements typically permit bi-annual valuations thereafter or more frequently if it is likely that the covenants may be breached.

When a commercial real estate loan is transferred to FEVE or Workouts and Collections, the Group typically undertakes a revaluation of the collateral as part of the process for determining the strategy to be pursued (e.g. whether to restructure the loan or to realise the collateral). An assessment is made of the need to establish an impairment loss allowance based on the valuation in relation to the loan amount outstanding while also taking into consideration any loan restructuring solution to be adopted (e.g. whether provision of additional security or guarantees is available, the prospects of additional equity and the ability to enhance value through asset management initiatives etc).

Of the non-standardised commercial real estate portfolio of £4.7bn at 31 December 2011, 10% had a value in excess of the loan balance and the average value of collateral represented 67% of the loan balance. Collateral is rarely taken into possession. The Group seeks to dispose of the collateral as early as practical in order to minimise the loss to the Group.

Corporate Banking – Watchlist

In order to ensure adequate credit quality control, in addition to the tasks performed by the internal audit division, the Group monitors exposures within these portfolios through an ongoing process of observation to enable early detection of any incidents that might arise in the evolution of the risk, the transactions, the customers and their environment, with a view to implement mitigating actions.

Summaries of the watchlist and workout cases at 31 December 2011 and 2010 by portfolio and assessment of risk are:

2011	**Portfolio £m**	**Enhanced Monitoring £m**	**Enhanced Monitoring %**	**Pro-active £m**	**Pro-active %**	**Workout £m**	**Workout %**	**NPL(1) £m**	**NPL %**	**Impairment loss allowances(2) Observed £m**	**Impairment loss allowances(2) IBNO £m**
Large Corporates (including Sovereign)	**16,212**	**87**	**0.5**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Mid Corporate and SME	**4,576**	**67**	**1.5**	**2**	**0.1**	**29**	**0.6**	**21**	**0.5**	**2**	**6**
Real Estate	**5,316**	**98**	**1.8**	**166**	**3.1**	**424**	**8.0**	**356**	**6.7**	**95**	**27**
Social Housing	**9,941**	**212**	**2.1**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Total	**36,045**	**463**	**1.3**	**168**	**0.5**	**453**	**1.3**	**377**	**1.0**	**97**	**33**

2010	Portfolio £m	Enhanced Monitoring £m	Enhanced Monitoring %	Pro-active £m	Pro-active %	Workout £m	Workout %	NPL(1) £m	NPL %	Impairment loss allowances(2) Observed £m	Impairment loss allowances(2) IBNO £m
Large Corporates (including Sovereign)	21,415	549	2.6	545	2.5	-	-	-	-	-	-
Mid Corporate and SME	3,014	23	0.6	6	0.2	83	2.1	23	0.6	3	-
Real Estate	4,111	293	7.1	309	7.5	544	13.2	369	9.0	77	29
Social Housing	9,234	179	1.9	-	-	-	-	-	-	-	-
Total	37,774	1,044	2.7	860	2.2	627	1.6	392	1.0	80	29

(1) Includes committed facilities and swaps.
(2) Excludes Insurance Funding Solutions ('IFS') and First National Motor Finance ('FNMF').

Exposures are classified as 'workout' if they are non-performing loans or have been passed to the Risk Division for intensive management. Exposures are classified as 'proactive' if they are included in the three categories (extinguish, secure and reduce) being actively managed. Exposures are classified as 'enhanced monitoring' where they are subject to more intense and frequent monitoring. These are described in 'Risk monitoring and control' above. Non-performing loans are discussed in 'Corporate Banking non-performing loans and advances' below.

There are a range of indicators that may trigger a case being added to FEVE including downturn in trade, covenant breaches, major contract loss and resignation of key management. Such cases are assessed to determine the potential financial implications of these trigger events and in consultation with the borrower, a range of options available is considered which may include temporary forbearance.

In 2011, assets classified as 'enhanced monitoring' decreased due to the rehabilitation of certain large corporate and real estate clients, together with ongoing exits through repayment of a number of legacy real estate deals. Assets classified as 'proactive' decreased due largely to the successful execution of manage-down strategies within the large corporate portfolio which saw exposure significantly reduced in this FEVE category. In addition, the ongoing workout of a number of legacy real estate deals also contributed to the decrease in this category. Assets classified as 'workout' and 'NPL' categories fell across both real estate and mid corporate portfolios as exit strategies were executed.

Corporate Banking arrears

	2011 **£m**	2010 £m
Total Corporate Banking loans and advances to customers in arrears	266	287
Total Corporate Banking loans and advances to customers[1]	13,867	12,118
Corporate Banking loans and advances to customers in arrears as a % of Corporate Banking loans and advances to customers	1.9%	2.4%

(1) Corporate Banking loans and advances to customers include social housing loans and finance leases.
Accrued interest is excluded for purposes of these analyses.

In 2011, loans and advances to customers in arrears levels decreased both absolutely and as a percentage of Corporate Banking loans and advances to customers due to effective management of arrears and the growth in the book being on more conservative terms.

Corporate Banking – restructuring (a form of forbearance)

Restructurings (a form of forbearance) allow a customer by negotiation to vary the amount of their contractual payments for an agreed period (such as interest-only period or term extensions). During the period of forbearance, arrears management activity continues with the aim to rehabilitate accounts. When customers come to the end of their arrangement period they will either be returned to the performing portfolio or continue to be managed as a mainstream workout or collections case, which may include the use of other restructuring or collections options.

Corporate Banking – arrears management

The Workouts & Collections department, as well as credit partners, are responsible for debt management initiatives on the Corporate Banking loan portfolio. Debt management strategies, which include negotiating restructuring or repayment arrangements and concessions, often commence prior to actual payment default. Different collection strategies are applied to different segments of the portfolio subject to the perceived levels of risk and the individual circumstances of each case.

Workouts & Collections activities exist to ensure customers who have failed or are likely to fail to make their contractual payments when due or have exceeded their agreed credit limits are encouraged to pay back the required amounts, and in the event they are unable to do so to pursue recovery of the debt in order to maximise the net recovered balance.

The overall aim is to minimise losses whilst not adversely affecting brand, customer loyalty, fee income, or compliance with relevant legal and regulatory standards.

Problem debt management activity is performed within Santander UK:

> Initially by the relationship manager and, for non standardised cases, the credit partner, and for standardised cases the Business Support Unit.

> Subsequently by Workouts & Collections where the circumstances of the case become more critical or specialist expertise is required.

Santander UK seeks to detect weakening financial performance early through close monitoring of regular financial and trading information, periodic testing to ensure compliance with both financial and non-financial covenants and regular dialogue with corporate clients.

Notes to the Financial Statements continued

The FEVE process is used proactively on cases which need enhanced management activity ranging from increased frequency and intensity of monitoring through to more specific activities to reduce the Group's exposure, enhance the Group's security or in some cases seek to exit the position altogether.

Once categorised as FEVE, a strategy is agreed with Credit Risk and this is monitored through monthly FEVE meetings for each portfolio. Where circumstances dictate a more dedicated debt management expertise is required or where the case has been categorised as non-performing (be that through payment arrears or through management judgement that a payment default is likely), the case is transferred to Workouts & Collections.

Corporate loans restructured

Loans may be restructured by following strategies that are bespoke to each individual case and achieved through negotiation with the customer. The aim of agreeing to a restructuring with a customer is to bring the Group's exposure back within acceptable risk levels by negotiating suitable revised terms, conditions and pricing, including reducing the amount of the outstanding debt or increasing the amount of collateral provided to the Group. The Group seeks to retain the customer relationship where possible, provided the Group's risk position is not unduly compromised. Loans are considered to be a "refinancing" if non-performing at the time of the restructuring and a "renegotiation" if in early arrears or up to date.

Solutions in a restructuring, whether a refinancing or renegotiation, may include:

> **Term Extensions** - the term of the credit facility may be extended to reduce the regular periodic repayments, and where as a minimum, the interest can be serviced and there is a realistic prospect of full or improved recoveries in the foreseeable future. Customers may be offered a term extension where they are up-to-date but showing evidence of financial difficulties, or where the maturity of the loan is about to fall due and near term refinancing is not possible on current market terms.

> **Interest Only Concessions** – the regular periodic repayment may be reduced to interest payment only for a limited period with capital repayment deferred where other options, such as a term extension, are not appropriate. Customers may be offered an interest only concession where they are up-to-date but showing evidence of financial difficulties, or are already in the Workouts & Collections process. Periodic reviews of the customer financial situation are undertaken to assess when the customer can afford to return to the repayment method.

The Group may offer a term extension or interest only concession provided that the forecasts indicate that the borrower will be able to meet the revised payment arrangements.

The table below also includes debt-for-equity swaps where, on occasion, the Group may agree to exchange a proportion of the amount owed by the borrower for equity in that borrower. In circumstances where a borrower's balance sheet is materially over-leveraged but the underlying business is viewed as capable of being turned around, the Group may agree to reduce the debt by exchanging a portion of it for equity in the company. This will typically only be done alongside new cash equity being raised, the implementation of a detailed business plan to effect a turnaround in the prospects of the business, and satisfaction with management's ability to deliver the strategy.

The incidence of the main types of restructures above at 31 December was:

	2011 £m	**2011 % of loans by value**	2010 £m	2010 % of loans by value
Refinancing	**122**	**19**	124	20
Renegotiations	**470**	**75**	469	75
Debt-equity swaps	**35**	**6**	35	5
	627	**100**	628	100

Within the total portfolio above, the incidence of the main types of restructures applied to Commercial Real Estate loans were:

	2011 £m	**2011 % of loans by value**	2010 £m	2010 % of loans by value
Refinancing	**88**	**25**	107	27
Renegotiations	**255**	**72**	274	70
Debt-equity swaps	**9**	**3**	9	3
	352	**100**	390	100

In 2011, the level of restructures (both refinancing and renegotiations) was broadly stable across the book which in part reflected cases being exited offsetting new cases arising, although no new debt-for-equity swaps were entered into during the year.

In 2011, the level of restructured cases in the Commercial Real Estate portfolio reduced slightly as certain of the earlier restructurings were successfully exited, which was only partially offset by new restructurings.

The majority of corporate loan restructurings to date have been by way of term extensions and payment re-profiling (e.g. interest only concessions), with only a limited number of debt for equity swaps. Loan loss allowances are assessed on a case-by-case basis taking into account amongst other factors, the value of collateral held as confirmed by third party professional valuations as well as the cash flow available to service debt over the period of the restructuring. These loan loss allowances are assessed regularly and are independently reviewed both at quarterly provision review forum, as well as by the internal audit department. In the case of a debt for equity conversion, the converted debt is written off against the existing loan loss allowance upon completion of the restructuring. The value of the equity acquired is initially held at nil value and reassessed periodically in light of subsequent performance of the restructured company.

Other forms of debt management
In addition to the restructurings and debt-for-equity swaps, the Group also uses other forms of debt management which can include:

> **Provision of additional security or guarantees** – Where a borrower has unencumbered assets, these may be charged as new or additional security in return for the Group restructuring existing facilities. Alternatively, the Group may take a guarantee from other companies within the borrower's group and/or major shareholders provided it can be established the proposed guarantor has the resources to support such a commitment.

> **Resetting of covenants and trapping surplus cashflow** – Financial covenants may be reset at levels which more accurately reflect the current and forecast trading position of the borrower. This may also be accompanied by a requirement for all surplus cash after operating costs to be trapped and used in reduction of the Group's lending.

> **Seeking additional equity** – Where a business is over-leveraged, fresh equity capital will be sought from existing or new investors to adjust the capital structure in conjunction with the Group agreeing to restructure the residual debt.

Exit the position consensually
Where it is not possible to agree a restructuring, the Group may seek to exit the position consensually by:

> Agreeing with the borrower an orderly sale of assets outside insolvency to pay down the Group's debt;
> Arranging for the refinance of the debt with another lender; or
> Sale of the debt where a secondary market exists (either individual loans or on occasion as a portfolio sale).

Litigation and recovery
Where it is not possible to agree a restructuring or to exit the position consensually, the Group will pursue recovery by:

> Pursuing its rights through an insolvency process;
> Optimising the sale proceeds of any collateral held; and
> Seeking compensation from third parties, as appropriate.

Where the Group has to pursue recovery through the appointment of an Administrator (or a Receiver under the Law of Property Act in the case of real estate security), the Group's shortfall is assessed against the Administrator's estimate of the outcome and an appropriate loan loss allowance is raised. In cases where a sale of the debt is deemed to offer the optimum recovery outcome, the shortfall, if the debt is sold below its par value, is written off upon sale.

Impairment losses on loans and advances to customers

The Group's impairment loss allowances policy for corporate assets is set out in Note 1 of the Consolidated Financial Statements.

Corporate Banking analysis of impairment loss allowances on loans and advances to customers

An analysis of the Corporate Banking impairment loss allowances on loans and advances to customers is presented below.

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Observed impairment loss allowances					
Corporate loans - UK	**97**	79	63	13	-
Total observed impairment loss allowances	**97**	**79**	**63**	**13**	**-**
Incurred but not yet observed impairment loss allowances					
Corporate loans - UK	**33**	29	14	13	-
Total incurred but not yet observed impairment loss allowances	**33**	**29**	**14**	**13**	**-**
Total impairment loss allowances	**130**	**108**	**77**	**26**	**-**

Notes to the Financial Statements continued

Corporate Banking movements in impairment loss allowances on loans and advances

An analysis of movements in the Corporate Banking impairment loss allowances on loans and advances is presented below.

	2011 £m	2010 £m
Impairment loss allowances at the start of the year	**108**	77
Amounts written off:		
- Corporate Loans – UK	**(32)**	(49)
Total amounts written off	**(32)**	(49)
Observed impairment losses charged against profit:		
- Corporate Loans – UK	**50**	65
Total observed impairment losses charged against profit	**50**	65
Incurred but not yet observed impairment losses charged against profit	**4**	15
Total impairment losses charged against profit	**54**	80
Impairment loss allowances at the end of the year	**130**	108

Corporate Banking recoveries

An analysis of the Corporate Banking recoveries is presented below.

	2011 £m	2010 £m
Corporate Loans – UK	**-**	11
Total amount recovered	**-**	11

Corporate Banking non-performing loans and advances(1)

An analysis of Corporate Banking's non-performing loans and advances is presented below.

	2011 £m	2010 £m
Corporate Banking non-performing loans and advances that are impaired	**260**	288
Corporate Banking non-performing loans and advances that are not impaired	**101**	84
Total Corporate Banking non-performing loans and advances(2)	**361**	372
Total Corporate Banking loans and advances to customers(3)	**13,867**	12,118
Total Corporate Banking impairment loan loss allowances(4)	**135**	117
	%	%
Non-performing loans and advances as a % of loans and advances to customers	**2.61**	3.07
Coverage ratio(5)	**35.85**	31.45

(1) Loans and advances are classified as non-performing typically when the counterparty fails to make payments when contractually due for three months or longer or where it is deemed unlikely that the counterparty will be able to maintain payments.
(2) All non-performing loans continue accruing interest.
(3) Corporate Banking loans and advances to customers include social housing loans and finance leases. Accrued interest is excluded for purposes of these analyses.
(4) Includes Insurance Funding Solutions ('IFS') and First National Motor Finance ('FNMF').
(5) Impairment loan loss allowances as a percentage of non-performing loans and advances.

In 2011, non-performing loans and advances as a percentage of customers assets decreased to 2.61% from 3.07% at 31 December 2010 due to effective management of problem cases.

In 2011, non-performing loans and advances fell whilst impairment loss allowances increased. The level of new non-performing loans was broadly in line with expectations, however, the options available for managing them were reduced compared to 2010. The real estate market became more challenging as the year progressed, with reduced sales activity especially for development finance and land-bank transactions and for older transactions underwritten in 2008 and earlier years.

Interest income recognised on impaired loans amounted to £5m (2010: £4m).

Restructured loans

As described above, loans may be restructured or renegotiated where customers in arrears have maintained an agreed monthly repayment for a specified period. At 31 December 2011, there were £97m financial assets that would otherwise be past due or impaired whose terms have been renegotiated (2010: £nil).

CREDIT RISK – MARKETS

The wholesale activities of the Group are undertaken by the Markets division and the ALM division. Each division is responsible for managing its on balance sheet credit exposures. Off balance sheet exposures (through derivatives, repos, reverse repos and stock borrow or stock lending contracts) entered into with Financial Institutions are managed under a single limit structure for each counterparty and are mainly managed by the Markets division.

Definition

Credit risk is the risk of financial loss arising from the default of a customer or counterparty to which the Group has directly provided credit, or for which the Group has assumed a financial obligation, after realising collateral held. Credit risk arises by Markets making loans, investing in debt securities or other financial instruments or entering into financing transactions or derivative contracts.

Managing credit risk

Markets aims to actively manage and control credit risk. The Board has approved a set of risk appetite limits to cover different types of risk, including credit risk, arising in Markets. The Group's credit risk appetite is measured and controlled by a maximum Economic Capital value, which is defined as the maximum level of unexpected loss that the Group is willing to sustain over a one-year period. Markets exposures, including intra-group items, are captured on the global risk management systems.

All transactions are accommodated under credit limits approved by the appropriate credit authority. For transactions that fall under Santander UK's delegated authority, approval is required from the CAC or those individuals directly mandated by the CAC. Transactions or exposures above this local limit will be referred by the CAC to the relevant approval authorities in Banco Santander, S.A.. The Wholesale Credit Risk Department is responsible for controlling credit risk in Markets portfolios. Analysis of credit exposures and credit risk trends are provided each month to the Wholesale Risk Oversight and Control Forum with key issues escalated to the Risk Committee as required. Large Exposures (as defined by the UK Financial Services Authority) are reported monthly to the Risk Committee and quarterly to the UK Financial Services Authority.

Markets is a business focused on providing value added financial services to financial institutions (banks, insurance companies and funds) and large corporates not serviced by Corporate Banking (being, in general, large multinationals), as well as treasury products to the rest of Santander UK's business (including the Retail Banking and Corporate Banking divisions).

In 2011, Markets continued to be active in the financial markets focusing its activities on derivative products (as analysed in the section on counterparty risk) while limiting the direct lending to financial institutions.

Markets commitments by credit rating of the issuer or counterparty(1) (2) (3) (4)

2011	Sovereign £m	Credit £m	Derivatives £m	Total £m
AAA	**71**	**-**	**26**	**97**
AA	**-**	**1**	**1,573**	**1,574**
A	**-**	**73**	**3,374**	**3,447**
BBB and below	**-**	**1**	**259**	**260**
Total	**71**	**75**	**5,232**	**5,378**

2010	Sovereign £m	Credit £m	Derivatives £m	Total £m
AAA	177	-	-	177
AA	-	17	94	111
A	-	19	179	198
BBB and below	-	28	130	158
Total	177	64	403	644

(1) External ratings are applied to all exposures where available.
(2) Credit includes core financing facilities to insurance companies.
(3) Exposure to Sovereigns is incurred when entering into derivative contracts under market standard documentation
(4) The increase in exposure from 31 December 2010 is due to a change of internal risk measurement methodology for OTC derivatives.

Notes to the Financial Statements continued

Markets commitments by geographical area

2011	Sovereign £m	Credit £m	Derivatives £m	Total £m
UK	**34**	**66**	**1,196**	**1,295**
Rest of Europe	**17**	**9**	**2,168**	**2,194**
US	**20**	**-**	**1,460**	**1,480**
Rest of world	**-**	**-**	**408**	**408**
Total	**71**	**75**	**5,232**	**5,378**

2010	Sovereign £m	Credit £m	Derivatives £m	Total £m
UK	144	1	107	252
Rest of Europe	12	49	183	244
US	-	14	21	35
Rest of world	21	-	92	113
Total	177	64	403	644

Markets – Watchlist

In order to ensure adequate credit quality control, in addition to the tasks performed by the internal audit division, the Wholesale Credit Risk Department analysts monitor the exposures within their assigned portfolios through an ongoing process of observation to enable early detection of any incidents that might arise in the evolution of the risk, the transactions, the customers and their environment, with a view to implement mitigating actions.

For this purpose, the Wholesale Credit Risk Department follows the Santander UK's risk monitoring and control processes for FEVE, where risks are classified into four levels of monitoring, three of which are considered as 'proactive' (through the implementation of actions that can be classified as extinguish, secure and reduce) and one of which is considered 'enhanced monitoring' (monitor). This is further explained in the 'Credit risk cycle – Risk monitoring and control' section above. Markets Banks and Financial Institutions exposures are managed at the Wholesale FEVE forum.

At 31 December 2011 and 2010, there were no impaired or non-performing loans or exposures and the assets in the ProActive category were £40m (2010: £29m).

Restructured loans

At 31 December 2011 and 2010, there were no financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Derivatives

Derivatives are financial instruments whose value is derived from the price of one or more underlying items such as equities, equity indices, interest rates, foreign exchange rates, property indices, commodities and credit spreads. Derivatives enable users to manage exposure to credit or market risks. The Group sells derivatives to its customers and uses derivatives to manage its own exposure to credit and market risks.

For details about the Group's use of derivatives, trading derivatives and hedging derivatives, see Note 15 to the Consolidated Financial Statements.

Corporate Banking deals with customers who wish to enter into derivative contracts. Any market risk arising from such transactions is hedged by Markets. Markets is responsible for implementing Group derivative hedging with the external market together with its own trading activities. For trading activities, its objectives are to gain value by:

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

Markets – Derivatives

Credit risk on derivative instruments (OTC derivatives, repos and stock borrowing/lending) is taken under specific limits approved for each counterparty for this type of activity. This credit risk is controlled by the Wholesale Risk department, and managed and reported on a counterparty basis, regardless of whether the exposure is incurred by the Markets or the ALM divisions.

Credit risk on derivative instruments is calculated using the potential future mark-to-market exposure ('PFE') of the instruments at a 97.5% statistical confidence level and adding this value to the current mark-to-market value. The resulting PFE or credit risk is then included against the credit limits approved for individual counterparties (financial institutions, corporates or structured finance), along with other non-derivative exposures.

In addition, there is a policy framework to enable the collateralisation of derivative instruments. If collateral is deemed necessary to reduce credit risk, any unsecured risk threshold, and the nature of any collateral to be accepted, is determined by the Wholesale Risk department's management's credit evaluation of the counterparty.

Credit risk mitigation in derivative transactions

(i) Netting arrangements for derivative transactions
The Group restricts its credit risk by entering into transactions under industry standard agreements which facilitate netting of transactions in the jurisdictions where netting agreements are recognised and have legal force. The netting arrangements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis.

However, there is scope for the credit risk associated with favourable contracts to be reduced by netting arrangements embodied in the agreements to the extent that if an event of default occurs, all amounts with the counterparty under the specific agreement can be terminated and settled on a net basis. In line with industry practice, the Group executes the standard documentation according to the type of contract being entered into. For example, derivatives will be contracted under the International Swaps and Derivatives Association ('ISDA') Master Agreements, repurchase and reverse repurchase transactions will be governed by Global Master Repurchase Agreement ('GMRA'), stock borrowing/lending transactions and other securities financing transactions are covered by Global Master Securities Lending Agreement ('GMSLA').

(ii) Collateralisation for derivative transactions
The Group also mitigates its credit risk to counterparties with which it primarily transacts financial instruments through collateralisation, using industry standard collateral agreements (i.e. the Credit Support Annex ('CSA')) in conjunction with the ISDA Master Agreement. Under these agreements, net exposures with counterparties are collateralised with cash, securities or equities. Exposures and collateral are generally revalued daily and collateral is adjusted accordingly to reflect deficits/surpluses. Collateral taken must comply with the Group's collateral parameters policy. This policy is designed to control the quality and concentration risk of collateral taken such that collateral held can be liquidated when a counterparty defaults. Cash collateral in respect of derivatives held at the year-end was £1.1bn (2010: £0.7bn), not all derivative arrangements being subject to collateral agreements. Collateral obtained during the year in respect of purchase and resale agreements (including securities financing) is equal to at least 100% of the amount of the exposure.

(iii) Use of Central Counterparties
The Group continues to use Central Counterparties ('CCPs') as an additional means to mitigate counterparty credit risk in derivative transactions.

Notes to the Financial Statements continued

CREDIT RISK - ALM

ALM is responsible for managing Santander UK's structural balance sheet shape, the Treasury asset portfolio and, in conjunction with Risk Division, strategic and tactical liquidity risk management. This includes short-term and medium-term funding, covered bond and securitisation programmes. ALM's responsibilities also include Santander UK's banking products and structural exposure to interest rates and, in that role, is a link between the Santander UK Markets and all other divisions. ALM recommends and helps to implement Santander UK Board, Asset and Liability Management Committee and Risk Committee policies for all aspects of balance sheet management - formulating guidance for, and monitoring, the overall balance sheet shape, including maturity profile.

Definition

Credit risk is the risk of financial loss arising from the default of a customer or counterparty to which the Group has directly provided credit, or for which the Group has assumed a financial obligation, after realising collateral held. Credit risk arises by ALM making loans (including to other businesses within the Group) and investing in debt securities. Credit risk also arises by ALM investing in other financial instruments (including assets held for liquidity purposes and assets held in the Treasury asset portfolio which is being run down) or entering into financing transactions or derivative contracts.

Managing credit risk

ALM aims to actively manage and control credit risk. Credit risk is managed by Santander UK's Wholesale Credit Risk Department in accordance with limits, asset quality plans and criteria approved by the Board with respect to risk appetite parameters, and as set out in other relevant policy statements. All exposures, including intra-group items, are captured on the global risk management systems and fall within limits approved by the appropriate credit authority. For transactions that fall under Santander UK's delegated authority, approval is required from the CAC or those individuals directly mandated by the CAC. Transactions or exposures above this local limit will be referred by the CAC to the relevant approval authorities in Banco Santander, S.A.

The Treasury asset portfolio is monitored for potential impairment through a detailed expected cashflow analysis taking into account the structure and underlying assets of each individual security. Once specific events give rise to a reasonable expectation that future anticipated cash flows may not be received, the asset originating these doubtful cash flows will be deemed to be impaired. Objective evidence of loss events includes significant financial distress of the issuer and default or delinquency in interest and principal payments (breach of contractual terms).

As discussed in detail below, counterparty credit risk on derivative assets, repos and stock borrowing/lending is managed and reported collectively rather than split between ALM and Markets. Disclosures relating to the credit risk on these types of asset are presented on a collective basis within the Markets division section. The following tables therefore exclude these assets.

ALM exposure by credit rating of the issuer or counterparty(1)

2011	Sovereign £m	Credit £m	Derivatives £m	Total £m
AAA	**7,266**	**255**	**-**	**7,521**
AA	**-**	**27**	**587**	**614**
A	**-**	**20**	**716**	**736**
BBB and below	**-**	**59**	**-**	**59**
Total	**7,266**	**361**	**1,303**	**8,930**

2010	Sovereign £m	Credit £m	Derivatives £m	Total £m
AAA	5,373	356	-	5,729
AA	183	18	-	201
A	-	80	-	80
Total	5,556	454	-	6,010

(1) External ratings are applied to all exposures where available.

ALM exposure by geographical area

2011	Sovereign £m	Credit £m	Derivatives £m	Total £m
UK	**218**	**19**	**-**	**237**
Rest of Europe	**-**	**276**	**1,111**	**1,387**
US	**7,048**	**-**	**192**	**7,240**
Rest of world	**-**	**66**	**-**	**66**
Total	**7,266**	**361**	**1,303**	**8,930**

2010	Sovereign £m	Credit £m	Derivates £m	Total £m
UK	49	18	-	67
Rest of Europe	183	271	-	454
US	5,138	165	-	5,303
Rest of world	186	-	-	186
Total	5,556	454	-	6,010

The exposure to sovereigns in the UK and US principally reflects the holdings of liquid assets.

Treasury asset portfolio

These assets were acquired as part of an alignment of portfolios across the Banco Santander group in 2010 and are being run down. The Treasury asset portfolio principally contains asset-backed securities ('ABS') and loans to banks. It also contains certain credit derivatives. The assets in the Treasury asset portfolio are principally classified as loan and receivable securities, as set out in Note 21 to the Consolidated Financial Statements, and debt securities designated at fair value through profit or loss, as set out in Note 16 to the Consolidated Financial Statements. The following disclosures relate to the credit derivatives contained in the portfolio. Further information on all the Group's holdings of derivatives (including these credit derivatives) is set out in Note 15 to the Consolidated Financial Statements.

Credit derivatives – Treasury asset portfolio by geographical location of issuer or counterparty

			31 December 2011			31 December 2010
	Contract/notional amount		**Fair value**	Contract/notional amount		Fair value
Country	**£m**	**%**	**£m**	£m	%	£m
UK	**-**	**-**	**-**	-	-	-
Spain	**-**	**-**	**-**	559	85	21
Rest of Europe	**22**	**34**	**5**	25	4	4
US	**42**	**66**	**12**	73	11	13
Total	**64**	**100**	**17**	657	100	38

Losses of £2m were recognised in the income statement in respect of these credit derivatives in 2011 (2010: nil) as a result of changes in fair value. The credit rating of the issuer or counterparty of all holdings at 31 December 2011 was A (2010: 85% AA, 15% A).

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ALM – Watchlist

The ALM exposures are managed by the Wholesale Credit Risk Department using the same process as for the Markets Banks and Financial Institutions and Global Corporates exposures described in 'Markets – Watchlist' above. Structured Assets exposures are managed by the Wholesale Credit Risk Department on a separate basis.

At 31 December 2011 and 2010, there were no impaired or non-performing loans or exposures and the assets in the ProActive category were £nil (2010: £nil).

Restructured loans

At 31 December 2011 and 2010, there were no financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Market Risk

Definition

Market risk is the risk of a reduction in economic value or reported income resulting from a change in the variables of financial instruments including interest rate, equity, credit spread, property and foreign currency risks. Market risk consists of trading and non-traded market risks. Trading market risk includes risks on exposures held with the intention of benefiting from short-term price differences in interest rate variations and other market price shifts. Non-traded market risk includes, inter alia, interest rate risk in investment portfolios.

Interest rate risks primarily result from exposures to changes in the level, slope and curvature of the yield curve, the volatility of interest rates and mortgage prepayment rates. Equity risks result from exposures to changes in prices and volatilities of individual equities, equity baskets and equity indices. Credit spread risk arises from the possibility that changes in credit spreads will affect the value of financial instruments. Property risks result from exposures to changes in property prices. Foreign currency risks result from exposures to changes in spot prices, forward prices and volatilities of currency rates. The Group accepts that market risk arises from its full range of activities.

Managing market risk

Activities giving rise to market risk

Market risk arises in connection with the following activities:

- **Trading**: this includes financial services for customers and the buying and selling and positioning mainly in fixed-income, equity and foreign currency products. Trading activities are undertaken by the Markets and Corporate Banking divisions.
- **Balance sheet management**: Interest rate and liquidity risk arises from mismatches between maturities and repricing of assets and liabilities. For a discussion of liquidity risk, see "Liquidity Risk" in "Funding and Liquidity Risk". The exchange rate risk related to funding raised in currencies other than sterling in excess of balance sheet requirements is swapped back into sterling. Balance sheet management activities are undertaken by ALM.

Santander UK aims to actively manage and control market risk by limiting the adverse impact of market movements whilst seeking to enhance earnings within clearly defined parameters. The Market Risk Manual, which is reviewed and approved by the Chief Risk Officer (supported by the Deputy Chief Risk Officer) annually, sets the framework under which market risks are managed and controlled. Business area policies, risk limits and mandates are established within the context of the Market Risk Manual.

Executive directors are responsible for ensuring that they have sufficient expertise to manage the risks originated and retained within their business divisions. The business areas are responsible for ensuring that they have sufficient expertise to manage the risks associated with their operations. The independent Risk function, under the direction of the Chief Risk Officer (supported by the Deputy Chief Risk Officer), aims to ensure that risk-taking and risk control occur within the framework prescribed by the Market Risk Manual. The Risk function also provides oversight of all risk-taking activities through a process of reviews.

Santander UK aims to ensure that exposure to market risks is measured and reported on an accurate and timely basis to senior management. In addition to the regular reporting for the purposes of active risk management, the Santander UK Board also receives reporting of all significant market risk exposures on a monthly basis where actual exposure levels are measured against limits. Market activity and liquidity of financial instruments are discussed in the relevant monthly Risk Forum. Senior management recognise that different risk measures are required to best reflect the risks faced in different types of business activities. In measuring exposure to market risk, Santander UK uses a range of complementary measures, covering both value and income as appropriate.

Trading market risk exposure arises only in the Group. Exposures are managed on a continuous basis, and are marked to market daily.

Methodologies

Trading Activities
For trading activities the standardised risk measure adopted is VaR. This is calculated at a 99% confidence level over a one-day time horizon in accordance with the standard used throughout the Banco Santander, S.A. group. In 2012, to further align with the Banco Santander, S.A. group, Santander UK has moved to using a 520 day dataset period for VaR from the existing 250 day dataset methodology.

On a daily basis market risk factor sensitivities, VaR measures and stress tests are produced, reported and monitored against limits for each major activity and at the aggregate divisional level. These limits are used to align risk appetite with the business' risk-taking activities and are reviewed on a regular basis.

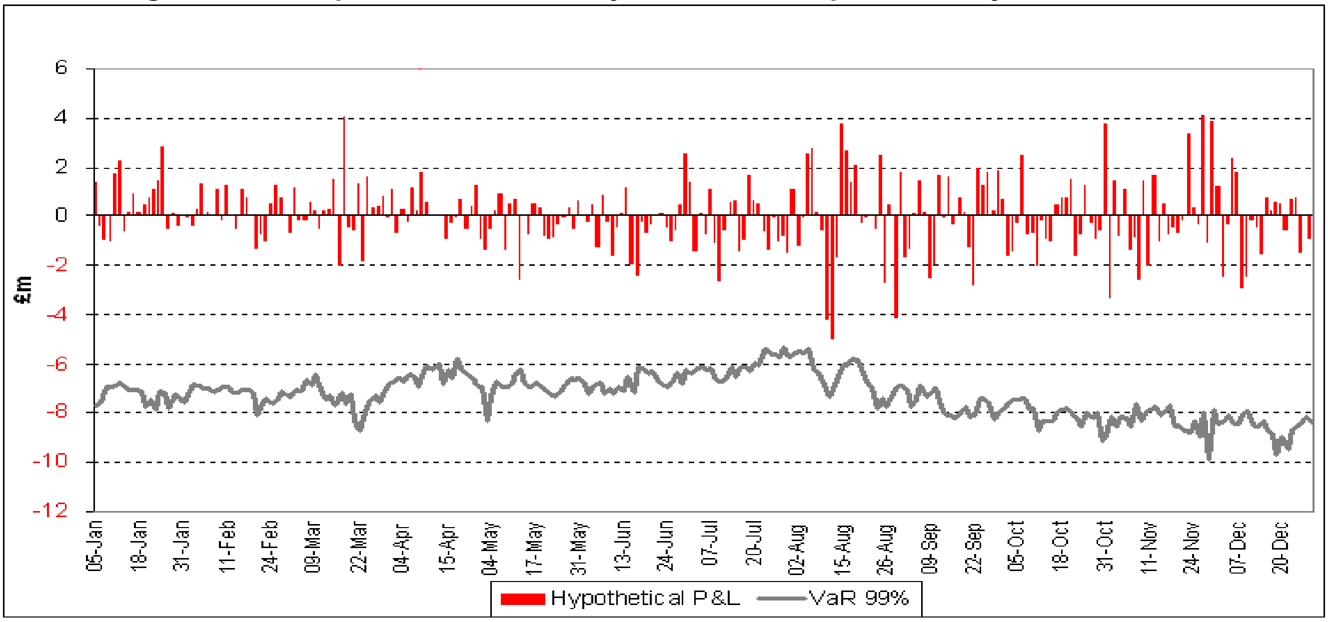
Measurement of risks can involve the use of complex quantitative methods and mathematical principles to model and predict the changes in instruments and portfolio valuation. These methods are essential tools to understand the risk exposures.

The range of possible statistical modelling techniques and assumptions mean these measures are not precise indicators of expected future losses, but are estimates of the potential change in the value of the portfolio over a specified time horizon and within a given confidence interval. Historical simulation models are used with appropriate add-ons to reflect unobservable inputs.

From time to time, losses may exceed the amounts stated where the movements in market rates fall outside the statistical confidence interval used in the calculation of the VaR analysis. The 99% confidence interval means that the theoretical loss at a risk factor level is likely to be exceeded in one period in a hundred. This risk is addressed by monitoring stress-testing measures across the different business areas. For trading instruments the actual, average, highest and lowest VaR exposures shown below are all calculated to a 99% level of confidence using a simulation of actual one day market movements over a one-year period. The effect of historic correlations between risk factors is additionally shown below. The use of a one-day time horizon for all risks associated with trading instruments reflects the horizon over which market movements will affect the measured profit and loss of these activities.

The Group's risk performance with regards to trading activity in financial markets in both the Corporate Banking and Markets divisions during 2011 was as follows:

Back-testing of business portfolios 2011: daily results versus previous day's value at risk



VaR is not the only measure used by Santander UK. It is used because it is easy to calculate and because it provides a good reference of the level of risk incurred by the Group. However, other measures are also used to enable the Group to exercise greater risk control in the markets in which it operates.

One of these measures is scenario analysis, which consists of defining behaviour scenarios for various financial variables and determining the impact on results of applying them to the Group's activities. These scenarios can replicate past events (such as crises) or determine plausible scenarios that are unrelated to past events. A minimum of three types of scenarios are defined (plausible, severe and extreme) which, together with VaR, make it possible to obtain a more complete spectrum of the risk profile. In addition, the market risk area, in accordance with the principle of independence of the business units, monitors daily the positions of each unit through an exhaustive control of changes in the portfolios, the aim being to detect possible incidents and correct them immediately. The daily preparation of an income statement is an important risk indicator, insofar as it allows the Group to identify the impact of changes in financial variables on the portfolios.

All activities are controlled daily using specific measures. Sensitivities to price fluctuations are calculated for cash instruments, while sensitivities to changes in underlyings, volatilities, correlations and time (theta) are calculated for derivatives.

Notes to the Financial Statements continued

Balance sheet management
The Group analyses the sensitivity of net interest margin ('NIM') and market value of equity ('MVE') to changes in interest rates. See "Managing market risk" in "Market Risk – ALM" below.

Market risk – Corporate Banking

Market risks originated in the Corporate Banking division are transferred from the originating business to ALM, where they can be managed in conjunction with exposures arising from the funding, liquidity or capital management activities of ALM. Funds received with respect to deposits taken are lent on to Santander UK's Group Infrastructure on matching terms as regards interest rate repricing and maturity. Similarly, loans are funded through matching borrowings from Santander UK's Group Infrastructure. Any permitted retained market risk exposure is minimal, and is monitored against the limits approved by the Deputy Chief Risk Officer.

	Actual exposure at 31 December		
Trading instruments	**2011 £m**	2010 £m	2009 £m
Interest rate risks	**1.9**	2.1	1.0
Equity risks	**0.5**	0.7	-
Credit spread risks	**0.2**	0.6	1.5
Correlation offsets(1)	**(0.6)**	(0.3)	(0.9)
Total correlated one-day Value at Risk	**2.0**	3.1	1.6

	Exposure for the year ended 31 December								
	Average exposure			Highest exposure			Lowest exposure		
Trading instruments	**2011 £m**	2010 £m	2009 £m	**2011 £m**	2010 £m	2009 £m	**2011 £m**	2010 £m	2009 £m
Interest rate risks	**1.9**	2.1	3.6	**2.6**	4.4	7.1	**1.4**	0.9	0.8
Equity risks	**0.5**	0.7	-	**0.7**	0.7	-	**0.2**	0.7	-
Credit spread risks	**0.6**	1.1	3.5	**0.9**	1.6	4.9	**0.2**	0.6	1.5
Correlation offsets(1)	**(0.6)**	(0.9)	(2.1)	**-**	-	-	**-**	-	-
Total correlated one-day Value at Risk	**2.4**	3.0	5.0	**3.6**	5.0	8.4	**1.6**	2.2	1.4

(1) The highest and lowest exposure figures reported for each risk type did not necessarily occur on the same day as the highest and lowest total correlated one-day Value-at-Risk. A corresponding correlation offset effect cannot be calculated and is therefore omitted from the above tables.

Market risk - Markets

Market risk-taking is performed within the framework established by the Market Risk Manual. A major portion of the market risk arises from exposures to changes in the levels of interest rates, equity markets and credit spreads. Interest rate exposure is generated from most trading activities. Exposure to equity markets is generated by the creation and risk management of structured products by Markets for the personal financial services market and trading activities. Credit spread exposure arises indirectly from trading activities within Markets.

Managing market risk
Risks are managed within limits approved by the Chief Risk Officer (supported by the Deputy Chief Risk Officer) or Banco Santander, S.A.'s Board Risk Committee and within the risk control framework defined by the Market Risk Manual. For trading activities the primary risk exposures for Markets are interest rate, equity, credit spread and residual exposure to property indices. Interest rate risks are managed via interest rate swaps, futures and options (caps, floors and swaptions). Equity risks are managed via equity stock, index futures, options and structured equity derivatives. Credit spread risks are managed via vanilla credit derivatives. Property index risk is managed via insurance contracts and property derivatives.

To facilitate understanding and communication of different risks, risk categories have been defined. Exposure to all market risk factors is assigned to one of these categories. The Group considers two categories:

> **Short-term liquid market risk** covers activities where exposures are subject to frequent change and could be closed out over a short-time horizon. Most of the exposure is generated by Markets.

> **Structural market risk** includes exposures arising as a result of the structure of portfolios of assets and liabilities, or where the liquidity of the market is such that the exposure could not be closed out over a short-time horizon. The risk exposure is generated by features inherent in either a product or portfolio and normally presented over the life of the portfolio or product. Such exposures are a result of the decision to undertake specific business activities, can take a number of different forms, and are generally managed over a longer-time horizon.

Markets operates within a market risk framework designed to ensure that it has the capability to manage risk in a well-controlled manner. A comprehensive set of policies, procedures and processes have been developed and implemented to identify, measure, report, monitor and control risk across Markets.

Trading market risk

For trading activities the standardised risk measure adopted is Value at Risk, as described above. The following table shows the VaR-based consolidated exposures for the major risk classes at 31 December 2011, 2010 and 2009, together with the highest, lowest and average exposures for the year. Exposures within each risk class reflect a range of exposures associated with movements in that financial market.

The amounts below represent the potential change in market values of trading instruments. Since trading instruments are recorded at market value, these amounts also represent the potential effect on income.

	Actual Exposure at 31 December		
Trading instruments	**2011 £m**	2010 £m	2009 £m
Interest rate risks	**1.6**	2.0	3.0
Equity risks	**5.3**	1.1	1.2
Property risks	**2.1**	2.9	8.5
Other risks(1)	**1.9**	0.2	0.5
Correlation offsets(2)	**(2.4)**	(0.7)	(1.1)
Total correlated one-day Value at Risk	**8.5**	5.5	12.1

	Exposure for the year ended 31 December								
	Average exposure			Highest exposure			Lowest exposure		
Trading instruments	**2011 £m**	2010 £m	2009 £m	**2011 £m**	2010 £m	2009 £m	**2011 £m**	2010 £m	2009 £m
Interest rate risks	**2.3**	2.4	3.0	**3.8**	5.2	4.8	**1.2**	1.2	2.0
Equity risks	**2.6**	1.2	2.7	**6.9**	1.8	4.6	**0.6**	0.7	1.1
Property risks	**2.2**	5.5	8.6	**2.9**	9.1	9.5	**1.9**	2.9	7.7
Other risks(1)	**0.4**	0.3	0.7	**1.9**	0.8	1.2	**0.2**	0.2	0.4
Correlation offsets(2)	**(1.1)**	(0.9)	(1.6)	**-**	-	-	**-**	-	-
Total correlated one-day Value at Risk	**6.4**	8.5	13.4	**10.0**	14.6	15.5	**3.9**	4.8	11.1

(1) Other risks include foreign exchange risk.
(2) The highest and lowest exposure figures reported for each risk type did not necessarily occur on the same day as the highest and lowest total correlated one-day Value-at-Risk. A corresponding correlation offset effect cannot be calculated and is therefore omitted from the above tables.

Derivatives held for Trading Purposes

Markets is responsible for implementing Group derivative hedging with the external market together with its own trading activities. For trading activities, its objectives are to gain value by:

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

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

Under IAS 39, all derivatives are classified as "held for trading" (except for derivatives which are designated as effective hedging instruments in accordance with the detailed requirements of IAS 39) even if this is not the purpose of the transaction. The held for trading classification therefore includes two types of derivatives: those used in sales activities; and those used for risk management purposes but, for various reasons, either the Group does not elect to claim hedge accounting for or they do not meet the qualifying criteria for hedge accounting. See Note 15 to the Consolidated Financial Statements.

Derivatives held for Hedging Purposes

The Group uses derivatives (principally interest rate swaps and cross-currency swaps) for hedging purposes in the management of its own asset and liability portfolios, including fixed-rate lending, fixed-rate asset purchases, medium-term note issues, capital issues, and structural positions. This enables the Group to optimise the overall cost to it of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities. See Note 15 to the Consolidated Financial Statements.

Notes to the Financial Statements continued

Market risk - ALM

Most market risks arising from Santander UK's Retail Banking and Corporate Banking divisions are transferred from the originating business to the ALM business, where they can be managed in conjunction with exposures arising from the funding, liquidity or capital management activities of ALM. As a consequence, non-trading risk exposures are substantially transferred to ALM. Market risks mainly arise through the provision of banking products and services to personal and corporate/business customers, as well as structural exposures arising in the Group's balance sheet. These risks impact the Group's current earnings and economic value.

The most significant market risk in ALM is interest rate risk which includes yield curve and basis risks. Yield curve risk arises from the timing mismatch in the repricing of fixed and variable rate assets, liabilities and off-balance sheet instruments, as well as the investment of non-interest-bearing liabilities in interest-bearing assets. Basis risk arises, to the extent that the volume of administered variable rate assets and liabilities are not precisely matched, which exposes the balance sheet to changes in the relationship between administered rates and market rates.

Other risks that are inherent in ALM include credit spread, foreign currency, prepayment and launch risks. Credit spread risk arises principally on ALM's holdings of mortgage-backed securities. Foreign exchange risk arises from differences in the present value of existing foreign–currency denominated assets and liabilities, and future known cashflows. The Group is also exposed to risks arising from features in Santander UK's retail products that give customers the right to alter the expected cash flows of a financial contract. This creates prepayment risk, for example where customers may prepay loans before their contractual maturity. In addition, the Group is exposed to product launch risk, for example where the customers may not take up the expected volume of new fixed rate mortgages or other loans.

Managing market risk

The SRFM Committee, on the recommendation of ALCO, is responsible for managing the Group's overall balance sheet position. Natural offsets are used as far as possible to mitigate yield curve exposures but the overall balance sheet position is generally managed using derivatives that are transacted through Markets and with external counterparties. The Finance Director is responsible for managing risks in accordance with the SRFM Committee's direction and on behalf of the Chief Financial Officer. Risks are managed within a three-tier limit structure defined by the Market Risk Manual:

> Global limits approved by Banco Santander, S.A.'s Board Risk Committee;
> Limits and triggers approved by Deputy Chief Risk Officer; and
> Local sub-limits set to control the exposures retained within individual business areas.

The key risk metrics, Net Interest Margin ('NIM') and Market Value of Equity ('MVE'), measure the Group's exposure to yield curve risk. The following table shows the results of these measures at 31 December 2011 and 2010:

	2011 **£m**	2010 £m
Net Interest Margin sensitivity to +100 basis points shift in yield curve	**225**	309
Market Value of Equity sensitivity to +100 basis points shift in yield curve	**387**	410

NIM and MVE sensitivities are calculated based on market rate paths implied by the current yield curve, and based on contractual product features including re-pricing and maturity dates. The NIM and MVE sensitivities reflect how the base case valuations would be affected by a 100 basis point parallel shift applied instantaneously to the yield curve, and provide complementary views of the Group's exposure to interest rate movements.

MVE sensitivity provides a long-term view covering the present value of all future cash flows, whereas NIM sensitivity considers the impact on net interest margin over the next 12 months. The calculations for NIM and MVE sensitivities involve many assumptions, including expected customer behaviour (e.g. early repayment of loans) and how interest rates will evolve. The assumptions are reviewed and updated on a regular basis.

The change in the sensitivities between 2010 and 2011 was largely explained by the execution of a strategy designed to mitigate the impact of margin compression, should interest rates remain at low levels.

ALM - Derivatives

ALM enters into derivative contracts with Markets to manage the risks associated with its activities. Medium term funding may also be hedged directly with third parties. See Note 15 of the Consolidated Financial Statements.

Funding and Liquidity Risk

Funding risk

Funding risk is the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient or a funding programme such as debt issuance subsequently fails. For example, a securitisation arrangement may fail to operate as anticipated or the values of the assets transferred to a funding vehicle do not emerge as expected creating additional risks for the Group and its depositors. Risks arising from the encumbrance of assets are also included within this definition. Primary sources of funding include:

> Customer deposits;
> Secured and unsecured money-market funding (including unsecured cash, repo, CD and CP issuance);
> Senior debt issuance (including discrete bond issues and MTNs);
> Mortgage-backed funding (including securitisation and covered bond issuance); and
> Subordinated debt and capital issuance (although the primary purpose is not funding).

For accounting purposes, wholesale funding comprises deposits by customers, deposits by banks, debt securities in issue and subordinated liabilities. Retail and Corporate funding primarily comprises deposits by customers.

The funding risks of the Group are managed on a combined basis with Santander UK plc. For further information please refer to the funding risk discussion in the Risk Management Report in Santander UK plc's Consolidated Financial Statements.

Liquidity risk

Liquidity risk is the risk that the Group, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure them only at excessive cost. Liquidity risks arise throughout the Group. The Group's primary business activity is commercial banking and, as such, it engages in maturity transformation, whereby callable and short-term commercial deposits are invested in longer-term customer loans.

The liquidity risks of the Group are managed on a combined basis with Santander UK plc. For further information please refer to the liquidity risk discussion in the Risk Management Report in Santander UK plc's Consolidated Financial Statements.

Maturities of financial liabilities

The table below analyses the maturities of the undiscounted cash flows relating to financial liabilities of the Group based on the remaining period to the contractual maturity date at the balance sheet date. In particular the 'Demand' grouping includes current accounts and other variable rate savings products. The 'Up to 3 months' grouping largely constitutes wholesale funding of wholesale assets of a similar maturity. There are no significant financial liabilities related to financial guarantee contracts. This table is not intended to show the liquidity of the Group.

At 31 December 2011	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	4,784	31,111	25,655	40,615	16,191	118,356
Deposits by customers	101	913	823	5,477	109	7,423
Trading liabilities	7,781	14,488	1,415	1,564	656	25,904
Financial liabilities designated at fair value	-	1,632	1,634	3,074	1,015	7,355
Loan commitments	10	2	666	6,279	2,322	9,279
Debt securities in issue	-	4,533	2,575	15,617	7,846	30,571
	12,676	52,679	32,768	72,626	28,139	198,888
Derivative financial instruments	-	6	24	502	803	1,335
Total financial liabilities	**12,676**	**52,685**	**32,792**	**73,128**	**28,942**	**200,223**

At 31 December 2011						Company
	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	4,783	31,111	25,655	40,615	16,191	118,355
Deposits by customers	247	3,355	1,545	7,444	108	12,699
Trading liabilities	7,781	14,488	1,415	1,564	656	25,904
Financial liabilities designated at fair value	-	1,631	1,574	3,074	1,015	7,294
Loan commitments	10	2	666	6,279	2,322	9,279
Debt securities in issue	-	2,152	1,879	15,612	7,846	27,489
	12,821	52,739	32,734	74,588	28,138	201,020
Derivative financial instruments	-	6	24	502	803	1,335
Total financial liabilities	**12,821**	**52,745**	**32,758**	**75,090**	**28,941**	**202,355**

Notes to the Financial Statements continued

At 31 December 2010	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Group Total £m
Deposits by banks	4,484	48,457	29,120	40,196	15,291	137,548
Deposits by customers	476	615	261	5,580	204	7,136
Trading liabilities	1,329	35,088	4,229	1,770	705	43,121
Financial liabilities designated at fair value	-	1,299	542	860	1,058	3,759
Loan commitments	4	79	605	1,816	5,163	7,667
Debt securities in issue	-	10,745	4,702	11,121	10,246	36,814
Subordinated liabilities	-	8	24	130	424	586
	6,293	96,291	39,483	61,473	33,091	236,631
Derivative financial instruments	-	74	16	199	1,908	2,197
Total financial liabilities	6,293	96,365	39,499	61,672	34,999	238,828

At 31 December 2010	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Company Total £m
Deposits by banks	4,433	48,467	29,102	40,196	15,288	137,486
Deposits by customers	479	4,726	3,023	5,642	204	14,074
Trading liabilities	1,329	35,088	4,229	1,770	705	43,121
Financial liabilities designated at fair value	-	1,237	542	860	1,058	3,697
Loan commitments	4	79	605	1,816	5,163	7,667
Debt securities in issue	-	6,847	4,162	11,121	10,246	32,376
	6,245	96,444	41,663	61,405	32,664	238,421
Derivative financial instruments	-	74	16	199	1,908	2,197
Total financial liabilities	6,245	96,518	41,679	61,604	34,572	240,618

As the above table is based on contractual maturities, no account is taken of call features related to subordinated liabilities. The repayment terms of the debt securities may be accelerated in line with the covenants described in Note 31 to the Consolidated Financial Statements. The maturity analyses above for derivative financial liabilities include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows. These consist of interest rate swaps and cross-currency swaps which are used to hedge the Group's exposure to interest rates and exchange rates, and all loan commitments.

Operational Risk (unaudited)

The Group's operational risks are managed at a Santander UK level.

Definition

Operational risk is the risk of loss to the Group, resulting from inadequate or failed internal processes, people and systems, or from external events. This includes regulatory, legal and compliance risk. Such risks can materialise as frauds, process failures, system downtime or damage to assets due to fire, floods for example. When such risks materialise they have not only immediate financial consequences for the Group but also an effect on its business objectives, customer service and regulatory responsibilities.

Objective

As operational risk is inherent in the processes the Group operates in order to provide services to customers and generate profit for investors, an objective of Operational Risk management is not to remove operational risk altogether but to manage the risk to an acceptable level, taking into account the cost/benefits of minimisation as opposed to the inherent risk levels.

The Operational Risk Framework

Operational risk exposures arise across the Group's business divisions and operating units, and are managed on a consistent basis. The aim pursued by the Group in operational risk management is to identify, measure/assess, control/mitigate and inform regarding this risk. The Group's priority is to identify and minimise the risk of loss wherever appropriate, irrespective of whether losses have occurred. Measurement of the risk also contributes to the establishment of priorities in operational risk management, and includes the use of such methods as:

> Scenario analysis;
> Risk and control self-assessment;
> Capture and analysis of losses and incidents; and
> The use of key risk indicators to monitor risks and set tolerance levels

The Operational Risk Framework creates the consistent approach to how the Group controls and manages its operational risks and helps everyone understand their responsibilities within this approach. The Operational Risk Framework is a core component of the overall Risk Framework and crucially involves the setting of risk appetite, risk and issue escalation processes, and underpins management approaches to the control environment. The Framework facilitates the ongoing reassessment of risk, appetites and controls, in order to ensure that the Group manages its risks at all times in line with its business objectives.

Work to further strengthen this Framework began in 2011 and will continue in 2012. As part of this development the Group has used the services of a third party, approved by the regulator, to challenge and verify the content of the policy standards that comprise the Operational Risk Framework. The intention is to extend the methods for managing operational risks, increase the transparency of risk management and produce a tighter internal control framework which enhances the assurance that risks are being managed consistently and appropriately across the business.

For the purpose of calculating capital for operational risk, the Group employs the standardised approach provided for under Basel II rules in line with the Banco Santander group. The Group also uses its operational risk data and especially its stress and scenario data to assess its capital adequacy.

Managing operational risk

The Framework defines the Operational Risk requirements to be adhered to. The Group obtains assurance that the appropriate standards of risk management are being maintained through the the application of the Group's three tier Risk Governance Framework as follows:

> **In the first line**, the day-to-day management of operational risk is the responsibility of business managers who identify, assess and monitor the risks in line with the processes described in the Framework. The Group undertakes extensive activity to minimise the impact operational risks may have on business areas. Within the first line, a specialist operational risk function (IT & Operational Risk) co-ordinates this activity. They are responsible for challenging the adequacy of the risk and control processes operating in the business and monitoring adherence to the Operational Risk Framework. They are also responsible for co-ordinating the implementation and maintenance of the operational risk framework tools and methodologies and ensuring that all key risks are regularly reported to business line Risk Fora, Risk Committee and the Executive Committee.

> **In the second line**, an independent central operational risk function within the Risk Division has responsibility for establishing the Framework within which the risks are managed, providing the direction for delivering effective operational risk management, as well as overseeing its implementation to ensure consistent approaches are applied across the Group. The primary purpose of the Framework is to define and articulate the Group-wide policy, processes, roles and responsibilities. The Framework incorporates industry practice and regulatory requirements.

> **In the third line**, the Internal Audit function provides an independent assurance around the design, implementation, and effectiveness of the Group's Operational Risk Framework.

The "three lines of defence" model applies throughout the Group and is implemented taking account of the materiality and perceived risk of the different business areas by using the following key operational risk management techniques:

Scenario Analysis

The Group performs simulations of control failures that may cause the most extreme loss events. These simulations are developed around high impact risks likely to exceed the Group's future appetite. The scenario analysis allows management to better understand the potential impacts and remediate issues:

> Identifying the high impact events that would most damage the Company financially and reputationally;
> Ensuring that the business is focused on its most critical risks; and
> Facilitating the assessment of capital adequacy.

Risk and Control Self Assessments

Business units identify and assess their operational risks to ensure they are being effectively managed and controlled, and actions prioritised and aligned to the Group's risk appetite.

Key Risk Indicators

Santander UK uses Key Risk Indicators to monitor, and mitigation strategies to manage, operational risks. Indicator metrics are used to provide insight into the changing risk profile of the organisation and are also used to assess the performance of key controls.

Key Risk Indicator performance is monitored against tolerances and trigger points that prompt an early warning to potential exposures, whilst the creation of mitigation strategies help address potential concerns.

Notes to the Financial Statements continued

Loss Data Management

Loss data capture and analysis processes exist to capture all operational risk loss events. The data is used to identify and correct control weaknesses using events as opportunities to prevent or reduce the impacts of recurrence, identify emerging themes, inform risk and control assessments, scenario analysis and risk reporting. Escalation of single or aggregated events to senior management and risk fora is determined by threshold breaches.

Reporting

Reporting forms an integral part of operational risk management ensuring that issues are identified, escalated and managed on a timely basis. Exposures for each business area are reported through monthly risk and control reports which include details on risk exposures and mitigating plans. Events that have a material impact on the Group's finances, reputation, or customers are prioritised and reported immediately to key executives.

Measurement

A high proportion of the Group's operational risk events have a low financial cost associated with them and only a very small proportion have a material impact. Operational Risk loss events are categorised using the international Basel standards.

2011 operational risk loss profile
The percentage distribution of the value and number of loss events by category was:

Event type
I Internal Fraud

II External Fraud

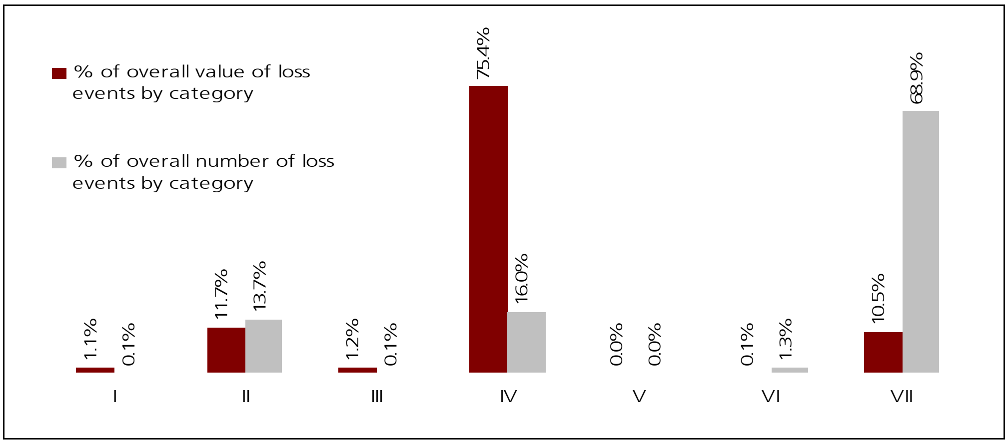
III Employment Practices

IV Clients Products & Business Practices

V Business Disruption

VI Damage To Physical Assets

VII Execution, Delivery & Process Management



In 2011, 69% of the events fell within the execution, delivery and process management category and yet accounted for only 11% of the losses by value. In contrast, over 75% of losses by value were caused by only 16% of the events.

Key operational risk activity in 2011

During 2011, Santander UK continued to manage its key operational risk in the interest of all its stakeholders, responding to critical developments both within the Group and in the environment in which it operated. Below are some of key risks and the activities undertaken to manage them during 2011.

Financial Crime

Financial crime risk is the risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related legal and regulatory obligations, these losses may include censure, fines or the cost of litigation.

The Group has continued to invest in staff education and improved fraud detection and prevention systems, processes and controls in order to counter the increasing threat of financial crime and to safeguard the investments of the Group's customers and assets. The introduction of sophisticated chip and pin terminals at counters in the Group's retail branches, for example, has reduced the risk of fraudulent account takeovers by organised criminals by enhancing our customer identification protocols in a customer-friendly manner.

The Group Financial Crime Team and Fraud Oversight function continually monitor emerging fraud trends and losses on a case-by-case basis. Action plans are formulated and tracked to ensure root causes have been identified and effective remediation conducted.

Losses and prevention strategies deployed in response to financial crime are reported to the Retail Banking Risk Forum, Risk Committee and Executive Committee.

During 2011, a specific Anti-Bribery and Corruption Unit was formed to provide assurance that the Group has the appropriate controls in response to the introduction of the UK's Bribery Act.

People

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate colleague actions and behaviour, industrial action, legal action in relation to people, or health and safety issues. Loss can also be incurred through failure to recruit, retain, train, reward and incentivise appropriately skilled staff to achieve business objectives and through failure to take appropriate action as a result of staff underperformance.

The Group takes a robust approach to managing people risk in full alignment with the operational risk framework. The Group has a mandatory training suite and policies which set out minimum standards and aim to mitigate risk in the areas of:

> Attraction and retention of suitable employees, using appropriate recruitment and pre-employment checks;
> Reward;
> Performance Management, Training & Development of employees;
> Succession Planning and continuing investment in people;
> Whistleblowing, Disciplinary & Grievance Management;
> Gathering employee opinion and managing employee engagement;
> Hiring former employees of the statutory auditor; and
> Health & Safety.

Conformance to policies is monitored through a comprehensive committee structure which reviews and actions enhancements on an ongoing basis. Risks are identified, managed and mitigated through ongoing risk management practices. Significant risks are reported to the HR Operational Loss Committee and the Executive Committee.

The Group has a robust Employee Relations governance framework in place that enables regular consultation at both national and local levels with its recognised trade unions enabling the Group to maintain a stable Employee Relations climate minimising any risk of disruption.

During 2011 the Group reviewed its approach to complying with the FSA Remuneration Code, and in 2012 intends to further review its pay management framework and remuneration governance arrangements. Significant progress has been made on harmonising terms and conditions from the Group's legacy acquisitions, and preparing for the acquisition and integration from the Royal Bank of Scotland group of a number of branches, regional offices and associated customers to ensure strong risk controls are maintained.

In 2011, the Group worked to develop its employer brand to embed an identity and a set of recognisable cultural values in a sector that is dominated by established brand names. The outcomes of this activity will underpin the Group's recruitment proposition and communications, to support attracting new talent into the organisation.

Customers

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate or poor customer treatment (customer treatment risk) or reductions resulting from poor externally-facing business processes (customer process risk). Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and/or system failure.

Customer risks are primarily managed through the Group Service Quality framework. Service Quality is an independent function which guides, supports, reviews and reports on customer satisfaction as measured through surveys, agreed service levels and feedback via complaints. There is regular weekly and monthly reporting to Executive Committee members and other senior directors across the business. Payments arising from complaints and root cause improvement initiatives are managed within the operational risk and losses framework.

Notes to the Financial Statements continued

Regulatory, legal and compliance risk

Regulatory, legal and compliance risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from failing to comply with the laws, regulations or codes applicable.

Regulatory, legal and compliance exposure is driven by the significant volume of current legislation and regulation with which the Group has to comply, along with new legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. Following the financial crisis, the pace and extent of regulatory reform proposals both in the UK and internationally have increased significantly, and can be expected to remain at high levels. Future changes in regulation, fiscal or other policies are unpredictable and beyond the control of the Group, but could for instance affect the Group's future business strategy, structure or approach to funding. Further uncertainties arise where regulations are principles-based without the regulator defining supporting minimum standards either for the benefit of the consumer or firms. This gives rise to both the risk of retrospection from any one regulator and also to the risk of differing interpretation by individual regulators.

For legal and regulatory issues there are significant reputational impacts associated with potential censure which drive the Group's stance on the appetites referred to above. There are clear accountabilities and processes in place for reviewing new and changing requirements. Each division and significant business areas have a nominated individual with 'compliance oversight' responsibility under UK Financial Services Authority rules. The role of such individuals is to advise and assist management to ensure that each business has a control structure which creates awareness of the rules and regulations, to which the Group is subject, and to monitor and report on adherence to these rules and regulations.

Basel II

Santander UK's risk management complies with Basel principles. A combination of the advanced and foundation internal ratings-based approaches was employed for the principal portfolios. For the remaining credit exposures, currently on the Basel II standardised approach, a rolling programme of transition to the appropriate IRB approach continues. The standardised approach for Operational Risk continued to be applied during 2011.

The Group applied Basel II to its capital disclosures made to the market. The Group has applied Banco Santander, S.A.'s approach to risk management in its application of Basel II. Further information on the Group's capital position under Basel II is included in Note 46 to the Consolidated Financial Statements.

Further information on the Basel II risk measurement of the Group's exposures is included in Banco Santander, S.A.'s 2010 Pillar 3 disclosures report. The Pillar 3 disclosures for Santander UK, of which the Group is part, can be found in the Santander UK plc 2011 Annual Report.

Forthcoming regulatory changes

In forecasting the Group's capital and liquidity positions, the implications of forthcoming regulatory changes (commonly referred to as Basel III), have been taken into account. In cases where proposed rules are still in the formative stage, the Group has applied appropriately conservative assumptions. Similarly, a conservative approach has been adopted in respect of the proposed implementation timescales, to allow for acceleration by the regulatory authorities.

Cyber security risk

Cyber security risk is the risk of reductions in earnings and/or value, through financial or reputational loss, associated with the failure of electronic information security or failure to comply with related legal and regulatory obligations. These losses may include censure, fines or the cost of litigation.

All customer, employee and Group data is considered confidential and appropriate security applied to protect it. The Group continues to invest in the protection of customer, employee and Group information to reduce the risks associated with the loss of confidentiality, integrity and of availability of this information. Measures taken to reduce the risks include staff education, data encryption and the deployment of specialist software such as Rapport which identifies when internet banking customers are at risk of disclosing information to unauthorised parties.

Losses and prevention strategies deployed in response to cyber security are reported to the Risk Committee and Executive Committee.

Other Risks (Unaudited)

Business/strategic risk

Definition
Business/strategic risk is the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment. This includes pro-cyclicality and capital planning risk. The internal component is the risk related to implementing the strategy. The external component is the risk of the business environment change on the Group's strategy.

Managing business/strategic risk
Business/strategic risk is managed on a monthly basis by the Risk Committee via the Economic Capital model. This is further discussed in the 'Economic capital' section. In addition, economically driven risks are assessed through the Group's stress-testing programme.

Reputational risk

Definition
Reputational risk is the risk of financial loss or reputational damage arising from treating customers unfairly, a failure to manage risk, a breakdown in internal controls, or poor communication with stakeholders. This includes the risk of decline in the value of the Group's franchise potentially arising from reduced market share, a change in business development expectations, complexity, tenor and performance of products and distribution mechanisms. Reputational risk also relates to judicial, economic-financial, ethical, social and environmental aspects, amongst others.

Managing reputational risk
Reputational risk is managed within the operational risk framework and other internal control and approval processes, and is undertaken by various governance structures, depending on where the risk originated from.

The management of reputational risk which could arise from an inadequate product sales process or an inappropriate provision of service, or non-compliance is undertaken by the following bodies:

a) The Risk Committee
As the senior body responsible for the management of risk, the committee assesses reputational risk whenever it is relevant to its activities and decision-making.

b) The Product Approval and Oversight Committee
This committee is currently chaired by the Chief Financial Officer of Santander UK plc and has representatives from Risk, Product Development and Marketing, Regulatory Affairs, Compliance, Manufacturing, Customer Experience, Finance, Legal, Human Resources and Internal Governance and Control as members. It is Santander UK's decision-making body which approves and monitors products and services. The scope of the Product Approval and Oversight Committee in respect of new products is as follows:

> Approving all new products;
> Ensuring each Division with Santander UK has stated its opinion and given the required approvals;
> Ensuring adherence to all applicable new product approval policies within Santander UK;
> Reviewing policies established for the control of all new product approvals within Santander UK;
> Defining the Company's culture in terms of managing conduct risk; and
> Ensuring the Santander UK policy for approving the launch of new products is complied with across all business areas.

The Products Committee pays particular attention to adjusting the product or service to the framework where it is going to be sold and especially to ensuring that:

> Each product or service is sold by someone who knows how to sell it;
> The client knows what he or she is investing in and the risk of each product or service and this can be accredited with the relevant documents;
> The product or service fits the customer's risk profile;
> Each product or service is sold where it can be, not only for legal or tax reasons (i.e. it fits into the legal and tax regime in the UK), but also on the basis of the prevailing financial culture; and
> When a product or service is approved the maximum limits for placement are set

Notes to the Financial Statements continued

Financial Instruments of Special Interest

This section summarises the types of financial instruments which have been of special interest as a result of the economic environment of the last few years. The table below shows the type of financial instrument and where they are classified on the Group's Consolidated Balance Sheet. It also provides cross references to the Notes to the Consolidated Financial Statements containing additional analysis of the significant assets.

The Group's financial instruments which are considered to have been most affected by the current credit environment include floating rate notes ('FRNs'), asset-backed securities ('ABS') (including mortgage-backed securities ('MBS') and the Group's exposures to monoline insurers), loans to banks, certain credit derivatives in the Treasury asset portfolio, and off-balance sheet entities. The Group has no investments in Collateralised Debt Obligations ('CDOs') or Collateralised Loan Obligations ('CLOs') and has no holdings in Structured Investment Vehicles.

The Group aims to actively manage these exposures.

Classification in the Consolidated Balance Sheet

The classification of these assets in the Group's Consolidated Balance Sheet, and cross references to the Notes to the Consolidated Financial Statements containing additional analysis of the significant assets, is as follows:

2011		Type of Financial Instrument						**Total**
Balance sheet line item	**Note**	**FRNs £m**	**ABS £m**	**Loans £m**	**Derivatives(1) £m**	**OECD Govt debts £m**	**Bank CDs £m**	**£m**
Trading assets – debt securities	14	**5,768**	**-**	**-**	**-**	**2,943**	**-**	**8,711**
Derivatives – equity & credit contracts	15	**-**	**-**	**-**	**16**	**-**	**-**	**16**
Financial assets designated at fair value – debt securities	16	**-**	**379**	**-**	**-**	**-**	**-**	**379**
Loans and advances to banks	17	**-**	**-**	**113,222**	**-**	**-**	**-**	**113,222**
Loans and receivables securities	21	**-**	**278**	**-**	**-**	**-**	**-**	**278**
		5,768	**657**	**113,222**	**16**	**2,943**	**-**	**122,606**

2010		Type of Financial Instrument						Total
Balance sheet line item	Note	FRNs £m	ABS £m	Loans £m	Derivatives(1) £m	OECD Govt debts £m	Bank CDs £m	£m
Trading assets – debt securities	14	10,901	-	-	-	6,630	290	17,821
Derivatives – equity & credit contracts	15	-	-	-	38	-	-	38
Financial assets designated at fair value – debt securities	16	-	1,046	-	-	-	-	1,046
Loans and advances to banks	17	-	-	146,412	-	-	-	146,412
Loans and receivables securities	21	-	626	-	-	-	-	626
		10,901	1,672	146,412	38	6,630	290	165,943

(1) Credit derivatives – Treasury asset portfolio. In November 2010, the Group acquired a portfolio of loans to banks, asset-backed securities and related credit derivatives, as part of an alignment of portfolios across the Banco Santander group. Disclosures regarding the geographic location of the counterparties to the credit derivatives recognised as a result of the acquisition of that portfolio are set out in the "ALM" section within "Credit Risk" on page 91. Further information on all the Group's holdings of derivatives (including these credit derivatives) is set out in Note 15 to the Consolidated Financial Statements.

Exposure to off-balance sheet entities sponsored by the Group

Certain Special Purpose Entities ('SPE's) are formed by the Group to accomplish specific and well-defined objectives, such as securitising financial assets. The Group consolidates these SPEs when the substance of the relationship indicates control, as described in Note 1 of the Consolidated Financial Statements. Details of SPEs sponsored by the Group (including SPEs not consolidated by the Group) are set out in Note 19 to the Consolidated Financial Statements.

The only SPEs sponsored but not consolidated by the Group are SPEs which issue shares that back retail structured products. The Group's arrangements with these entities comprise the provision of equity derivatives and a secondary market-making service to those retail customers who wish to exit early from these products. Further information on these entities is set out in Note 19 to the Consolidated Financial Statements.

45. FINANCIAL INSTRUMENTS

a) Measurement basis of financial assets and liabilities

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. Note 1 describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the Group's financial instruments into those measured at fair value and those measured at amortised cost in the balance sheet:

Group

31 December 2011	Held at fair value			Held at amortised cost		Non-financial assets / liabilities	Total
	Trading	Derivatives designated as hedges	Designated at fair value through profit or loss	Financial assets at amortised cost	Financial liabilities at amortised cost		
	£m	£m	£m	£m	£m	£m	£m
Assets							
Cash and balances at central banks	-	-	-	7,013	-	-	7,013
Trading assets	21,891	-	-	-	-	-	21,891
Derivative financial instruments	32,864	360	-	-	-	-	33,224
Financial assets designated at FV	-	-	4,710	-	-	-	4,710
Loans and advances to banks	-	-	-	113,222	-	-	113,222
Loans and advances to customers	-	-	-	38,826	-	-	38,826
Loans and receivables securities	-	-	-	278	-	-	278
Macro hedge of interest rate risk	-	-	-	1,141	-	-	1,141
Intangible assets	-	-	-	-	-	3	3
Property, plant and equipment	-	-	-	-	-	5	5
Deferred tax assets	-	-	-	-	-	17	17
Other assets	-	-	-	-	-	43	43
	54,755	360	4,710	160,480	-	68	220,373
Liabilities							
Deposits by banks	-	-	-	-	114,019	-	114,019
Deposits by customers	-	-	-	-	7,114	-	7,114
Derivative financial liabilities	34,180	1,237	-	-	-	-	35,417
Trading liabilities	25,745	-	-	-	-	-	25,745
Financial liabilities at FVTPL	-	-	6,836	-	-	-	6,836
Debt securities in issue	-	-	-	-	26,980	-	26,980
Other liabilities	-	-	-	-	142	-	142
Provisions	-	-	-	-	-	20	20
Current tax liabilities	-	-	-	-	-	393	393
	59,925	1,237	6,836	-	148,255	413	216,666

Company

31 December 2011	Held at fair value			Held at amortised cost		Non-financial assets / liabilities	Total
	Trading	Derivatives designated as hedges	Designated at fair value through profit or loss	Financial assets at amortised cost	Financial liabilities at amortised cost		
	£m	£m	£m	£m	£m	£m	£m
Assets							
Cash and balances at central banks	-	-	-	7,013	-	-	7,013
Trading assets	21,564	-	-	-	-	-	21,564
Derivative financial instruments	32,882	360	-	-	-	-	33,242
Financial assets designated at FV	-	-	4,710	-	-	-	4,710
Loans and advances to banks	-	-	-	113,211	-	-	113,211
Loans and advances to customers	-	-	-	38,926	-	-	38,926
Loans and receivables securities	-	-	-	278	-	-	278
Macro hedge of interest rate risk	-	-	-	1,141	-	-	1,141
Investment in subsidiary undertakings	-	-	-	-	-	2,187	2,187
Intangible assets	-	-	-	-	-	3	3
Property, plant and equipment	-	-	-	-	-	5	5
Deferred tax assets	-	-	-	-	-	17	17
Other assets	-	-	-	-	-	43	43
	54,446	360	4,710	160,569	-	2,255	222,340
Liabilities							
Deposits by banks	-	-	-	-	114,018	-	114,018
Deposits by customers	-	-	-	-	12,276	-	12,276
Derivative financial liabilities	34,180	1,237	-	-	-	-	35,417
Trading liabilities	25,745	-	-	-	-	-	25,745
Financial liabilities at FVTPL	-	-	6,780	-	-	-	6,780
Debt securities in issue	-	-	-	-	23,906	-	23,906
Other liabilities	-	-	-	-	137	-	137
Provisions	-	-	-	-	-	20	20
Current tax liabilities	-	-	-	-	-	384	384
	59,925	1,237	6,780	-	150,337	404	218,683

Notes to the Financial Statements continued

Group

31 December 2010	Held at fair value: Trading	Held at fair value: Derivatives designated as hedges	Held at fair value: Designated at fair value through profit or loss	Held at amortised cost: Financial assets at amortised cost	Held at amortised cost: Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m
Assets							
Cash and balances at central banks	-	-	-	5,088	-	-	5,088
Trading assets	35,461	-	-	-	-	-	35,461
Derivative financial instruments	22,951	286	-	-	-	-	23,237
Financial assets designated at FV	-	-	6,468	-	-	-	6,468
Loans and advances to banks	-	-	-	146,412	-	-	146,412
Loans and advances to customers	-	-	-	34,550	-	-	34,550
Held-to-maturity securities	-	-	-	331	-	-	331
Loans and receivables securities	-	-	-	626	-	-	626
Macro hedge of interest rate risk	-	-	-	908	-	-	908
Intangible assets	-	-	-	-	-	26	26
Property, plant and equipment	-	-	-	-	-	22	22
Current tax assets	-	-	-	-	-	40	40
Deferred tax assets	-	-	-	-	-	26	26
Other assets	-	-	-	-	65	-	65
	58,412	286	6,468	187,915	65	114	253,260
Liabilities							
Deposits by banks	-	-	-	-	136,753	-	136,753
Deposits by customers	-	-	-	-	7,061	-	7,061
Derivative financial liabilities	23,168	1,875	-	-	-	-	25,043
Trading liabilities	42,827	-	-	-	-	-	42,827
Financial liabilities at FVTPL	-	-	3,657	-	-	-	3,657
Debt securities in issue	-	-	-	-	33,659	-	33,659
Subordinated liabilities	-	-	-	-	331	-	331
Other liabilities	-	-	-	-	191	-	191
Current tax liabilities	-	-	-	-	-	374	374
Deferred tax liabilities	-	-	-	-	-	1	1
	65,995	1,875	3,657	-	177,995	375	249,897

Company

31 December 2010	Held at fair value: Trading	Held at fair value: Derivatives designated as hedges	Held at fair value: Designated at fair value through profit or loss	Held at amortised cost: Financial assets at amortised cost	Held at amortised cost: Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m
Assets							
Cash and balances at central banks	-	-	-	5,088	-	-	5,088
Trading assets	35,110	-	-	-	-	-	35,110
Derivative financial instruments	22,991	286	-	-	-	-	23,277
Financial assets designated at FV	-	-	6,468	-	-	-	6,468
Loans and advances to banks	-	-	-	146,398	-	-	146,398
Loans and advances to customers	-	-	-	34,935	-	-	34,935
Loans and receivables securities	-	-	-	626	-	-	626
Macro hedge of interest rate risk	-	-	-	908	-	-	908
Investment in subsidiary undertakings	-	-	-	-	-	2,187	2,187
Intangible assets	-	-	-	-	-	26	26
Property, plant and equipment	-	-	-	-	-	22	22
Current tax assets	-	-	-	-	-	40	40
Deferred tax assets	-	-	-	-	-	25	25
Other assets	-	-	-	-	65	-	65
	58,101	286	6,468	187,955	65	2,300	255,175
Liabilities							
Deposits by banks	-	-	-	-	136,701	-	136,701
Deposits by customers	-	-	-	-	13,989	-	13,989
Derivative financial liabilities	23,168	1,875	-	-	-	-	25,043
Trading liabilities	42,827	-	-	-	-	-	42,827
Financial liabilities at FVTPL	-	-	3,595	-	-	-	3,595
Debt securities in issue	-	-	-	-	29,226	-	29,226
Other liabilities	-	-	-	-	182	-	182
Current tax liabilities	-	-	-	-	-	357	357
	65,995	1,875	3,595	-	180,098	357	251,920

Notes to the Financial Statements continued

b) Fair values of financial instruments carried at amortised cost

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

			Group
31 December 2011	**Carrying value £m**	**Fair value £m**	**Surplus/ (deficit) £m**
Assets			
Cash and balances at central banks	**7,013**	**7,013**	**-**
Loans and advances to banks	**113,222**	**114,915**	**1,693**
Loans and advances to customers	**38,826**	**41,133**	**2,307**
Loans and receivable securities	**278**	**280**	**2**
Liabilities			
Deposits by banks	**114,019**	**115,060**	**(1,041)**
Deposits by customers	**7,114**	**7,213**	**(99)**
Debt securities in issue	**26,980**	**27,788**	**(808)**

			Company
31 December 2011	**Carrying value £m**	**Fair value £m**	**Surplus/ (deficit) £m**
Assets			
Cash and balances at central banks	**7,013**	**7,013**	**-**
Loans and advances to banks	**113,211**	**114,905**	**1,694**
Loans and advances to customers	**38,926**	**41,233**	**2,307**
Loans and receivable securities	**278**	**281**	**3**
Liabilities			
Deposits by banks	**114,018**	**115,058**	**(1,040)**
Deposits by customers	**12,276**	**12,362**	**(86)**
Debt securities in issue	**23,906**	**24,714**	**(808)**

			Group
31 December 2010	Carrying value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	5,088	5,088	-
Loans and advances to banks	146,412	148,141	1,729
Loans and advances to customers	34,550	35,525	975
Held-to-maturity	331	495	164
Loans and receivable securities	626	638	12
Liabilities			
Deposits by banks	136,753	137,583	(830)
Deposits by customers	7,061	6,911	150
Debt securities in issue	33,659	33,948	(289)
Subordinated liabilities	331	495	(164)

			Company
31 December 2010	Carrying value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	5,088	5,088	-
Loans and advances to banks	146,398	148,127	1,729
Loans and advances to customers	34,935	35,910	975
Loans and receivable securities	626	638	12
Liabilities			
Deposits by banks	136,701	137,531	(830)
Deposits by customers	13,989	13,839	150
Debt securities in issue	29,226	29,515	(289)

The surplus/(deficit) in the table above represents the surplus/(deficit) of fair value compared to the carrying amount of those financial instruments for which fair values have been estimated. The carrying value above of any financial assets and liabilities that are designated as hedged items in a portfolio (or macro) fair value hedge relationship excludes gains and losses attributable to the hedged risk, as this is presented as a single separate line item on the balance sheet.

Valuation methodology

The fair value of financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. Where quoted market prices are not available, fair value is determined using pricing models which use a mathematical methodology based on accepted financial theories, depending on the product type and its components. Further information on fair value measurement can be found in Note 1 and the valuation techniques section below.

Notes to the Financial Statements continued

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

Assets

Cash and balances at central banks
The carrying amount of cash and balances at central banks is deemed a reasonable approximation of the fair value.

Loans and advances to banks
The fair value of loans and advances to banks has been estimated using the same valuation technique for financial instruments accounted for at fair value as described in the Valuation techniques section below.

Loans and advances to customers
Loans and advances to personal customers are made both at variable and at fixed rates. As there is no active secondary market in the UK for such loans and advances, there is no reliable market value available for such a significant portfolio.
a) Variable rate
The Directors believe that the carrying value of the variable rate loans may be assumed to be their fair value.
b) Fixed rate
Certain of the loans secured on residential properties are at a fixed rate for a limited period, typically two to five years from their commencement. At the end of this period these loans revert to the relevant variable rate. The excess of fair value over carrying value of each of these loans has been estimated by reference to the market rates available at the balance sheet date for similar loans of maturity equal to the remaining fixed period.

Loan and receivable securities
These debt securities are valued with the assistance of valuations prepared by an independent, specialist valuation firm.

Held to maturity
The held to maturity assets comprise fixed rate bonds. The fair value has been estimated by reference to the market rates available at the balance sheet date for similar bonds of maturity equal to the remaining fixed period.

Liabilities

Deposits by banks
The fair value of deposits by banks has been estimated using the same valuation technique for financial instruments accounted for at fair value as described in the Valuation techniques section below.

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

The fair value of such deposits liabilities has been estimated using the same valuation technique for financial instruments accounted for at fair value as described in the Valuation techniques section below.

Debt securities in issue and subordinated liabilities
Where reliable prices are available, the fair value of debt securities in issue and subordinated liabilities has been calculated using quoted market prices. Other market values have been determined using the same valuation technique for financial instruments accounted for at fair value as described in the Valuation techniques section below.

c) Fair value valuation bases of financial instruments carried at fair value

The following tables summarise the fair values at 31 December 2011 and 2010 of the financial asset and liability classes accounted for at fair value, analysed by the valuation methodology used by the Group to determine their fair value. The tables also disclose the percentages that the recorded fair values of financial assets and liabilities represent of the total assets and liabilities, respectively, that are recorded at fair value in the balance sheet:

31 December 2011

Balance sheet category		Quoted prices in active markets (Level 1)		Internal models based on: Market observable data (Level 2)		Internal models based on: Significant unobservable data (Level 3)		Total		Valuation technique
		£m	%	£m	%	£m	%	£m	%	
Assets										
Trading assets	Loans and advances to banks	**-**	**-**	**6,144**	**10**	**-**	**-**	**6,144**	**10**	**A**
	Loans and advances to customers	**-**	**-**	**6,687**	**11**	**-**	**-**	**6,687**	**11**	**A**
	Debt securities	**8,711**	**15**	**-**	**-**	**-**	**-**	**8,711**	**15**	**-**
	Equity securities	**349**	**1**	**-**	**-**	**-**	**-**	**349**	**1**	**-**
Derivative assets	Exchange rate contracts	**-**	**-**	**1,586**	**3**	**70**	**-**	**1,656**	**3**	**A**
	Interest rate contracts	**54**	**-**	**29,782**	**50**	**-**	**-**	**29,836**	**50**	**A & C**
	Equity & credit contracts	**407**	**-**	**921**	**2**	**360**	**-**	**1,688**	**2**	**B**
	Commodity contracts	**-**	**-**	**12**	**-**	**-**	**-**	**12**	**-**	**A**
Financial assets at FVTPL	Loans and advances to customers	**-**	**-**	**4,273**	**7**	**58**	**-**	**4,331**	**7**	**A**
	Debt securities	**-**	**-**	**328**	**1**	**51**	**-**	**379**	**1**	**A**
Total assets at fair value		**9,521**	**16**	**49,733**	**84**	**539**	**-**	**59,793**	**100**	
Liabilities										
Trading liabilities	Deposits by banks	**-**	**-**	**14,508**	**21**	**-**	**-**	**14,508**	**21**	**A**
	Deposits by customers	**-**	**-**	**10,482**	**15**	**-**	**-**	**10,482**	**15**	**A**
	Short positions	**755**	**1**	**-**	**-**	**-**	**-**	**755**	**1**	**-**
Derivative liabilities	Exchange rate contracts	**-**	**-**	**3,087**	**5**	**-**	**-**	**3,087**	**5**	**A**
	Interest rate contracts	**41**	**-**	**29,490**	**44**	**-**	**-**	**29,531**	**44**	**A & C**
	Equity & credit contracts	**1,240**	**2**	**1,459**	**2**	**89**	**-**	**2,788**	**4**	**B**
	Commodity contracts	**-**	**-**	**11**	**-**	**-**	**-**	**11**	**-**	**A**
Financial liabilities at FVTPL	Debt securities in issue	**-**	**-**	**6,695**	**10**	**141**	**-**	**6,836**	**10**	**A**
Total liabilities at fair value		**2,036**	**3**	**65,732**	**97**	**230**	**-**	**67,998**	**100**	

31 December 2010

Balance sheet category		Quoted prices in active markets (Level 1)		Internal models based on: Market observable data (Level 2)		Internal models based on: Significant unobservable data (Level 3)		Total		Valuation technique
		£m	%	£m	%	£m	%	£m	%	
Assets										
Trading assets	Loans and advances to banks	-	-	8,281	13	-	-	8,281	13	A
	Loans and advances to customers	-	-	8,659	13	-	-	8,659	13	A
	Debt securities	17,821	27	-	-	-	-	17,821	27	-
	Equity securities	699	1	1	-	-	-	700	1	B
Derivative assets	Exchange rate contracts	-	-	1,185	2	61	-	1,246	2	A
	Interest rate contracts	3	-	19,649	30	-	-	19,652	30	A & C
	Equity & credit contracts	500	1	1,492	2	347	1	2,339	4	B
Financial assets at FVTPL	Loans and advances to customers	-	-	5,372	8	50	-	5,422	8	A
	Debt securities	-	-	978	2	68	-	1,046	2	A
Total assets at fair value		19,023	29	45,617	70	526	1	65,166	100	
Liabilities										
Trading liabilities	Deposits by banks	-	-	25,738	36	-	-	25,738	36	A
	Deposits by customers	-	-	15,971	22	-	-	15,971	22	A
	Short positions	1,118	2	-	-	-	-	1,118	2	-
Derivative liabilities	Exchange rate contracts	-	-	2,108	3	-	-	2,108	3	A
	Interest rate contracts	-	-	19,683	28	-	-	19,683	28	A & C
	Equity & credit contracts	55	-	3,095	4	102	-	3,252	4	B
Financial liabilities at FVTPL	Debt securities in issue	-	-	3,520	5	137	-	3,657	5	A
Total liabilities at fair value		1,173	2	70,115	98	239	-	71,527	100	

Notes to the Financial Statements continued

d) Valuation techniques

The main valuation techniques employed in the Group's internal models to measure the fair value of the financial instruments disclosed above at 31 December 2011 and 2010 are set out below. In substantially all cases, the principal inputs into these models are derived from observable market data. The Group did not make any material changes to the valuation techniques and internal models it used during the years ended 31 December 2011 and 2010.

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

B In the valuation of equity financial instruments requiring dynamic hedging (principally equity securities, options and other structured instruments), proprietary local volatility and stochastic volatility models are used. These types of models are widely accepted in the financial services industry. Observable market inputs used in these models include the bid-offer spread, foreign currency exchange rates, volatility and correlation between indices. In limited circumstances, other inputs may be used in these models that are based on data other than observable market data, such as the Halifax's UK House Price Index ('HPI') volatility, HPI forward growth, HPI spot rate and mortality.

C In the valuation of financial instruments exposed to interest rate risk that require either static or dynamic hedging (such as interest rate futures, caps and floors, and options), the present value method (futures), Black's model (caps/floors) and the Hull/White and Markov functional models (Bermudan options) are used. These types of models are widely accepted in the financial services industry. The significant inputs used in these models are observable market data, including appropriate interest rate curves, volatilities, correlations and exchange rates. In limited circumstances, other inputs may be used in these models that are based on data other than observable market data, such as HPI volatility, HPI forward growth, HPI spot rate and mortality.

The fair values of the financial instruments arising from the Group's internal models take into account, among other things, contract terms and observable market data, which include such factors as bid-offer spread, interest rates, credit risk, exchange rates, the quoted market price of raw materials and equity securities, volatility and prepayments. In all cases, when it is not possible to derive a valuation for a particular feature of an instrument, management uses judgement to determine the fair value of the particular feature. In exercising this judgement, a variety of tools are used including proxy observable data, historical data and extrapolation techniques. Extrapolation techniques take into account behavioural characteristics of equity markets that have been observed over time, and for which there is a strong case to support an expectation of a continuing trend in the future. Estimates are calibrated to observable market prices when they become available.

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

e) Fair value adjustments

The internal models incorporate assumptions that the Group believes would be made by a market participant to establish fair value. Fair value adjustments are adopted when the Group considers that there are additional factors that would be considered by a market participant in the determination of fair value of the instrument that are not incorporated in the valuation model. The magnitude of fair value adjustments depends upon many entity-specific factors, including modelling sophistication, the nature of products traded, and the size and type of risk exposures. For this reason, fair value adjustments may not be comparable across the banking industry.

The Group classifies fair value adjustments as either 'risk-related' or 'model-related'. The fair value adjustments form part of the portfolio fair value and are included in the balance sheet values of the product types to which they have been applied. The majority of these adjustments relate to Markets.

The magnitude and types of fair value adjustment adopted by Markets are listed in the following table:

	2011 £m	2010 £m
Risk-related:		
- Bid-offer and trade specific adjustments	**71**	62
- Uncertainty	**47**	49
- Credit risk adjustment	**70**	15
	188	126
Model-related:		
- Model limitation	**23**	25
Day One profits	**-**	-
	211	151

Risk-related adjustments

'Risk-related' adjustments are driven, in part, by the magnitude of the Group's market or credit risk exposure, and by external market factors, such as the size of market spreads.

(i) Bid-offer and trade specific adjustments

IAS 39 requires that portfolios are marked at bid or offer, as appropriate. Bid prices represent the price at which a long position could be sold and offer prices represent the price at which a short position could be bought back. Valuation models will typically generate mid market values. The bid-offer adjustment reflects the cost that would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the actual position.

The majority of the bid-offer adjustment relates to OTC derivative portfolios. For each portfolio, the major risk types are identified. These may include, inter alia, delta (the sensitivity to changes in the price of an underlying), vega (the sensitivity to changes in volatilities) and basis risk (the sensitivity to changes in the spread between two rates). For each risk type, the net portfolio risks are first classified into buckets, and then a bid-offer spread is applied to each risk bucket based upon the market bid-offer spread for the relevant hedging instrument.

The granularity of the risk bucketing is determined by reference to several factors, including the actual risk management practice undertaken by the Group, the granularity of risk bucketing within the risk reporting process, and the extent of correlation between risk buckets. Within a risk type, the bid-offer adjustment for each risk bucket may be aggregated without offset or limited netting may be applied to reflect correlation between buckets. There is no netting applied between risk types or between portfolios that are not managed together for risk management purposes. There is no netting across legal entities.

As bid-offer spreads vary by maturity and risk type to reflect different spreads in the market, for positions where there is no observable quote, a trade specific adjustment is further made. This is to reflect widened spreads in comparison to proxies due to reduced liquidity or observability. Trade specific adjustments can also be made to incorporate liquidity triggers whereby wider spreads are applied to risks above pre-defined thresholds or on exotic products to ensure overall reserves match market close-out costs. These market close-out costs inherently incorporate risk decay and cross-effects which are unlikely to be adequately reflected in the static hedge based on vanilla instruments.

(ii) Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective, with less market evidence available from which to determine general market practice. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt rather more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model. Uncertainty adjustments are derived by considering the potential range of derivative portfolio valuation given the available market data. The objective of an uncertainty adjustment is to arrive at a fair value that is not overly prudent but rather reflects a level of prudence believed to be consistent with market pricing practice.

Uncertainty adjustments are applied to various types of exotic OTC derivative. For example, the mean reversion speed of interest rates may be an important component of an exotic derivative value and an uncertainty adjustment may be taken to reflect the range of possible values that market participants may assume for this parameter.

(iii) Credit risk adjustment

The Group adopts a credit risk adjustment (also frequently known as a 'credit valuation adjustment') against OTC derivative transactions to reflect within fair value the possibility that the counterparty may default, and the Group may not receive the full market value of the transactions. The Group calculates a separate credit risk adjustment for each Santander UK legal entity, and within each entity for each counterparty to which the entity has exposure. The Group attempts to mitigate credit risk to third parties by entering into netting and collateral arrangements. The net counterparty exposure (i.e. counterparty positions netted by offsetting transactions and both cash and securities collateral) is then assessed for counterparty creditworthiness. The Group has only a limited exposure to monolines, consisting of exposure to securitisations which are wrapped by monoline insurers. The principal risk exposures are recorded against the securitisations, with the monoline wraps being viewed as contingent exposures, as described in Note 21. The description below relates to the credit risk adjustment taken against counterparties other than monolines.

Notes to the Financial Statements continued

The Group calculates the credit risk adjustment by applying the probability of default of the counterparty to the expected positive exposure to the counterparty, and multiplying the result by the loss expected in the event of default (i.e. the loss given default or 'LGD'). The timing of the expected losses is reflected by using a discount factor. The calculation is performed over the life of the potential exposure i.e. the credit risk adjustment is measured as a lifetime expected loss.

The expected positive exposure is calculated at a portfolio level and is based on the underlying risks of the portfolio. The main drivers of the expected positive exposure are the size of the risk position with the counterparty along with the prevailing market environment. The probability of default assumptions are based upon analysis of historic default rates. The credit rating used for a particular counterparty is that determined by the Group's internal credit process. The LGD is calculated at the facility level and takes into account the counterparty characteristics. Credit ratings and LGD are updated by the credit team as new relevant information becomes available and at periodic reviews performed at least annually.

The Group also considers its own creditworthiness when determining the fair value of an instrument, including OTC derivative instruments and financial liabilities held at fair value through profit or loss if the Group believes market participants would take that into account when transacting the respective instrument. The approach to measuring the impact of the Group's credit risk on an instrument is done in the same manner as for third party credit risk. The impact of the Group's credit risk is considered when calculating the fair value of an instrument, even when credit risk is not readily observable such as in OTC derivatives. The Group has not realised any profit or loss on revaluing fair values of derivatives to reflect its own creditworthiness. If the Group had reflected such adjustments it would not have had a material impact on the valuations. Consequently, the Group does not derive the adjustment on a bilateral basis and has a zero adjustment against derivative liabilities, often referred to as a 'debit valuation adjustment'.

For certain types of exotic derivatives where the products are not currently supported by the standard methodology, the Group adopts an alternative methodology. Alternative methodologies used by the Group fall into two categories. One method maps transactions against the results for similar products which are accommodated by the standard methodology. Where such a mapping approach is not appropriate, a bespoke methodology is used, generally following the same principles as the standard methodology, reflecting the key characteristics of the instruments but in a manner that is computationally less intensive. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than used in the standard methodology described previously.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises where the underlying value of the derivative prior to any credit risk adjustment is related to the probability of default of the counterparty. A more detailed description of wrong-way risk is set out below.

The Group includes all third-party counterparties in the credit risk adjustment calculation and the Group does not net credit risk adjustments across Group entities. During 2011, the methodologies used to calculate the credit risk adjustment were refined in line with evolving market practice.

Wrong-way risk

Wrong-way risk arises when there is a strong correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction. Wrong-way risk can be seen in the following examples:

> When the counterparty is resident and/or incorporated in an emerging market and seeks to sell a non-domestic currency in exchange for its home currency;

> When the trade involves the purchase of an equity put option from a counterparty whose shares are the subject of the option;

> The purchase of credit protection from a counterparty who is closely associated with the reference entity of the credit default swap or total return swap; and

> The purchase of credit protection on an asset type which is highly concentrated in the exposure of the counterparty selling the credit protection.

Exposure to 'wrong-way risk' is limited via internal governance processes and deal pricing. The Group considers that an appropriate adjustment to reflect wrong-way risk is currently nil (2010: nil).

Model-related adjustments

These adjustments are primarily related to internal factors, such as the ability of the Group's models to incorporate all material market characteristics. A description of each adjustment type is given below:

(i) Model limitation

Models used for portfolio valuation purposes, particularly for exotic derivative products, may be based upon a simplifying set of assumptions that do not capture all material market characteristics or may be less reliable under certain market conditions. Additionally, markets evolve, and models that were adequate in the past may require development to capture all material market characteristics in current market conditions. In these circumstances, model limitation adjustments are adopted outside the core valuation model. The adjustment methodologies vary according to the nature of the model. The Quantitative Risk Group ('QRG'), an independent quantitative support function reporting into Risk Department, highlights the requirement for model limitation adjustments and develops the methodologies employed. Over time, as model development progresses, model limitations are addressed within the core revaluation models and a model limitation adjustment is no longer needed.

Day One profits adjustments
Day One profit adjustments are adopted where the fair value estimated by a valuation model is based on one or more significant unobservable inputs, in accordance with IAS 39. Day One profits adjustments are amounts that have yet to be recognised in the income statement, which represent the difference between a transaction price (i.e. the fair value at initial recognition) and the amount that would have arisen had valuation models using unobservable inputs been used on initial recognition), less amounts subsequently recognised. Day One profits adjustments are calculated and reported on a portfolio basis. At 31 December 2011 and 2010, the Day One profits adjustments were less than £1m.

f) Control framework

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with the Risk Department and the Finance Department. For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the Group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable.

The factors that are considered in this regard include:

> The extent to which prices may be expected to represent genuine traded or tradeable prices;
> The degree of similarity between financial instruments;
> The degree of consistency between different sources;
> The process followed by the pricing provider to derive the data;
> The elapsed time between the date to which the market data relates and the balance sheet date; and
> The manner in which the data was sourced.

The source of pricing data is considered as part of the process that determines the classification of the level of a financial instrument. Consideration is given to the quality of the information available that provides the current mark-to-model valuation and estimates of how different these valuations could be on an actual trade, taking into consideration how active the market is. For spot assets that cannot be sold due to illiquidity, forward estimates are discounted to provide an estimate of a realisable value over time. All adjustments for illiquid positions are regularly reviewed to reflect changing market conditions.

Internal valuation model review
Models provide a logical framework for the capture and processing of necessary valuation inputs. For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of:

> The logic within valuation models;
> The inputs to those models;
> Any adjustments required outside the valuation models; and
> Where possible, model outputs.

All internal valuation models are validated independently by QRG. A validation report is produced for each model-derived valuation that assesses the mathematical assumptions behind the model and the implementation of the model and its integration within the trading system. Where there is observable market data, the models calibrate to market. Where pricing data is unobservable then the input parameters are regularly reviewed by QRG.

The independent valuation process applies fair value adjustments in line with the Group's established documented policies. The results of the independent validation process are reported to, and considered monthly by Risk Fora. Each Risk Forum is composed of representatives from several independent support functions (Product Control, Market Risk, QRG and Finance) in addition to senior management and the front office. The members of each Risk Forum consider the appropriateness and adequacy of the fair value adjustments and the effectiveness of valuation models. Changes to the fair value adjustments methodologies are considered by the Risk Fora and signed off by the Head of Wholesale Risk. The Risk Fora are overseen by the Wholesale Risk Oversight and Control Forum and Risk Committee.

Notes to the Financial Statements continued

g) Internal models based on observable market data (Level 2)

During 2011 and 2010, there were no transfers between Level 1 and Level 2 financial instruments.

1. Trading Assets

Loans and advances to banks and loans and advances to customers - securities purchased under resale agreements
These instruments consist of reverse repos with both professional non-bank customers and bank counterparties as part of the Group's trading activities. The fair value of reverse repos is estimated by using the 'present value' method. Future cash flows are evaluated taking into consideration any derivative features of the reverse repos and are then discounted using the appropriate market rates for the applicable maturity and currency. Under these agreements, the Group receives collateral with a market value equal to, or in excess of, the principal amount loaned. The level of collateral held is monitored daily and if required, further calls are made to ensure the market values of collateral remains at least equal to the loan balance. As a result, there would be no adjustment, or an immaterial adjustment, to reflect the credit quality of the counterparty related to these agreements. As the inputs used in the valuation are based on observable market data, these reverse repos are classified within level 2 of the valuation hierarchy.

Loans and advances to banks and loans and advances to customers - other
These instruments consist of term deposits placed which are short-term in nature and are both utilised and managed as part of the funding requirements of the trading book. The fair value of loans and advances to banks and loans and advances to customers is estimated using the 'present value' method. Expected future cash flows are discounted using the interest rate curves of the applicable currencies. The interest rate curves are generally observable market data and reference yield curves derived from quoted interest rates in appropriate time bandings, which match the timings of the cashflows and maturities of the instruments. As the inputs used in the valuation are based on observable market data, these loans are classified within level 2 of the valuation hierarchy.

2. Derivative assets and liabilities

These instruments consist of exchange rate contracts, interest rate contracts, equity and credit contracts and equity derivatives. The models used in estimating the fair value of these derivatives do not contain a high level of subjectivity as the methodologies used in the models do not require significant judgement, and the inputs used in the models are observable market data such as plain vanilla interest rate swaps and option contracts. As the inputs used in the valuation are based on observable market data, these derivatives are classified within level 2 of the valuation hierarchy.

Certain derivatives which represent cross currency swaps, reversionary property interests, credit default swaps and options and forwards contain significant unobservable inputs or are traded less actively or traded in less-developed markets, and so are classified within level 3 of the valuation hierarchy. The valuation of such instruments is further discussed in the 'internal models based on information other than market data' section below.

3. Financial assets at fair value through profit or loss ('FVTPL')

Loans and advances to customers
These instruments consist of loans secured on residential property to housing associations. The fair value of these social housing loans is estimated using the 'present value' model based on a credit curve derived from current market spreads observable in the social housing bond data. Observable market data include current market spreads for new accepted mandates and bids for comparable loans and are used to support or challenge the benchmark level.

This provides a range of reasonably possible estimates of fair value. As the inputs used in the valuation are based on market observable data, these loans are classified within level 2 of the valuation hierarchy.

Certain loans and advances to customers which represent a portfolio of roll-up mortgages contain significant unobservable inputs and so are classified within level 3 of the valuation hierarchy. The valuation of such instruments is further discussed below.

Debt securities
These instruments consist of holdings of asset-backed securities. A significant portion of these securities are priced using the 'present value' models, based on observable market data e.g. LIBOR, credit spreads. Where there are quoted prices for these instruments, the model value is checked against the quoted prices for reference purposes, but is not used as the fair value as the market for these instruments are lacking in liquidity and depth. As the inputs used in the valuation are based on observable market data, these debt securities are classified within level 2 of the valuation hierarchy.

Certain debt securities which represent reversionary property securities and securities issued by Banco Santander entities contain significant unobservable inputs, and so are classified within level 3 of the valuation hierarchy. The valuation of such instruments is further discussed below.

4. Trading liabilities

Deposits by banks and deposits by customers - securities sold under repurchase agreements
These instruments consist of repos with both professional non-bank customers and bank counterparties as part of the Group's trading activities. The fair value of repos is estimated using the same technique as those reverse repos in trading assets discussed above. Under these agreements, the Group is required to provide and maintain collateral with a market value equal to, or in excess of, the principal amount borrowed. As a result, there would be no adjustment, or an immaterial adjustment, to reflect the credit quality of the Group related to these agreements. As the inputs used in the valuation are based on observable market data, these repos are classified within level 2 of the valuation hierarchy.

Deposits by banks and deposits by customers - other
These instruments consist of certain term and time deposits which tend to be short-term in nature and are both utilised and managed as part of the funding requirements of the trading book. These instruments are valued using the same techniques as those instruments in trading assets - loans and advances to banks and loans and advances to customers discussed above. As the inputs used in the valuation are based on observable market data, these deposits are classified within level 2 of the valuation hierarchy.

5. Financial liabilities at FVTPL

Debt securities in issue
These instruments include commercial paper, medium term notes and other bonds and are valued using the same techniques as those instruments in financial assets at FVTPL - debt securities discussed above. As the inputs used in the valuation are based on observable market data, these debt securities are classified within level 2 of the valuation hierarchy.

Certain debt securities in issue which represent the more exotic senior debt issuances, consisting of power reverse dual currency ('PRDC') notes contain significant unobservable inputs and so are classified within level 3 of the valuation hierarchy. The valuation of such instruments is further discussed below.

h) Internal models based on information other than market data (Level 3)

The table below provides an analysis of financial instruments valued using internal models based on information other than market data together with the subsequent valuation technique used for each type of instrument. Each instrument is initially valued at transaction price:

			Balance sheet value		Amount recognised in income/(expense)	
			2011	2010	**2011**	2010
Balance sheet line item	**Category**	**Financial instrument product type**	**£m**	£m	**£m**	£m
1. Derivative assets	Exchange rate contracts	Cross-currency swaps	**70**	61	**7**	42
2. Derivative assets	Equity and credit contracts	Reversionary property interests	**78**	67	**14**	(6)
3. Derivative assets	Equity and credit contracts	Credit default swaps	**16**	38	**1**	-
4. Derivative assets	Equity contracts	Options and forwards	**266**	242	**5**	(20)
5. FVTPL	Loans and advances to customers	Roll-up mortgage portfolio	**58**	50	**8**	5
6. FVTPL	Debt securities	Mortgage-backed securities	**51**	68	**(8)**	53
7. Derivative liabilities	Equity contracts	Options and forwards	**(89)**	(102)	**8**	99
8. FVTPL	Debt securities in issue	Non-vanilla debt securities	**(141)**	(137)	**(6)**	(42)
Total net assets(1)			**309**	287	**-**	-
Total income/(expense)			**-**	-	**29**	131

(1) The Group's holdings of property unit trusts previously included in the disclosures above are no longer significant.

Valuation technique

1. Derivative assets - Exchange rate contracts
These cross currency swaps are used to hedge the foreign currency risks arising from the power reverse dual currency ('PRDC') notes issued by the Group, as described in Instrument 8 below. These derivatives are valued using a standard valuation model valuing each leg of the swap, with expected future cash flows less notional amount exchanged at maturity date discounted using an appropriate floating rate. The floating rate is adjusted by the relevant cross currency basis spread. Interest rates, foreign exchange rates, cross currency basis spread and long-dated foreign exchange ('FX') volatility are used as inputs to determine fair value. Interest rates, foreign exchange rates are observable on the market. Cross currency spreads may be market observable or unobservable depending on the liquidity of the cross currency pair. As the Japanese Yen-US dollar cross currency pair related to the PRDC notes is liquid, the cross currency spreads (including long-dated cross currency spread) for these swaps are market observable.

The significant unobservable inputs for the valuation of these financial instruments are the long-dated FX volatility and the correlation between the underlying assets. The correlation between the underlying assets is assumed to be zero, as there are no actively traded options from which correlations between the underlying assets could be implied. Furthermore, the zero correlation assumption implies that the sources of the long-dated FX volatility are independent.

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Long-dated FX volatility
Long-dated FX volatility is extrapolated from shorter-dated FX volatilities which are directly observable on the market. Short dated FX volatility is observable from the trading of FX options. As there is no active market for FX options with maturities greater than five years (long-dated FX options), long-dated FX volatility is not market observable. Furthermore, as historical prices are not relevant in determining the cost of hedging long-dated FX risk, long-dated FX volatility cannot be inferred from historical volatility. The Group extrapolates the long-dated FX volatility from the shorter-dated FX volatilities using Black's model.

FX volatility is modelled as the composition of the domestic interest rate, foreign interest rates and FX spot volatilities using standard Hull-White formulae. The Hull-White approach is used for estimating the future distribution of domestic and foreign zero-coupon rates, constructed from the relevant yield curves. Using short dated FX options, the FX spot volatility is calculated which is then extrapolated to derive the long-dated FX volatility.

2. Derivative assets - Equity and credit contracts
These reversionary property derivatives are valued using a probability weighted set of HPI forward prices, which are assumed to be a reasonable representation of the increase in value of the Group's reversionary interest portfolio underlying the derivatives. The probability used reflects the likelihood of the home owner vacating the property and is calculated from mortality rates and acceleration rates which are a function of age and gender, obtained from the relevant mortality tables. Indexing is felt to be appropriate due to the size and geographical dispersion of the Group's reversionary interest portfolio. These are determined using HPI Spot Rates adjusted to reflect estimated forward growth. Launched in 1984, the Halifax's UK HPI is the UK's longest running monthly house price data series covering the whole country. The indices calculated are standardised and represent the price of a typically transacted house. Both national and regional HPI are published. The national HPI is published monthly. The regional HPI reflects the national HPI disaggregated into 12 UK regions and is published quarterly. Both indices are published on two bases, including and excluding seasonal adjustments in the housing market. The Group uses the non-seasonally adjusted ('NSA') national and regional HPI in its valuation model to avoid any subjective judgement in the adjustment process which is made by Halifax.

The inputs used to determine the value of the reversionary property derivatives are HPI spot, HPI forward growth and mortality rates. The principal pricing parameter is HPI forward growth.

HPI Spot Rate
The HPI spot rate used in the model is a weighted average of NSA regional HPI spot rates i.e. adjusted for difference in the actual regional composition of the property underlying the Group's reversionary interest portfolio and the composition of the published regional indices. The regional HPI spot rate (which is observable market data) is only published on specific quarterly dates. In between these dates, its value is estimated by applying the growth rate over the relevant time period inferred from the national HPI spot rates (which are observable market data and published monthly) to the most recently calculated weighted average regional HPI spot rate based on published regional indices.

An adjustment is also made to reflect the specific property risk i.e. possible deviation between the actual growth in the house prices underlying the Group's reversionary interest portfolio and their assumed index-linked growth, which is based on the regional HPI. This adjustment is based on the average historical deviation of price changes of the Group's actual property portfolio from that of the published indices over the time period since the last valuation date.

HPI Forward Growth Rate
Long-dated HPI forward growth rate is not directly observable in the market but is estimated from broker quotes and traded forward contracts. A specific spread is applied to the long-dated forward growth rate to reflect the uncertainty surrounding long dated data. This spread is calculated by analysing the historical volatility of the HPI, whilst incorporating mean reversion. An adjustment is made to reflect the specific property risk as for the HPI spot rate above.

Mortality Rate
Mortality rates are obtained from the PNMA00 and PNFA00 Continuous Mortality Investigation Tables published by the UK Institute and Faculty of Actuaries. These mortality rates are adjusted by acceleration rates to reflect the mortality profile of the holders of Group's reversionary property products underlying the derivatives.

3. Derivative assets - Equity and credit contracts
These derivative assets are credit default swaps held against certain bonds. The credit default swaps are valued using the credit spreads of the referenced bonds. These referenced bonds are valued with the assistance of valuations prepared by an independent, specialist valuation firm as a deep and liquid market does not exist.

In valuing the credit default swaps, the main inputs used to determine the underlying cost of credit are quoted risk premiums and the correlation between the quoted credit derivatives of various issuers. The assumptions relating to the correlation between the values of quoted and unquoted assets are based on historical correlations between the impact of adverse changes in market variables and the corresponding valuation of the associated unquoted assets. The measurement of the assets will vary depending on whether a more or less conservative scenario is selected. The other main input is the probability of default of the referenced bonds. The significant unobservable input for the valuation of these financial instruments is the probability of default.

Probability of default
The probability of default is assessed by considering the credit quality of the underlying referenced bonds. However, as no deep and liquid market exists for these assets the assessment of the probability of default is not directly observable and instead an estimate is calculated using the Standard Gaussian Copula model.

4. Derivative assets – Equity contracts
There are three types of derivatives within this category:

European options
These derivatives are valued using a modified Black-Scholes model where the HPI is log-normally distributed with the forward rates determined from the HPI forward growth.
Asian options
Asian (or average value) options are valued using a modified Black-Scholes model, with an amended strike price and volatility assumption to account for the average exercise period, through a closed form adjustment that reflects the strike price relative to the distribution of stock prices at each relevant date. This is also known as the Curran model.
Forward contracts
Forward contracts are valued using a standard forward pricing model.

The inputs used to determine the value of the above instruments are HPI spot rate, HPI forward growth rate and HPI volatility. The principal pricing parameter is HPI forward growth rate.

HPI Spot Rate
The HPI spot rate used is the NSA national HPI spot rate which is published monthly and directly observable in the market. This HPI rate used is different from the weighted average regional HPI spot rate used in the valuation of Instrument 2 above, as the underlying of these derivatives is the UK national HPI spot rate.

HPI Forward Growth Rate
The HPI forward growth rate used is unobservable and is the same as used in the valuation of Instrument 2 above.

HPI Volatility
Long-dated HPI volatility is not directly observable in the market but is estimated from the most recent traded values. An adjustment is applied to the long-dated HPI volatility rate to reflect the uncertainty surrounding long-dated data. This adjustment is based on the empirical standard deviation of historical volatility over a range of time horizons.

5. FVTPL – Loans and advances to customers
These loans and advances to customers represent roll-up mortgages, which are an equity release scheme under which a property owner takes out a loan secured against their home. The owner does not make any interest payments during their lifetime and the fixed interest payments are rolled up into the mortgage. The loan or mortgage (capital and rolled-up interest) is repaid upon the owner's vacation of the property and the value of the loan is only repaid from the value of the property. This is known as a 'no negative pledge'. The Group suffers a loss if the sale proceeds from the property are insufficient to repay the loan, as it is unable to pursue the homeowner's estate or beneficiaries for the shortfall.

The value of the mortgage 'rolls up' or accretes until the owner vacates the property. In order to value the roll-up mortgages, the Group uses a probability-weighted set of European option prices (puts) determined using the Black-Scholes model, in which the 'no negative pledges' are valued as short put options. The probability weighting applied is calculated from mortality rates and acceleration rates as a function of age and gender, taken from mortality tables.

The inputs used to determine the value of these instruments are HPI spot, HPI forward growth, HPI volatility, mortality rates and repayment rates. The principal pricing parameter is HPI forward growth. The HPI forward growth rate used is unobservable and is the same as used in the valuation of Instrument 2 above. The other parameters do not have a significant effect on the value of the instruments.

6. FVTPL – Debt securities
These securities consist of residential mortgage-backed securities issued by Banco Santander entities. Each instrument is valued with reference to the price from a consensus pricing service. This is then corroborated against the price from another consensus pricing service due to the lack of depth in the number of available market quotes. An average price is used where there is a more than insignificant difference between the two sources.

The significant unobservable input is the adjustment to the credit spread embedded in the pricing consensus quotes.

7. Derivative liabilities - Equity contracts
These derivatives are the same as Instrument 4 with the exception that they have a negative fair value.

8. FVTPL - Debt securities in issue
These debt securities in issue are power reverse dual currency notes. These notes are financial structured products where an investor is seeking a better return and a borrower/issuer a lower rate by taking advantage of the interest rate differential between two countries. The note pays a foreign interest rate in the investor's domestic currency. The power component of the name denotes higher initial coupons and the fact that coupons rise as the domestic/foreign exchange rate depreciates. The power feature comes with a higher risk for the investor. Cash flows may have a digital cap feature where the rate gets locked once it reaches a certain threshold. Other add-on features are barriers such as knockouts and cancellation provisions for the issuer.

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These debt securities in issue are valued using a three-factor Gaussian Model. The three factors used in the valuation are domestic interest rates, foreign interest rates and foreign exchange rates. The correlations between the factors are assumed to be zero within the valuation.

The Hull-White approach is used for estimating the future distribution of domestic and foreign zero-coupon rates, constructed from the relevant yield curves. A Geometric Brownian Motion model is used for estimating the future distribution of spot foreign exchange rates. The foreign exchange and interest rate volatilities are the most crucial pricing parameters; the model calibrates to the relevant swaption volatility surface.

The significant unobservable inputs for the valuation of these financial instruments are the long dated FX volatility and the correlation between the underlying assets and are the same as Instrument 1.

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	Assets			**Liabilities**		
	Derivatives £m	**Fair value through P&L £m**	**Total £m**	**Derivatives £m**	**Fair value through P&L £m**	**Total £m**
At 1 January 2011	**408**	**118**	**526**	**(102)**	**(137)**	**(239)**
Total gains/(losses) recognised in profit/(loss):						
- Fair value movements	**27**	**-**	**27**	**8**	**(6)**	**2**
- Foreign exchange and other movements	**4**	**(2)**	**2**	**-**	**(7)**	**(7)**
Purchases	**27**	**-**	**27**	**(6)**	**-**	**(6)**
Sales	**(1)**	**-**	**(1)**	**-**	**-**	**-**
Settlements	**(35)**	**(7)**	**(42)**	**11**	**9**	**20**
At 31 December 2011	**430**	**109**	**539**	**(89)**	**(141)**	**(230)**
Total gains/(losses) recognised in profit/(loss) relating to those assets and liabilities held at the end of the year	**31**	**(2)**	**29**	**8**	**(13)**	**(5)**

	Assets			Liabilities		
	Derivatives £m	Fair value through P&L £m	Total £m	Derivatives £m	Fair value through P&L £m	Total £m
At 1 January 2010	383	1,431	1,814	(260)	(109)	(369)
Total gains/(losses) recognised in profit/(loss):						
- Fair value movements	16	58	74	99	(42)	57
- Foreign exchange and other movements	(16)	3	(13)	-	10	10
Purchases	38	-	38	-	-	-
Settlements	-	(1,215)	(1,215)	-	-	-
Transfers out	(13)	(159)	(172)	59	4	63
At 31 December 2010	408	118	526	(102)	(137)	(239)
Total gains/(losses) recognised in profit/(loss) relating to those assets and liabilities held at the end of the year	-	61	61	99	(32)	67

(1) The Group's holdings of property unit trusts previously included in the disclosures above are no longer significant.

Financial instrument assets and liabilities at 31 December 2011

Financial instrument assets valued using internal models based on information other than market data were 1% (2010: 1%) of total assets measured at fair value and 0.2% (2010: 0.2%) of total assets at 31 December 2011.

Derivative assets increased in 2011 principally due to purchases of credit default swaps. Assets designated at fair value through profit or loss decreased in 2011 principally due to sales and maturities of securities issued by Banco Santander entities which were backed by small business and automotive loans and other collateralised debt obligations.

Financial instrument liabilities valued using internal models based on information other than market data were 0.3% (2010: 0.3%) of total liabilities measured at fair value and 0.1% (2010: 0.1%) of total liabilities at 31 December 2011.

Derivative liabilities decreased in 2011 due to settlements and gains reflecting changes in credit spreads, the HPI index and foreign exchange rates. Liabilities designated at fair value through profit or loss increased in 2011 principally due to maturities of debt securities in issue.

Gains and losses for the year ended 31 December 2011

Gains of £31m in respect of derivatives assets principally reflected changes in credit spreads and the HPI Index. Losses of £2m in respect of assets designated at fair value through profit or loss principally reflected favourable changes in foreign exchange rates during the year.

Gains of £8m in respect of derivatives liabilities principally reflected changes in credit spreads and the HPI Index. Losses of £13m in respect of liabilities designated at fair value through profit or loss principally reflected changes in foreign exchange and interest rates. They are fully matched with derivatives.

Gains and losses for the year ended 31 December 2010

Gains of £nil in respect of derivatives assets principally reflected gains in changes in credit spreads and the HPI Index being offset by losses in foreign exchange rates. Gains of £61m in respect of assets designated at fair value through profit or loss principally reflected the smaller mark-to-market volatility on a reduced portfolio of asset-backed and mortgage-backed securities held during the year.

Gains of £99m in respect of derivatives liabilities principally reflected changes in credit spreads, the HPI index and foreign exchange rates. Losses of £32m in respect of liabilities designated at fair value through profit or loss principally reflected changes in credit spreads, foreign exchange and interest rates. They are fully matched with derivatives.

Effect of changes in significant unobservable assumptions to reasonably possible alternatives (Level 3)

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data and, as such require the application of a degree of judgement. Changing one or more of the inputs to the valuation models to reasonably possible alternative assumptions would change the fair values significantly. The following table shows the sensitivity of these fair values to reasonably possible alternative assumptions.

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable input as described in the table below. The potential effects do not take into effect any offsetting or hedged positions.

At 31 December 2011

				Reflected in income statement	
Balance sheet note line item and product	Fair value £m	Assumptions	Shift	Favourable changes £m	Unfavourable changes £m
2. Derivative assets – Equity and credit contracts: – Reversionary property derivatives	**78**	HPI Forward growth rate	**1%**	**11**	**(11)**
		HPI Spot rate	**10%**	**8**	**(8)**
		Mortality rate	**2 yrs**	**-**	**-**
3. Derivative assets – Equity and credit contracts: – Credit default swaps	**16**	Probability of default	**20%**	**3**	**(3)**
4. Derivative assets – Equity and credit contracts: – Options and forwards	**77**	HPI Forward growth rate	**1%**	**7**	**(7)**
		HPI Spot rate	**10%**	**4**	**(3)**
		HPI Volatility	**1%**	**1**	**(1)**
5. FVTPL – Loans and advances to customers: – Roll-up mortgage portfolio	**58**	HPI Forward growth rate	**1%**	**2**	**(2)**
6. FVTPL – Debt securities: – Mortgage-backed securities	**51**	Credit spread	**10%**	**5**	**(5)**
7. Derivative liabilities - Equity and credit contracts: – Options and forwards	**(89)**	HPI Forward growth rate	**1%**	**4**	**(4)**
		HPI Spot rate	**10%**	**13**	**(17)**
		HPI Volatility	**1%**	**2**	**(2)**

At 31 December 2010

				Reflected in income statement	
Balance sheet note line item and product	Fair value £m	Assumptions	Shift	Favourable changes £m	Unfavourable changes £m
2. Derivative assets – Equity and credit contracts: – Reversionary property derivatives	67	HPI Forward growth rate	1%	10	(10)
		HPI Spot rate	10%	7	(7)
		Mortality rate	2 yrs	1	(1)
3. Derivative assets – Equity and credit contracts: – Credit default swaps	38	Probability of default	20%	12	(12)
4. Derivative assets – Equity and credit contracts: – Options and forwards	242	HPI Forward growth rate	1%	7	(7)
		HPI Spot rate	10%	4	(4)
		HPI Volatility	1%	1	(1)
5. FVTPL – Loans and advances to customers: – Roll-up mortgage portfolio	50	HPI Forward growth rate	1%	1	(1)
6. FVTPL – Debt securities: – Mortgage-backed securities	68	Credit spread	3%	3	(3)
7. Derivative liabilities - Equity and credit contracts: – Options and forwards	(102)	HPI Forward growth rate	1%	4	(4)
		HPI Spot rate	10%	13	(17)
		HPI Volatility	1%	2	(2)

No sensitivities are presented for the FVTPL - debt securities in issue (instrument 8) per page 117 and related exchange rate derivatives (instrument 1) per page 115 as the terms of these instruments are fully matched. As a result, any changes in the valuation of the debt securities in issue would be exactly offset by an equal and opposite change in the valuation of the exchange rate derivatives.

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46. CAPITAL MANAGEMENT AND RESOURCES

Capital management and capital allocation

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

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

Santander UK manages its capital requirements, debt funding and liquidity on the basis of policies and plans reviewed regularly at SFRM and ALCO and as part of the ICAAP process while debt funding and liquidity are also reviewed as part of the Internal Liquidity Adequacy Assessment ('ILAA') process. To support its capital and senior debt issuance programmes, the Company is rated on a stand alone basis.

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

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

Capital adequacy

From 1 January 2008, the Group has managed its capital on a Basel II basis. Throughout 2011 and 2010, the Group held capital over and above its regulatory requirements, and managed internal capital allocations and targets in accordance with its capital and risk management policies.

Group Capital

	31 December 2011 £m	31 December 2010 £m
Tier 1 capital	**3,637**	3,342
Deductions from Tier 1 capital	**(44)**	(55)
Total Tier 1 capital	**3,593**	3,287
Total Capital Resources	**3,593**	3,287

Tier 1 capital consists of shareholders' equity and audited profits for the years ended 31 December 2011 and 31 December 2010 after adjustment to comply with UK Financial Services Authority rules.

Tier 1 deductions relate to intangible assets and expected losses. In addition, the Group has elected to deduct certain securitisation positions from capital rather than treat these exposures as a risk weighted asset.

The expected loss deduction represents the difference between expected loss calculated in accordance with the Group's IRB models, and the impairment losses calculated in accordance with IFRS. The Group's accounting policy for impairment loss allowances is set out in Note 1. Expected losses are higher than the impairment losses as the expected loss amount includes all losses that are anticipated to arise over the twelve months following the balance sheet date, not just those incurred at the balance sheet date.

The increase in Tier 1 capital is due to the inclusion of audited profits for the year ended 31 December 2011.

An investment in Abbey National Treasury Services plc (the 'Company') and its subsidiaries (together, the 'Group') involves a number of risks, the material ones of which are set forth below. As a consequence of the reciprocal guarantee given by the Group in respect of the liabilities of Santander UK plc, the Group is exposed to the same risk factors as Santander UK, of which the Company and the Group are part.

The Group's operating results, financial condition and prospects may be materially impacted by economic conditions in the UK

Santander UK's business activities are concentrated in the UK and on the offering of mortgage and savings-related products and services. As a consequence, Santander UK's operating results, financial condition and prospects are significantly affected by economic conditions in the UK generally, and by the UK property market in particular.

In 2008 and 2009, the UK property market suffered a significant correction as a consequence of housing demand being constrained by a combination of rising unemployment, subdued earnings growth, greater pressure on disposable income, a decline in the availability of mortgage finance and the continued effect of global market volatility. Although the UK economy began to grow again in 2009 after the recession that followed the financial crisis, the ongoing sovereign debt crisis throughout the eurozone, elevated unemployment rates and high inflation (which hit real average earnings growth and consequently consumer spending) led to slower growth in 2011 of 0.9%. GDP fell by 0.2% in the final quarter of 2011 which raised the prospect of a renewed economic downturn in the UK. The Bank of England has held the base rate at a record low of 0.5% since March 2009, and announced a further quantitative easing programme in October 2011 and an extension to this in February 2012 in an effort to support economic activity. Consumer price inflation peaked at 5.2% in September 2011 falling to 3.6% in January 2012.

Adverse changes in the credit quality of the Group's borrowers and counterparties or a general deterioration in UK or global economic conditions could reduce the recoverability and value of the Group's assets and require an increase in the Group's level of provisions for bad and doubtful debts. Likewise, a significant reduction in the demand for the Group's products and services could negatively impact Santander UK's business and financial condition.UK economic conditions and uncertainties may have an adverse effect on the quality of Santander UK's loan portfolio and may result in a rise in delinquency and default rates. Santander UK recorded impairment loss allowances on loans and advances to customers of £1,563m, £1,655m and £1,299m at 31 December 2011, 2010 and 2009, respectively. There can be no assurance that Santander UK will not have to increase its provisions for loan losses in the future as a result of increases in non-performing loans or for other reasons beyond its control. Any increases in Santander UK's provisions for loan losses and write-offs/charge-offs could have a material adverse effect on Santander UK's operating results, financial condition and prospects.

As in several other economies, the UK Government has taken measures to address the exceptionally high level of national debt, including tax increases and public spending cuts. Political involvement in the regulatory process and in the major financial institutions in which the UK Government has a direct financial interest is set to continue. UK Government demands for financial institutions to increase lending to support the economic recovery will increase competition for deposits, potentially narrowing margins.

The combination of slow economic recovery, UK Government intervention and competition for deposits will maintain the pressure on Santander UK's retail business model. Although both the Office for Budget Responsibility and the Bank of England expect stronger economic growth in 2013 than in 2012, credit quality could be adversely affected by a further increase in unemployment. These negative conditions in the UK, together with any related significant reduction in the demand for Santander UK's products and services, could have a material adverse effect on the Group's operating results, financial condition and prospects.

The Group's operating results, financial condition and prospects may be negatively affected by conditions in global financial markets

The extreme volatility and disruption in global capital and credit markets since 2008 has led to severe dislocation of financial markets around the world, an unprecedented reduction in available liquidity and increased credit risk premiums for many market participants. This has caused severe problems at many of the world's largest commercial banks, investment banks and insurance companies, a number of which are the Group's counterparties or customers in the ordinary course of business. These conditions have also resulted in a material reduction in the availability of financing, both for financial institutions and their customers, compelling many financial institutions to rely on central banks and governments to provide liquidity and, in some cases, additional capital during this period. Governments around the world have sought to provide this liquidity in order to stabilise financial markets and prevent the failure of financial institutions.

Although conditions have eased to some extent since 2009, the volatility of the capital and credit markets has continued and liquidity problems remain, exacerbated recently by fears concerning the financial health of a number of European governments. Greece and other eurozone economies came under increased pressure in 2011, with concerns focused on the sustainability of their sovereign debt. These continuing sovereign debt concerns and the related fiscal deterioration in eurozone economies may continue to accentuate the existing disruption in the capital and credit markets. The continuing market instability and reduction of available credit have contributed to lower consumer confidence, increased market volatility, increased funding costs, reduced business activity and, consequently, increasing commercial and consumer loan delinquencies, and market value declines on debt securities held by the Group, all of which could have a material adverse effect on the Group's operating results, financial condition and prospects.

The Group may suffer adverse effects as a result of the ongoing economic and sovereign debt crisis in the eurozone

The financial health of a number of European governments was shaken by a sovereign debt crisis that escalated throughout 2011, contributing to volatility of the capital and credit markets. The sustainability of the sovereign debt of Greece and certain other eurozone economies remains uncertain.

The risk of contagion throughout and beyond the eurozone remains. A significant number of financial institutions throughout Europe have substantial exposures to sovereign debt issued by nations which are under considerable financial pressure. Should any of those nations default on their debt, or experience a significant widening of credit spreads, major financial institutions and banking systems throughout Europe could be destabilised, resulting in the further spread of the ongoing economic crisis. Although the Group conducts the majority of its business in the UK, it has some limited direct and indirect exposure to financial and economic conditions throughout the eurozone economies. . In addition, general financial and economic conditions in the UK, which directly affect the Group's operating results, financial condition and prospects, may deteriorate as a result of conditions in the eurozone.

While authorities throughout the European Union continue to work towards developing a political structure or economic plan to address the fiscal instability of certain eurozone nations, the ongoing economic crisis has increased the risk of a break-up of the eurozone. A break-up of the eurozone could have a dramatic impact on the whole financial sector, creating new challenges in sovereign and corporate lending and resulting in significant disruptions in financial activities at both the market and retail levels.

Furthermore, concerns that the eurozone sovereign debt crisis could worsen may lead to the reintroduction of national currencies in one or more eurozone countries or possibly the abandonment of the euro. The departure or risk of departure from the euro by one or more eurozone countries and/or the abandonment of the euro as a currency could have major negative effects on both existing contractual relations and the fulfilment of obligations by the Group and/or customers of the Group, which would have a significant negative impact on the activity, operating results and capital and financial position of the Group.

The Group's risk management measures may not be successful

The management of risk is an integral part of all of the Group's activities. Risk constitutes the Group's exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse effect on profitability or financial condition arising from different sources of uncertainty including credit risk (retail, wholesale and corporate), market risk, operational risk, securitisation risk, non-traded market risk, concentration risk, liquidity and funding risk, reputational risk, strategic risk, pension obligation risk, residual value risk and regulatory risk. The Group seeks to monitor and manage its risk exposure through a variety of separate but complementary financial, credit, market, operational, compliance and legal reporting systems. For further description of our risk management policies see Financial Risks and Risk Management in Note 44 to the Consolidate Financial Statements. While the Group employs a broad and diversified set of risk monitoring and risk mitigation techniques, such techniques, and the judgements that accompany their application, cannot anticipate every unfavourable event or the specifics and timing of every outcome. Accordingly, the Group's ability to successfully identify and balance risks and rewards, and to manage all material risks, is important. Failure to manage such risks appropriately could have a significant effect on the Group's operating results, financial condition and prospects. For example, failure to manage the credit risk (retail) associated with mortgage lending could result in the Group making mortgage loans outside of appropriate risk parameters and potentially resulting in higher levels of default or delinquency on the Group's mortgage loan assets.

Santander UK has a significant exposure to the UK real estate market.

The residential mortgage loan portfolio is one of Santander UK's principal assets, comprising 85% of its loan portfolio as of 31 December 2011. As a result, Santander UK is highly exposed to developments in the residential property market in the UK.

From 2002 to 2006, demand for housing and mortgage finance in the UK increased significantly driven by, among other things, sustained economic growth, declining unemployment rates, restrictions on new residential property building, demographic trends and the increasing prominence of London as an international financial centre. During 2007, the housing market began to adjust in the UK as a result of deteriorating affordability, slower real income growth and some reduction in credit availability.

From 2007, economic growth stalled, recession hit and unemployment rose in the UK and as a consequence housing demand decreased and credit availability reduced. Real estate prices declined and mortgage delinquencies increased. This adversely affected the credit performance of real estate-related exposures, in residential mortgages and also loans to the real estate sector by Corporate Banking. These property market conditions may continue to affect consumer confidence levels and cause further adverse movements in real estate markets. In turn this may cause adverse changes in repayment patterns, causing increases in delinquencies and default rates, which may impact Santander UK's provision for credit losses and write-offs/charge-offs. Trends such as these could have a material adverse effect on Santander UK's operating results, financial condition and prospects.

Risks concerning borrower credit quality are inherent in the Group's business

Risks arising from changes in credit quality and the recoverability of loans and amounts due from borrowers and counterparties are inherent in a wide range of the Group's businesses. Adverse changes in the credit quality of the Group's borrowers and counterparties, as a result of a general deterioration in UK or global economic conditions, or arising from systemic risks in the financial systems, could reduce the recoverability and value of the Group's assets and require an increase in the Group's level of provisions for bad and doubtful debts.

The Group estimates and establishes reserves for credit risks and potential credit losses inherent in its credit exposure. This process, which is critical to its results and financial condition, requires difficult, subjective and complex judgements, including forecasts of how these economic conditions might impair the ability of its borrowers to repay their loans. As is the case with any such assessments, the Group may fail to estimate accurately the impact of factors that it identifies. Any such failure may have a material adverse impact on the Group's operating results, financial condition and prospects.

The soundness of other financial institutions could materially and adversely affect the Group's business

The Group's ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness, or perceived commercial soundness, of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. The Group has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, investment banks, mutual funds and other institutional clients. Defaults by or even rumours or questions about one or more financial services institutions, or the financial services industry generally, can lead to market-wide liquidity problems and could result in losses for the Group or other institutions as well as increased funding costs. Many transactions expose the Group to credit risk in the event of default of the Group's counterparty or client. In addition, the Group's credit risk may be exacerbated when the collateral held by the Group cannot be realised or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due to the Group. There is no assurance that any such losses would not materially and adversely affect the Group's operating results, financial condition and prospects.

Risks associated with liquidity and funding are inherent in the Group's business

Liquidity risk is the risk that the Group, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due or can secure them only at excessive cost. This risk is inherent in any retail and commercial banking business and can be heightened by a number of enterprise-specific factors, including over-reliance on a particular source of funding, changes in credit ratings or market-wide phenomena such as market dislocation. While the Group has implemented liquidity management processes to seek to mitigate and control these risks, unforeseen systemic market factors in particular make it difficult to eliminate completely these risks. Adverse and continued constraints in the supply of liquidity, including inter-bank lending, has affected and may materially and adversely affect the cost of funding the Group's business, and extreme liquidity constraints may affect the Group's current operations as well as limit growth possibilities. Such events may also have a material adverse effect on the market value and liquidity of bonds issued by the Group in the secondary markets. The prime residential mortgage securitisation and covered bond primary and secondary markets, which are important sources of funding for the Group, continue to experience severe disruptions as a result of constrained liquidity and a material reduction in investor demand for these securities. Global investor confidence also remains low and other forms of wholesale funding remain relatively scarce.

Continued or worsening disruption and volatility in the global financial markets could have a material adverse effect on the Group's ability to access capital and liquidity on financial terms acceptable to it.

The Group's cost of obtaining funding is directly related to prevailing market interest rates and to its credit spreads. Credit spreads are the amount in excess of the interest rate of Government benchmark securities, of the same maturity that the Group needs to pay to its funding providers. Increases in interest rates and its credit spreads can significantly increase the cost of the Group's funding. Changes in the Group's credit spreads are market-driven, and may be influenced by market perceptions of its creditworthiness. Changes to interest rates and its credit spreads occur continuously and may be unpredictable and highly volatile.

If wholesale markets financing ceases to become available, or becomes excessively expensive, the Group may be forced to raise the rates it pays on deposits, with a view to attracting more customers, and/or to sell assets, potentially at depressed prices. While central banks around the world have made coordinated efforts to increase liquidity in the financial markets, by taking measures such as increasing the amounts they lend directly to financial institutions, lowering interest rates and significantly increasing temporary reciprocal currency arrangements (or swap lines), it is not known how long central bank schemes will continue or on what terms. The Bank of England's Special Liquidity Scheme was not extended when it expired at the end of January 2012. Although there are no indications from the Monetary Policy Committee that policy interest rates are likely to be raised in the near future, and financial markets do not expect rates to rise in 2012, it always remains possible that the Bank of England might raise interest rates in the near term, thereby increasing the cost of the Group's funding. The persistence or worsening of these adverse market conditions, and the withdrawal of such central bank schemes or an increase in base interest rates, could have a material adverse effect on the Group's ability to access liquidity and cost of funding (whether directly or indirectly).

The Group relies, and will continue to rely, primarily on commercial deposits to fund lending activities. The ongoing availability of this type of funding is sensitive to a variety of factors outside the Group's control, such as general economic conditions and the confidence of commercial depositors in the economy, in general, and the financial services industry in particular, and the availability and extent of deposit guarantees, as well as competition between banks for deposits. Any of these factors could significantly increase the amount of commercial deposit withdrawals in a short period of time, thereby reducing the Group's ability to access commercial deposit funding on appropriate terms, or at all, in the future. If these circumstances were to arise, this could have a material adverse effect on the Group's operating results, financial condition and prospects.

For additional information about the Group's liquidity position and other liquidity matters, including credit ratings and outlooks and the policies and procedures the Group uses to manage its liquidity risks, see Financial Risks and Risk Management in Note 44 to the Consolidate Financial Statements.

The Group is subject to regulatory capital and liquidity requirements that could limit its operations, and changes to these requirements may further limit and adversely affect its operating results, financial condition and prospects

As a bank Santander UK plc is subject to capital adequacy requirements adopted by the UK Financial Services Authority (the 'FSA') which provide for a minimum ratio of total capital to risk-adjusted assets both on a consolidated basis and on a solo-consolidated basis (the basis used by the FSA solely for the purpose of the calculation of capital resources and capital resources requirements, which comprises Santander UK plc, the Company and certain subsidiaries), expressed as a percentage. Any failure by Santander UK's to maintain its ratios may result in administrative actions or sanctions which may affect Santander UK's ability to fulfil its obligations.

In response to the recent financial crisis, the FSA has imposed, and may continue to impose, more stringent capital adequacy requirements, including increasing the minimum regulatory capital requirements imposed on Santander UK. For instance, the FSA has adopted a supervisory approach in relation to certain UK banks, including Santander UK plc, under which those banks are expected to maintain Tier 1 Capital in excess of the minimum levels required by the existing rules and guidance of the FSA. The FSA is currently considering, and in the process of consulting on, changes to the eligibility criteria for Tier 1 Capital as well as provisions that may result in banks being required to increase the level of regulatory capital held in respect of trading book risks. This consultation is taking place ahead of the UK implementation of the recent amendments and proposed amendments to the EU-wide capital adequacy requirements (as set out in the amended Directive 2006/48/EC and Directive 2006/49/EC, collectively referred to as the 'Capital Requirements Directive').

On 5 October 2009, the FSA published its new liquidity rules which significantly broadened the scope of the existing liquidity regime. These are designed to enhance regulated firms' liquidity risk management practices. As part of these reforms, the FSA has implemented requirements for financial institutions to hold prescribed levels of specified liquid assets and have in place other sources of liquidity to address the institution-specific and market-wide liquidity risks that institutions may face in short-term and prolonged stress scenarios.

On 16 December 2010 and 13 January 2011, the Basel Committee on Banking Supervision issued its final guidance on a number of fundamental reforms to the regulatory capital framework intended to strengthen minimum capital requirements (referred to as Basel III). The changes in Basel III include, among other things, phasing out Innovative Tier 1 Capital instruments with incentives to redeem and implementing a leverage ratio on institutions in addition to current risk-based regulatory capital requirements. As essentially a retail bank lending mostly on secured residential mortgages, the Company's current leverage ratio is high, reflecting the low risk-weighting of its assets. Basel III also requires institutions to build counter-cyclical capital buffers that may be drawn upon in stress scenarios, as well as increasing the amount and quality of Tier 1 Capital that institutions are required to hold. The changes brought about by Basel III will be phased in gradually between January 2013 and January 2019. The most recent Basel capital rules have raised the minimum level of tangible common equity capital from 2 to 7 per cent. of risk-weighted assets, however it is not yet known whether the FSA will require UK banks to hold a further buffer above this level.

Regulators in the UK and world-wide have produced a range of proposals for future legislative and regulatory changes which could force the Group to comply with certain operational restrictions or take steps to raise further capital, or could increase the Group's expenses, or otherwise adversely affect its operating results, financial condition and prospects. These include:

- the introduction of recovery and resolution planning requirements (popularly known as 'living wills') for banks and other financial institutions as contingency planning for the failure of a financial institution that may affect the stability of the financial system;
- implementation of the Financial Services Act 2010, which enhances the FSA's disciplinary and enforcement powers;
- the introduction of more regular and detailed reporting obligations; and
- a proposal in the ICB's recommendations to require large UK retail banks to hold a minimum Core Tier 1 to risk-weighted assets ratio of at least 10 per cent., which is, broadly, 3 per cent. higher than the minimum capital levels required under Basel III.

These measures could have a material adverse effect on the Group's operating results, financial condition and prospects. There is a risk that changes to the UK capital adequacy regime (including any introduction of a minimum leverage ratio) may result in increased minimum capital requirements, which could reduce available capital and thereby adversely affect Santander UK's profitability and ability to pay dividends, continue organic growth (including increased lending), or pursue acquisitions or other strategic opportunities (unless Santander UK's were to restructure its balance sheet in order to reduce the capital charges incurred pursuant to the FSA's rules in relation to the assets held, or alternatively raise additional capital but at increased cost and subject to prevailing market conditions). In addition, changes to the eligibility criteria for Tier 1 Capital may affect Santander UK's ability to raise Tier 1 Capital or the eligibility of existing Tier 1 Capital resources.

There is also a risk that implementing and maintaining enhanced liquidity risk management systems may incur significant costs and more stringent requirements to hold liquid assets may materially affect the Group's lending business as more funds may be required to acquire or maintain a liquidity buffer, thereby reducing future profitability.

Any reduction in the credit rating assigned to Santander UK, the Company or to any Santander UK debt securities would be likely to increase Santander UK's cost of funding, require additional collateral to be placed and adversely affect its interest margins and liquidity position

Credit ratings affect the cost and other terms upon which Santander UK's is able to obtain funding. Rating agencies regularly evaluate Santander UK and the Company's, as well as their respective debt securities. Their ratings are based on a number of factors, including the financial strength of Santander UK or the Company , as well as conditions affecting the financial services industry generally. There can be no assurance that the rating agencies will maintain Santander UK's or the Company's current ratings or outlook, or with regard to those rating agencies who may have a negative outlook on Santander UK, there can be no assurances that such agencies will revise such outlooks upwards, especially in light of the difficulties in the financial services industry and the financial markets.

Any reduction in those ratings and outlook would be likely to increase the cost of Santander UK's funding, limit access to capital markets, and require additional collateral to be placed, and consequently, adversely affect the Group's interest margins and/or affect its liquidity position. For example, a ratings downgrade could adversely affect the Group's ability to sell or market certain of its products, such as subordinated securities and engage in certain longer-term and derivatives transactions. It could also adversely affect Santander UK's or the Company's ability to retain customers or attract new investors, particularly those who look for a minimum rating threshold in order to invest. Any of these could, in turn, reduce Santander UK's and the Group's liquidity and have an adverse effect on Santander UK's and the Group's operating results, financial condition and prospects.

Fluctuations in interest rates, bond and equity prices and other market factors are inherent in the Group's business

The Group faces significant interest rate and bond and equity price risks. Fluctuations in interest rates could adversely affect the Group's operations and financial condition in a number of different ways. An increase in interest rates generally may decrease the relative value of the Group's fixed rate loans and raise the Group's funding costs, although such an increase would be offset to some extent by an increase in income from variable rate loans. Such an increase could also generally decrease the relative value of fixed rate debt securities in the Group's securities portfolio. In addition, an increase in interest rates may reduce overall demand for new loans and increase the risk of customer default, while general volatility in interest rates may result in a gap between the Group's interest rate-sensitive assets and liabilities. Interest rates are sensitive to many factors beyond the Group's control, including the policies of central banks and, in particular, the Bank of England, as well as domestic and international economic conditions and political factors. It remains difficult to predict any changes in economic or financial market conditions.

Continued declines in housing markets over the past four years have adversely affected the credit performance of real estate-related loans and resulted in write-downs of asset values by many financial institutions (including Santander UK). These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced funding to borrowers, including to other financial institutions. As a result of these market forces, volatility in interest rates and basis spreads has increased, which has increased Santander UK's borrowing costs.

Any further increase in wholesale funding costs or deposit rates could precipitate a re-pricing of loans to customers, which could result in a reduction of volumes, and could also have an adverse effect on the Group's interest margins. While the Group would also expect to increase lending rates, there can be no assurance that it would be able to offset in full or at all its funding costs and, in addition, may face competitive pressure to pass on interest rate rises to retain existing and attract new customer deposits.

Santander UK also sponsors a number of defined benefit staff pension schemes, and its obligations to those schemes may increase depending on the performance of financial markets. Although Santander UK is taking measures to mitigate and control the effects of these conditions, there can be no assurances that such controls will insulate the Santander UK from deteriorating market conditions.

Currency fluctuations may adversely affect the Group's operating results, financial condition and prospects

Santander UK and the Group is exposed to risk from fluctuations in exchange rates for currencies, particularly the US dollar and the euro. In particular, a substantial portion of the Group's outstanding debt is denominated in currencies other than the British pound sterling, which is the primary currency of the Group's financial reporting. The Group's capital is also stated in pound sterling and it does not fully hedge its capital position against changes in currency exchange rates. Although the Group seeks to hedge most of its currency risk through hedging and purchase of cross-currency swaps, these hedges do not eliminate currency risk and the Group can make no assurance that it will not suffer adverse financial consequences as a result of currency fluctuations. Significant exchange rate volatility and the depreciation of the pound sterling in particular could have an adverse impact on the Group's results of operations and its ability to meet its US dollar and euro-denominated obligations, and could have a material adverse effect on the Group's operating results, financial condition and prospects.

Market conditions have, and could result, in material changes to the estimated fair values of financial assets of the Group. Negative fair value adjustments could have a material adverse effect on the Group's operating results, financial condition and prospects

In the past four years, financial markets have been subject to significant stress resulting in steep falls in perceived or actual financial asset values, particularly due to the recent volatility in global financial markets and the resulting widening of credit spreads. The Group has material exposures to securities and other investments that are recorded at fair value and are therefore exposed to potential negative fair value adjustments. Asset valuations in future periods, reflecting then prevailing market conditions, may result in negative changes in the fair values of the Group's financial assets and these may also translate into increased impairments. In addition, the value ultimately realised by the Group on disposal may be lower than the current fair value. Any of these factors could require the Group to record negative fair value adjustments, which may have a material adverse effect on its operating results, financial condition or prospects.

In addition, to the extent that fair values are determined using financial valuation models, such values may be inaccurate or subject to change, as 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 economic instability. In such circumstances, the Group's valuation methodologies require it to make assumptions, judgements and estimates in order to establish fair value, and reliable assumptions are difficult to make and are inherently uncertain and valuation models are complex, making them inherently imperfect predictors of actual results. Any consequential impairments or write-downs could have a material adverse effect on the Group's operating results, financial condition and prospects.

A core strategy of Santander UK plc is to grow Santander UK's operations and it may not be able to manage such growth effectively, which could have an adverse impact on its profitability

Santander UK allocates management and planning resources to develop strategic plans for organic growth, and to identify possible acquisitions and disposals and areas for restructuring Santander UK's businesses. Santander UK cannot provide assurance that it will, in all cases, be able to manage its growth effectively or deliver its strategic growth objectives. Challenges that may result from the strategic growth decisions include Santander UK's ability to:

- manage efficiently the operations and employees of expanding businesses;
- maintain or grow its existing customer base;
- assess the value, strengths and weaknesses of investment or acquisition candidates;
- finance strategic investments or acquisitions;
- fully integrate strategic investments, or newly-established entities or acquisitions in line with its strategy;
- align its current information technology systems adequately with those of an enlarged group;
- apply its risk management policy effectively to an enlarged group; and
- manage a growing number of entities without over-committing management or losing key personnel.

Any failure to manage growth effectively, including relating to any or all of the above challenges associated with Santander UK's growth plans, could have a material adverse effect on Santander UK's operating results, financial condition and prospects.

The Company may incur unanticipated losses related to Santander UK's business combinations

Santander UK plc has made several business acquisitions in recent years, including the acquisition of Alliance & Leicester plc in January 2009 and the retail deposits, branch network and related employees of Bradford & Bingley in September 2008. In October and November 2010, Santander UK plc also acquired the following Banco Santander, S.A. entities:

- Santander Cards Limited, Santander Cards UK Limited (and its subsidiaries) and Santander Cards Ireland Limited;
- Santander Consumer (UK) plc (of which the Company already held 49.9%); and
- Santander PB UK (Holdings) Limited (of which the Company already held 51%) and its subsidiaries.

In addition, in August 2010, Santander UK plc reached an agreement to acquire those parts of the banking business of the Royal Bank of Scotland Group which are carried out through its Royal Bank of Scotland branches in England and Wales and its NatWest branches in Scotland (the 'RBS Acquisition') upon completion of the acquisition.

Santander UK's assessment of the businesses acquired in October and November 2010 and to be acquired under the RBS Acquisition is based on certain assumptions with respect to operations, profitability, asset quality and other matters that may prove to be incorrect. In the case of the RBS Acquisition, this assessment was also based on limited information, as there were no standalone audited financial statements in respect of the relevant assets. There can be no assurance that Santander UK will not be exposed to currently unknown liabilities resulting from these business combinations. Any unanticipated losses or liabilities could have a material adverse effect on Santander UK's operating results, financial condition and prospects.

The Group may fail to realise the anticipated benefits of Santander UK plc's recent or proposed business combinations

The success of Santander UK's business combinations will depend, in part, on Santander UK's ability to realise the anticipated benefits from combining the businesses of Alliance & Leicester, Bradford & Bingley, those acquired in October and November 2010 and the assets to be acquired under the RBS Acquisition, with Santander UK's business. It is possible that the integration process could take longer or be more costly than anticipated. The eventual integration of the assets to be acquired under the RBS Acquisition is dependent upon, among other things, the successful transition to Partenon (the proprietary IT platform used by the Banco Santander group). Any delay could result in additional costs to Santander UK and mean that Santander UK does not receive the full benefit anticipated from such acquisition. Santander UK's efforts to integrate these businesses are also likely to divert management attention and resources. If Santander UK takes longer than anticipated or is not able to integrate these businesses, the anticipated benefits of Santander UK's business combinations may not be realised fully or at all. Any failure to realise all or any of the anticipated benefits of these business combinations could have a material adverse effect on Santander UK's operating results, financial condition and prospects.

Goodwill impairments may be required in relation to certain of Santander UK plc's acquired businesses

Santander UK plc has made business acquisitions in recent years and will acquire certain assets under the RBS Acquisition. It is possible that the goodwill which has been attributed, or will be attributed, to these businesses may have to be written-down if Santander UK plc valuation assumptions are required to be reassessed as a result of any deterioration in their underlying profitability, asset quality and other relevant matters. In 2011 there was a £60m impairment related to Cater Allen Private Bank as a result of a reassessment of the value of certain parts of the business in light of recent market conditions and regulatory developments Impairment testing in respect of goodwill is performed annually, more frequently if there are impairment indicators present, and comprises a comparison of the carrying amount of the cash-generating unit with its recoverable amount. There can be no assurances that Santander UK plc will not have to write down the value attributed to goodwill in the future, which would adversely affect Santander UK's results and net assets.

The Group's business is conducted in a highly competitive environment

The market for UK financial services is highly competitive, and the recent financial crisis has reshaped the banking landscape in the UK, reinforcing both the importance of a retail deposit funding base and strong capitalisation. The Group expects such competition to intensify in response to consumer demand, technological changes, the impact of consolidation, regulatory actions and other factors. If financial markets remain unstable, financial institution consolidation may continue (whether as a result of the UK Government taking ownership and control over other financial institutions in the UK or otherwise). Financial institution consolidation could also result from the UK Government disposing of its stake in those financial institutions it currently controls. Such consolidation could adversely affect the Group's operating results, financial condition and prospects. The potential increase in competition could result in declining lending margins or competition for savings driving up funding costs that cannot be recovered from borrowers, all of which could adversely affect the Group's operating results, financial condition and prospects.

In addition, if the Group's customer service levels were perceived by the market to be materially below those of its UK competitor financial institutions, the Group could lose existing and potential business. If the Group is not successful in retaining and strengthening customer relationships, it may lose market share, incur losses on some or all of its activities or fail to attract new deposits or retain existing deposits, which could have a material adverse effect on its operating results, financial condition and prospects.

Operational risks are inherent in the Group's business

Operational Risk losses can result from many actions, including fraud, criminal acts, errors by employees, employee misconduct, unauthorised breaches of authorities, failure to document transactions properly or to obtain proper authorisation, failure to comply with regulatory requirements and conduct of business rules, failure or breakdown of accounting, data processing and other record keeping systems, natural disasters, or failure or breakdown of external systems, including those of the Group's suppliers or counterparties. Such operational losses could have a material adverse effect on the Group's operating results, financial condition and prospects.

The Group relies on recruiting, retaining and developing appropriate senior management and skilled personnel

The Group's continued success depends in part on the continued service of key members of its management team. The ability to continue to attract, train, motivate and retain highly qualified and talented professionals is a key element of the Company's strategy. The successful implementation of the Company's growth strategy depends on the availability of skilled management, both at its head office and at each of its business units. If the Company or one of its business units or other functions fails to staff their operations appropriately or loses one or more of its key senior executives, and fails to replace them in a satisfactory and timely manner, its operating results, financial condition and prospects, including control and operational risks, may be adversely affected. Likewise, if the Company fails to attract and appropriately train, motivate and retain qualified and talented professionals, its business may be affected.

Reputational risk could cause harm to the Group and its business prospects

The Group's ability to attract and retain customers and conduct business transactions with its counterparties could be adversely affected to the extent that its reputation, the reputation of Banco Santander, S.A. (as the majority shareholder in the Company), or the reputation of affiliates operating under the "Santander" or the "Abbey National Treasury Services" brand or any of its other brands is damaged. Failure to address, or appearing to fail to address, various issues that could give rise to reputational risk could cause harm to the Group and its business prospects.

Reputational issues include, but are not limited to: appropriately addressing potential conflicts of interest; legal and regulatory requirements; ethical issues; adequacy of anti-money laundering processes; privacy issues; customer service issues; record-keeping; sales and trading practices; proper identification of the legal, reputational, credit, liquidity and market risks inherent in products offered; and general company performance (including the quality of the Company's customer services). A failure to address these issues appropriately could make customers unwilling to do business with the Group, which could adversely affect its operating results, financial condition and prospects.

Legislative, regulatory and governmental oversight and current banking reform initiatives and requirements could have a material adverse effect on the Group

The Group is subject to extensive financial services laws, regulations, administrative actions and policies in each location in which the Group operates (including in the US and, indirectly, in Spain as a result of being part of the Banco Santander, S.A. group). During the recent market turmoil, there have been unprecedented levels of government and regulatory intervention and scrutiny, and changes to the regulations governing financial institutions and the conduct of business. In addition, in light of the financial crisis, regulatory and governmental authorities are considering, or may consider, further enhanced or new legal or regulatory requirements intended to prevent future crises or otherwise assure the stability of institutions under their supervision. It is anticipated that this intensive approach to supervision will be continued by the successor regulatory authorities to the FSA.

Recent proposals and measures taken by governmental, tax and regulatory authorities and future changes in supervision and regulation, in particular in the UK, which are beyond the Group's control, could materially affect the Group's business, value of assets and the Group's operations, and result in significant increases in operational costs. Products and services offered by the Group could also be affected. The FSA is taking a more intrusive approach in respect of financial products and this power will be further enhanced with the introduction of the successor conduct regulatory authority to the FSA. Changes in UK legislation and regulation to address the stability of the financial sector may also affect the competitive position of the UK banks, including the Company, particularly if such changes are implemented before international consensus is reached on key issues affecting the industry, for instance in relation to the FSA's regulations on liquidity risk management and also the UK Government's introduction of the bank levy. Although the Group works closely with its regulators and continually monitors the situation, future changes in law, regulation, fiscal or other policies can be unpredictable and are beyond the control of the Group. No assurance can be given generally that laws or regulations will be adopted, enforced or interpreted in a manner that will not have an adverse effect on the Group's business.

On 16 June 2010, the Chancellor of the Exchequer announced the creation of the Independent Commission on Banking (the 'ICB'), chaired by Sir John Vickers. The ICB was asked to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition, and to make recommendations to the Government by the end of September 2011. The ICB gave its recommendations on 12 September 2011 and proposed: (i) implementation of a retail ring fence, (ii) increased capital requirements and (iii) improvement of competition. The Government published its response to the ICB's recommendations on 19 December 2011, broadly endorsing them. A consultation paper is due from the Government in Spring 2012 setting out detailed proposals for the implementation of the ICB's recommendations. Implementation of the proposals may require the Group to make changes to its structure and business. In addition, the resolution of a number of issues, including regulatory investigations and reviews and court cases, affecting the UK financial services industry could have an adverse effect on the Group's operating results, financial condition and prospects, or its relations with its customers and potential customers.

UK tax changes (including the UK bank levy) could have a material adverse effect on the Group's business

HM Treasury has introduced a new and permanent bank levy via legislation in the Finance Act 2011. The UK bank levy is imposed on (amongst other entities) UK banking groups and subsidiaries, and therefore applies to Santander UK. The amount of the bank levy is based on a bank's total liabilities, excluding (amongst other things) Tier 1 Capital, insured retail deposits and repos secured on sovereign debt. A reduced rate is applied to longer-term liabilities.

HM Treasury has emphasised that the bank levy will not be regarded as insurance against future bank failures and that it is exploring the costs and benefits of imposing a financial activities tax on the profits and remuneration of banking groups. As forecast 2011 receipts from the bank levy are expected to fall short of the £2.5billion target, bank levy rates were increased by 12.8% from 1 January 2012.

The UK bank levy, and possible future changes in the taxation of banking groups in the European Union, could have a material adverse effect on Santander UK's operating results, financial condition and prospects, and the competitive position of UK banks, including the Company.

Santander UK and the Group are exposed to various forms of legal and regulatory risk which could have a material adverse effect on its operating results, financial condition and prospects or relations with its customers

Santander UK and the Group are exposed to many forms of legal and regulatory risk, which may arise in a number of ways. Primarily:

> certain aspects of Santander UK's business may be determined by the Bank of England, the FSA, HM Treasury, the Financial Ombudsman Service ('FOS') or the courts as not being conducted in accordance with applicable laws or regulations, or, in the case of the FOS, with what is fair and reasonable in the FOS's opinion;

> the alleged misselling of financial products, resulting in disciplinary action or requirements to amend sales processes, withdraw products, or provide restitution to affected customers, all of which may require additional provisions.

> Santander UK holds accounts for entities that might be or are subject to interest from various regulators, including the UK's Serious Fraud Office, those in the US and others. The Group is not aware of any current investigation into the Group as a result of any such enquiries, but cannot exclude the possibility of the Group's conduct being reviewed as part of any such investigations; and

> Santander UK or the Group may be liable for damages to third parties harmed by the conduct of its business.

The FSA carries out regular and frequent reviews of the conduct of business by financial institutions including banks. An adverse finding by the regulator could result in the need for extensive changes in systems and controls, business policies, and practices coupled with customer redress, fines and reputational damage. For a discussion of Santander UK's approach to its provision for payment protection insurance complaints in connection with the related FSA policy statement and April 2011 High Court ruling see "Potential intervention by the UK Financial Services Authority (or an overseas regulator) may occur, particularly in response to customer complaints" on pages 130 and 131.

In addition, Santander UK or the Group face both financial and reputational risk where legal or regulatory proceedings, or the Financial Ombudsman Service, 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.

Failure to manage these risks adequately could have a material adverse effect on Santander UK or the Group's reputation, its operating results, financial condition and prospects.

The structure of the financial regulatory authorities in the UK and the UK regulatory framework that applies to members of Santander UK, including the Company is the subject of reform and reorganisation

The UK Government announced proposals in June 2010 to reform the institutional framework for UK financial regulation. Specifically, the UK Government intends to replace the FSA with two new successor bodies.

In July 2010 and February 2011, HM Treasury published consultations on proposals to replace the FSA with a new Prudential Regulation Authority (the 'PRA'), which will be responsible for micro-prudential regulation of financial institutions that manage significant risks on their balance sheets, and a new Financial Conduct Authority (the 'FCA') which will be responsible for regulation of conduct of business. HM Treasury proposes, amongst other things, that the FCA will have product intervention powers, and that cooperation will exist between the FCA and the FOS, particularly where issues identified potentially have wider implications. Draft guidance has also been published on how the FCA and PRA will interact.

In June 2011 HM Treasury published a further consultation document, including a draft Bill, which reiterates the proposals to replace the FSA with the PRA and the FCA and suggests that the regulatory approach under the new regime will be more intrusive than the existing regime and will challenge business models and governance culture in particular. HM Treasury intends that the Bill will become law by the end of 2012, with the new regime intended to come into effect in 2013. To prepare for this change, the FSA will be adopting a 'twin peaks' model internally and will have two supervisors; one focusing on prudential matters and the other on conduct.

Substantial reorganisation of the regulatory framework has the potential to cause administrative and operational disruption for the regulatory authorities concerned. This disruption could impact on the resources which the FSA or the successor authorities are able to devote to the supervision of regulated financial services firms, the nature of their approach to supervision and accordingly, the ability of regulated financial sector firms (including members of Santander UK) to deal effectively with their supervisors and to anticipate and respond appropriately to developments in regulatory policy.

It is anticipated that future changes in the nature of, or policies for, prudential and conduct of business supervision, as performed by the successor authorities to the FSA, will differ from the current approach taken by the FSA and that this could lead to a period of some uncertainty for members of Santander UK. The Financial Services Bill, which has been put before Parliament, not only details proposals for the creation of the FCA and PRA but also contains provisions enabling consumer credit regulation to be transferred from the OFT to the FCA. This decision will be subject to further consultation. Should this change occur, its introduction will bring about another reform to the institutional framework.

No assurance can be given that further changes will not be made to the regulatory regime in the UK generally, Santander UK's particular business sectors in the market or specifically in relation to Santander UK. Any or all of these factors could have a material adverse effect on the conduct of the business of Santander UK or the Group and, therefore, also on its strategy and profitability, and its ability to respond to and satisfy the supervisory requirements of the relevant UK regulatory authorities.

Various reforms to the mortgage lending market have been proposed which could require significant implementation costs or changes to the business strategy of Santander UK

In March 2009, the Turner Review, "A regulatory response to the global banking crisis", was published and set out a detailed analysis of how the global financial crisis began along with a number of recommendations for future reforms and proposals for consultation. In the Turner Review, it was announced that the FSA would publish a discussion paper considering the possibility of a move towards the regulation of mortgage products (in addition to the product providers) and other options for reform of the mortgage market. This discussion paper (Discussion Paper 09/3) was published in October 2009 and launched the FSA's Mortgage Market Review ("MMR"). The review involved a consultation concerning various potential reforms to the regulatory framework applicable to mortgage lenders and mortgage intermediaries, including mortgage firms' conduct of business, product distribution and advice, and their handling of arrears and repossessions.

Separately, in January 2011, HM Treasury announced a package of measures with the aim of enhancing consumer protection in the mortgage market. The measures provide for the transfer of the regulation of new and existing second charge residential mortgages from the OFT to the FSA, and provide for consumer protection when a mortgage book is sold by a regulated mortgage lender to an unregulated firm.

On 19 December 2011, the FSA issued its latest MMR consultation containing proposals for a change in the rules relating to the UK mortgage market. Key changes will require lenders to (i) verify borrowers income; (ii) check that interest-only mortgages can be repaid; and (iii) make sure that borrowers can pay for their mortgage after retirement. The consultation closes on 30 March 2012 and the FSA hopes to make a final decision on the definitive form of rules by Summer 2012. The ultimate impact of such measures on the Group is uncertain and no assurance can be given that such changes and any further reforms considered as part of the MMR will not adversely affect Santander UK and its business and operations. Further, it is possible that such reforms, if adopted, could lead to a period of change for Santander UK, particularly as regards changes that may be required to the operational strategy and capital management of Santander UK, and the supervisory approach taken by the FSA in relation to second charge mortgages, a portfolio of which Santander UK acquired as a result of its acquisition of Alliance & Leicester plc and any second charge mortgages which may be acquired under the RBS Acquisition.

As a consequence of such changes and any associated costs that may arise, it is possible that there could be a material adverse effect on the operating results, financial condition and prospects of Santander UK.

Potential intervention by the UK Financial Services Authority (or an overseas regulator) may occur, particularly in response to customer complaints.

Customers of financial services institutions, including customers of Santander UK, may seek redress if they consider that they have suffered loss as a result of the misselling of a particular product, or through incorrect application of the terms and conditions of a particular product. Given the inherent unpredictability of litigation and the evolution of judgements by the FOS, it is possible that an adverse outcome in some matters could have a material adverse effect on the operating results, financial condition and prospects of Santander UK arising from any penalties imposed or compensation awarded, together with the costs of defending such an action.

The Financial Services Act 2010 has provided a new power for the FSA which enables the FSA to require authorised firms, including members of Santander UK, to establish a consumer redress scheme if it considers that consumers have suffered loss or damage as a consequence of a widespread or regular regulatory failing, including misselling.

In recent years there have been several industry-wide issues in which the FSA has intervened directly. One such issue is the misselling of payment protection insurance ('PPI'), about which, in August 2010, the FSA published Policy Statement 10/12 entitled "The assessment and redress of Payment Protection Insurance complaints". This policy statement contains rules from the FSA which alter the basis on which the FSA regulated firms (including Santander UK plc and certain members of Santander UK) must consider and deal with complaints in relation to the sale of PPI and may potentially increase the amount of compensation payable to customers whose complaints are upheld. In October 2010 the British Bankers' Association (the 'BBA') applied for judicial review of these new rules and on 20 April 2011, the High Court rejected the BBA's legal challenge and upheld the FSA's policy statement about misselling of PPI. On 9 May 2011, the BBA announced its decision not to appeal against the High Court's PPI judgment. The High Court judgment on the misselling of PPI resulted in very significant provisions for customer redress being made by several UK financial services providers. Santander UK plc did not participate in the UK High Court case, and has taken a prudent approach in consistently settling claims over the last two years as they have arisen.

In light of the High Court ruling in April 2011, the BBA's decision not to appeal it and the consequent increase in claims levels Santander UK performed a detailed review of the provision requirement. As a result, Santander UK plc revised its provision for PPI complaint liabilities to reflect the new information. Previously, the provision for PPI complaint liabilities accounted for claims that were likely to be received over the next twelve months. The provision for PPI complaint liabilities has now been increased to reflect the total population of PPI customers who could file a claim.

The ultimate financial impact on Santander UK of the claims arising from PPI complaints is uncertain and will depend on a number of factors, including the implementation of the FSA's Policy Statement, the rate at which new complaints arise, the content and quality of the complaints (including the availability of supporting evidence), the role of claims management companies and the average uphold rates and redress costs. Santander UK can make no assurance that expenses associated with PPI complaints will not exceed the provision it has taken relating to these claims. More generally, Santander UK can make no assurance that its estimates for potential liabilities are correct, and the reserves taken as a result may prove inadequate. If Santander UK were to incur additional expenses that exceed provisions for PPI liabilities or other provisions, these expenses could have a material adverse effect on Santander UK's operating results, financial condition and prospects. .

The FSA may identify future industry-wide misselling or other issues that could affect Santander UK. This may lead from time to time to: (i) significant direct costs or liabilities (including in relation to misselling); and (ii) changes in the practices of such businesses which benefit customers at a cost to shareholders.

Decisions taken by the FOS (or any overseas equivalent that has jurisdiction) could, if applied to a wider class or grouping of customers, have a material adverse effect on the operating results, financial condition and prospects of Santander UK.

Members of Santander UK are responsible for contributing to compensation schemes in the UK in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers

In the UK, the Financial Services Compensation Scheme ('FSCS') was established under the Financial Services and Markets Act 2000 and is the UK's statutory fund of last resort for customers of authorised financial services firms. The FSCS can pay compensation to customers if an FSA-authorised firm is unable, or likely to be unable, to pay claims against it (for instance, an authorised bank is unable to pay claims by depositors). The FSCS is funded by levies on firms authorised by the FSA, including Santander UK plc and other members of Santander UK.

In the event that the FSCS raises funds from authorised firms, raises those funds more frequently or significantly increases the levies to be paid by such firms, the associated costs to Santander UK may have a material adverse effect on its operating results, financial condition and prospects. The recent measures taken to protect the depositors of deposit-taking institutions involving the FSCS have resulted in a significant increase in the levies made by the FSCS on the industry and such levies may continue to go up if similar measures are required to protect depositors of other institutions.

In addition, regulatory reform initiatives in the UK and internationally may result in further changes to the FSCS, which could result in additional costs and risks for Santander UK. For instance, the FSA announced in October 2011 that it was restarting its review of the funding of the FSCS with a view to formally consult in the first half of 2012. Changes as a result of this may affect the profitability of Santander UK plc (and other members of Santander UK required to contribute to the FSCS).

As a result of the structural reorganisation and reform of the UK financial regulatory authorities, it is proposed that the FSCS levies will be collected by the FCA under the new regime. It is possible that future policy of the FSCS and future levies on the firms authorised by the FSA may differ from those at present and that this could lead to a period of some uncertainty for members of Santander UK. In addition, it is possible that other jurisdictions where Santander UK operates could introduce similar compensation, contributory or reimbursement schemes. As a result of any such developments, Santander UK may incur additional costs and liabilities which may adversely affect its operating results, financial condition and prospects.

The Banking Act may adversely affect the Group's business

The Banking Act came into force on 12 February 2009. It provides HM Treasury, the Bank of England and the FSA with a variety of tools for dealing with UK institutions which are authorised deposit takers and are failing. If the position of a relevant entity in the Group were to decline so dramatically that it was considered to be failing, or likely to fail, to meet threshold authorisation conditions set out in FSMA (for example, if there were a mass withdrawal of deposits over solvency fears surrounding Santander UK, in a manner analogous to the situation that occurred at Northern Rock, adversely affecting the ability of Santander UK to continue to trade), it could become subject to the exercise of powers by HM Treasury, the Bank of England and the FSA under the special resolution regime set out in the Banking Act. The special resolution regime provides HM Treasury, the Bank of England and the FSA with a variety of powers for dealing with UK deposit taking institutions that are failing or likely to fail, including: (i) to take a bank or bank holding company into temporary public ownership; (ii) to transfer all or part of the business of a bank to a private sector purchaser; or (iii) to transfer all or part of the business of a bank to a "bridge bank". The special resolution regime also comprises a separate insolvency procedure and administration procedure each of which is of specific application to banks. These insolvency and administration measures may be invoked prior to the point at which an application for insolvency proceedings with respect to a relevant institution could be made.

If an instrument or order were made under the Banking Act in respect of Santander UK plc, such instrument or order (as the case may be) may (among other things): (i) result in a compulsory transfer of shares or other securities or property of Santander UK plc; (ii) impact on the rights of the holders of shares or other securities in Santander UK plc or result in the nullification or modification of the terms and conditions of such shares or securities; or (iii) result in the de-listing of Santander UK plc's shares and/or other securities. In addition, such an order may affect matters in respect of Santander UK plc and/or other aspects of Santander UK plc's shares or other securities which may negatively affect the ability of Santander UK plc to meet its obligations in respect of such shares or securities.

At present, no instruments or orders have been made under the Banking Act in respect of Santander UK and there has been no indication that any such order will be made, but there can be no assurance that holders of shares or other securities in Santander UK plc would not be adversely affected by any such order if made in the future.

The Group's operations are highly dependent on its information technology systems

The Group's business, financial performance and ability to meet its strategic objectives depend to a significant extent upon the functionality of its information technology systems (including Partenon, the global banking informational technology platform utilised by Banco Santander, S.A and to which the Group transitioned in 2008), and its ability to increase systems capacity. The proper functioning of the Group's financial control, risk management, credit analysis and reporting, accounting, customer service and other information technology systems, as well as the communication networks between its branches and main data processing centres, are critical to the Group's business and its ability to compete. For example, the Group's ability to process credit card and other electronic transactions for its customers is an essential element of its business. A disruption (even short-term) to the functionality of the Group's information technology system (whether as a result of so-called unintentional "cyber incidents" or targeted "cyber attacks," security breaches, the Company's own migration of new business onto Partenon or otherwise) could impose a significant financial loss, result in a disruption to the Group's businesses, liability to clients, regulatory intervention or reputational damage. Likewise, delays or other problems in increasing the capacity of the information technology systems or increased costs associated with such systems could have a material adverse effect on the Group's operating results, financial condition and prospects. Although the Group has implemented certain preventative measures to protect its information and data systems, it can give no assurance that such measures will be effective in preventing a cyber attack or other IT disruption. Any such event could also require the Group to expend significant additional resources to modify its protective measures or to investigate and remediate vulnerabilities or other exposures, and may subject the Group to additional litigation and financial losses. Operation losses related to a successful cyber attack or other operational risks could have a material adverse effect on the Group's operating results, financial condition and prospects.

The Group relies upon certain outsourced services (including information technology support, maintenance and consultancy services in connection with Partenon) provided by certain other members of the Banco Santander, S.A. group. Any material change in the basis upon which these services are provided to the Group or the extent to which they are available to the Group could have a material adverse effect on the Group's operating results, financial condition and prospects.

In addition, if the Group fails to update and develop its existing information technology systems as effectively as its competitors, this may result in a loss of the competitive advantages that the Group believes its information technology systems provide, which could also have a material adverse effect on the Group's operating results, financial condition and prospects.

Third parties may use the Group as a conduit for illegal activities without the Group's knowledge, which could have a material adverse effect on the Group

The Group is required to comply with applicable anti-money laundering laws and regulations and has adopted various policies and procedures, including internal control and "know-your-customer" procedures, aimed at preventing use of the Group for money laundering. For example, a major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and enforcing compliance with US economic sanctions. The outcome of any proceeding or complaint is inherently uncertain and could have a material adverse effect on the Group's operations or financial condition, especially to the extent that the scope of any such proceedings expands beyond its original focus.

In addition, while the Group reviews its relevant counterparties' internal policies and procedures with respect to such matters, the Group, to a large degree, relies upon its relevant counterparties to maintain and properly apply their own appropriate anti-money laundering procedures. Such measures, procedures and compliance may not be completely effective in preventing third parties from using the Group (and its relevant counterparties) as a conduit for money laundering (including illegal cash operations) without the Group's (and its relevant counterparties') knowledge. If the Group is associated with, or even accused of being associated with, or becomes a party to, money laundering, then its reputation could suffer and/or it could become subject to fines, sanctions and/or legal enforcement (including being added to any "black lists'' that would prohibit certain parties from engaging in transactions with the Group), any one of which could have a material adverse effect on the Group's operating results, financial condition and prospects.

Changes in the pension liabilities and obligations of the Group could have a materially adverse effect on the Group

Santander UK provides retirement benefits for many of its former and current employees in the United Kingdom through a number of defined benefit pension schemes established under trust. Santander UK has only limited control over the rate at which it pays into such schemes. Under the UK statutory funding requirements, employers are usually required to contribute to the schemes at the rate they agree with the scheme trustees, although if they cannot agree, such rate can be set by the Pensions Regulator. The scheme trustees may, in the course of discussions about future valuations, seek higher employer contributions. The scheme trustees' power in relation to the payment of pension contributions depends on the terms of the trust deed and rules governing the pension schemes.

The UK Pensions Regulator has the power to issue a financial support direction to companies within a group in respect of the liability of employers participating in the UK defined benefit pension plans where that employer is a service company, or is otherwise "insufficiently resourced" (as defined for the purposes of the relevant legislation). As some of the employers within Santander UK are service companies, if they become insufficiently resourced, other companies within Santander UK which are connected with or an associate of those employers are at risk of a financial support direction in respect of those employers' liabilities to the defined benefit pension schemes in circumstances where the Pensions Regulator properly considers it reasonable to issue one. Such a financial support direction could require the companies to guarantee or provide security for the pension liabilities of those employers, or could require additional amounts to be paid into the relevant pension schemes in respect of them.

The UK courts have decided that liabilities under financial support directions issued by the Pensions Regulator against companies after they have gone into administration were payable as an expense of the administration, and did not rank as provable debts. This means that such liabilities will have to be satisfied before any distributions to unsecured creditors could be made. It is understood that leave to appeal to the Supreme Court has been requested and therefore it is likely that there will be a further decision to come.

The Pensions Regulator can also issue contribution notices if it is of the opinion that an employer has taken actions, or failed to take actions, deliberately designed to avoid meeting its pension promises or which are materially detrimental to the scheme's ability to meet its pension promises. A contribution notice can be moved to any company which is connected with or an associate of such employer in circumstances where the Regulator considers it reasonable to issue. The risk of a contribution notice being imposed may inhibit the freedom of Santander UK to restructure itself or to undertake certain corporate activities.

Changes in the size of the deficit in the defined benefit schemes operated by Santander UK, due to reduction in the value of the pension fund assets (depending on the performance of financial markets) or an increase in the pension fund liabilities due to changes in mortality assumptions, the rate of increase of salaries, discount rate assumptions, inflation, the expected rate of return on plan assets, or other factors, could result in Santander UK having to make increased contributions to reduce or satisfy the deficits which would divert resources from use in other areas of Santander UK's business and reduce Santander UK plc's capital resources. While a number of the above factors can be controlled by Santander UK, there are some over which it has no or limited control. Although the trustees of the defined benefit pension schemes are obliged to consult Santander UK before changing the pension schemes' investment strategy, the trustees have the final say. Increases in the pension liabilities and obligations of Santander UK could have a material adverse effect on Santander UK's operating results, financial condition and prospects.

The ongoing changes in the UK supervision and regulatory regime and particularly the implementation of the ICB's recommendations may require Santander UK to make changes to its structure and business which could have an impact on Santander UK's pension schemes or liabilities. For a discussion of the ICB's recommendations see "Legislative, regulatory and governmental oversight and current banking reform initiatives and requirements could have a material adverse effect on the Group" on page 128.

Risks concerning enforcement of judgements made in the United States

Abbey National Treasury Services plc is a public limited company registered in England and Wales. All of the Company's Directors live outside the United States of America. As a result, it may not be possible to serve process on such persons in the United States of America or to enforce judgements obtained in US courts against them or the Group based on the civil liability provisions of the US federal securities laws or other laws of the United States of America or any state thereof. The Directors' Report on pages 3 to 10 has been prepared and presented in accordance with and in reliance upon English company law and the liabilities of the Directors in connection with that Report shall be subject to the limitations and restrictions provided by such law. Under the UK Companies Act 2006, a safe harbour limits the liability of Directors in respect of statements in and omissions from the Directors' Report on pages 3 to 10. Under this safe harbour, the Directors would be liable to the Company (but not to any third party) if the Directors' Report contains errors as a result of recklessness or knowing misstatement or dishonest concealment of a material fact, but would not otherwise be liable.

Guarantees

GUARANTEE

THIS INSTRUMENT by way of deed poll is executed on 29 January, 2008 by ABBEY NATIONAL plc (registered in England No. 2294747) whose registered office is at Abbey National House, 2 Triton Square, Regent's Place, London NW1 3AN (the 'Guarantor').

WHEREAS:

Abbey National Treasury Services plc, a company incorporated in England (number 2338548) whose registered office is at Abbey National House, 2 Triton Square, Regent's Place, London NW1 3AN ('ANTS'), has requested the Guarantor and the Guarantor has agreed to guarantee payment of all Obligations (as hereinafter defined) in accordance with, and as limited by, the terms and conditions of this Deed (the 'Guarantee').

NOW THEREOF the Guarantor hereby covenants and agrees as follows:

1. In this Guarantee, unless the context otherwise requires:

'Creditor' means any person (other than ANTS or any subsidiary of ANTS (as defined in section 736 of the Companies Act 1985 (the 'Act')) or any individual who is a connected person of ANTS within the meaning of section 346 of the Act) to whom an Obligation is from time to time owed;

'Obligation' means any obligation or liability, either primary or contingent, lawfully incurred by ANTS to any person on or before 31st July, 2012 (whether before or after the execution of this Guarantee) under or in respect of any dealing, transaction or engagement whatsoever, including without prejudice to the generality of the foregoing, for

- (i) any moneys lent, advanced or otherwise made available to ANTS (including, without limitation to the generality of the foregoing, the liability of ANTS for drawing or issuing bills of exchange, promissory notes, bonds, debentures, certificates of deposit, commercial paper or other negotiable instruments or securities);
- (ii) any moneys lent, advanced or otherwise made available to any person, the repayment or payments in respect of which have been guaranteed by ANTS or in respect of which ANTS has given an indemnity (including, without limitation to the generality of the foregoing, guarantees and letters of credit issued by ANTS and bills of exchange or other negotiable instruments accepted or endorsed by ANTS);
- (iii) any moneys which any person shall pay or become liable to pay, for or on account of ANTS, by reason of entering into or being party to any bond, indemnity, bill of exchange, guarantee, letter of credit or other engagement for the benefit or at the request of ANTS;
- (iv) deposits made with ANTS (including, without limitation of the generality of the foregoing, certificates of deposit issued by ANTS);
- (v) foreign exchange transactions to which ANTS is a party (including, without limitation of the generality of the foregoing, foreign exchange contracts, hedge settlement contracts, foreign exchange options, foreign exchange futures, and currency exchange or 'swap' agreements and cross-currency interest rate exchange or 'swap' agreements);
- (vi) interest rate transactions to which ANTS is a party (including, without limitation to the generality of the foregoing, interest rate options, interest rate futures, forward rate agreements, interest rate exchange or 'swap' agreements and cross-currency interest rate exchange or 'swap' agreements);

and payments of interest due from ANTS with respect to any of the foregoing transactions (whether or not the liability to pay such interest arises on or before 31st July, 2012) together with all reasonable costs, commissions and other expenses incurred by any person in connection with the enforcement of this Guarantee and for the avoidance of doubt, 'Obligations' shall include any such obligation or liability assumed under or incurred pursuant to any novation, transfer, assignment or other similar agreement between ANTS and any other person (including, without limitation to the generality of the foregoing, any such agreement relating to the obligations or liabilities of Abbey National Building Society) and references in this definition to 'ANTS' shall include persons whose obligations or liabilities have been so assumed by ANTS;

'person' means any person, firm, trust estate, corporation, association, cooperative, government or government agency or other entity.

2. (a) The Guarantor hereby unconditionally and irrevocably guarantees, for the benefit of each Creditor, in accordance with the terms and conditions of this Guarantee, the full payment by ANTS when due (whether at stated maturity, upon acceleration or otherwise) of each and every Obligation and in the event that ANTS shall default in the due and punctual payment of any Obligation, undertakes to pay, or procure the payment of, such Obligations in the currency in which the particular Obligation is denominated in the case of a payment upon written demand being made under this Guarantee by the relevant Creditor.

   (b) The Guarantor waives any right it may have of first requiring any Creditor to make demand, proceed or enforce any rights or security against ANTS or any other person before making a claim against the Guarantor under this Guarantee.

3. A Creditor shall only be entitled to take or obtain the benefit of this Guarantee upon the condition that, after receipt by the Guarantor of a written demand from the Creditor, the Guarantor shall be entitled to deal with the Creditor, and the Creditor shall be obliged to deal with the Guarantor with respect to the Obligation due to the Creditor and this Guarantee without the necessity or duty to rely on, act through or otherwise involve or deal with ANTS to the intent that the Guarantor and the Creditor shall deal with one another as principals in relation to the same provided that the rights, powers, privileges and remedies of the Creditor under this Guarantee shall not thereby be in any way limited or otherwise affected.

4. No delay or omission on the part of the Creditor in exercising any right, power, privilege or remedy (hereinafter together called 'Rights') in respect of this Guarantee shall impair any such Rights or be construed as a waiver of any thereof nor shall any single or partial exercise of any such Rights preclude any further exercise of any other Rights. The Rights herein provided are cumulative and not exclusive of any rights, powers, privileges or remedies provided by law. Nothing in this Guarantee shall be construed as voiding, negating or restricting any right of set-off or any other right whatsoever existing in favour of a Creditor or arising at common law, by statute or otherwise howsoever.

5. This Guarantee is a continuing guarantee and shall not be satisfied, discharged or affected by any intermediate payment or settlement of account.

6. The Guarantor will not exercise any rights of subrogation or any other rights or remedy (including, without limiting the generality of the foregoing, the benefit of any security or right of set-off) which it may acquire due to its payment of any Obligation pursuant to the terms of this Guarantee and will not prove in the liquidation of ANTS in competition with any Creditor unless and until all Obligations in respect of the relevant Creditor hereby guaranteed have been satisfied in full by the Guarantor or ANTS. In the event that the Guarantor shall receive any payment on account of such rights while any Obligation remains outstanding, the Guarantor shall pay all amounts so received to the relevant Creditor.

7. Payments hereunder shall be made free and clear of any deduction or withholdings other than those required by law and in that event the Guarantor shall pay such additional amount to the relevant Creditor as may be necessary in order that the actual amount received after all such deductions and withholdings shall equal the amount that would have been received if no such deduction or withholding were required provided that the Guarantor shall not be obliged to pay any such additional amount which would not have been payable if the payment which is the subject of the withholding or deduction had been made by ANTS. If the Guarantor makes a payment of an additional amount in compliance with its obligations under this paragraph and the Creditor determines that it has received or been granted a credit against or relief or payment of any tax paid or payable by it in respect thereof the Creditor shall to the extent that it can do so without prejudice to the retention of the amount of such credit, relief or repayment pay to the Guarantor such amount as shall be attributable to such deduction provided that nothing contained in this paragraph shall interfere with the right of any Creditor to arrange its tax affairs in whatsoever manner it thinks fit and, in particular, no Creditor shall be under any obligation to claim relief in respect of any such deduction in priority to any other claims for relief available to it.

8. Any demand or notice hereunder shall be given in writing or by cable, telex or facsimile transmission addressed to the Guarantor or to the person to or upon whom the demand is to be made or the notice served at the registered or principal office or last known place of abode of the Guarantor or of such person, as the case may be. A demand so made shall be deemed to have been duly made if left at such address on the day it was so left or, if sent by post, two weekdays after the time when the same was put in the post and in proving delivery it shall be sufficient to prove that the same was properly addressed and put in the post. Any such demand sent by cable, telex or facsimile transmission shall be deemed to have been duly made at the time of despatch.

9. The liability of the Guarantor under this Guarantee shall not be affected by the liquidation, winding-up or other incapacity of ANTS. In the event that any payment to a Creditor from ANTS in respect of an Obligation is avoided or reduced by virtue of any enactments for the time being in force relating to liquidation or insolvency the Creditor shall be entitled to recover the value or amount thereof from the Guarantor as if such payment by ANTS had not been made.

10. This Guarantee shall remain in full force and effect irrespective of the validity, regularity, legality or enforceability against ANTS of, or of any defence or counter-claim whatsoever, available in relation to, any Obligations whether or not any action has been taken to enforce the same or any judgement obtained against ANTS or any other person, whether or not any time or indulgence has been granted to ANTS or any other person by or on behalf of any Creditor, whether or not there have been any dealings or transactions between ANTS or any other person and any of the Creditors, whether or not ANTS or any other person has been dissolved, liquidated, merged, consolidated, become bankrupt or has changed its status, functions, control or ownership, whether or not ANTS or any other person has been prevented from making payment by foreign exchange provisions applicable at its place of registration or incorporation and whether or not any circumstances have occurred which might otherwise constitute a legal or equitable discharge of or defence to a guarantor.
11. In the event that any of the terms or provisions of this Guarantee are or shall become invalid, illegal or unenforceable, the remaining terms and provisions hereof shall survive unaffected.
12. The Guarantor shall be permitted from time to time and at any time to amend or vary the terms of this Guarantee PROVIDED THAT the liability of the Guarantor to a Creditor in respect of any Obligation incurred before or arising out of an Obligation entered into, before the date of such variation or amendment, shall not be in any way reduced or limited by such variation or amendment. Any person shall be entitled to rely on a certificate given by a director or other duly authorised officer of the Guarantor as to the existence and extent of this Guarantee and any such variation and/or amendment of this Guarantee on entering into any dealing, transaction or arrangement with ANTS under or in respect of which an Obligation would or might be incurred by ANTS to that person.
13. This Guarantee shall be governed by and construed in accordance with English law.

IN WITNESS whereof, this Guarantee has been executed as of the day and year first written above.

THE COMMON SEAL of)
ABBEY NATIONAL PLC)
was hereunto affixed)
in the presence of:)

Shaun Coles

Deputy Company Secretary

Directors' Responsibility Statement

We confirm to the best of our knowledge:

1. The financial statements, prepared in accordance with International Financial Reporting Standards, as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and

2. The management report, which is incorporated into the Directors' Report, includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties they face.

By Order of the Board

David Green
Director

15 March 2012