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

We have audited the financial statements of Abbey National Treasury Services plc for the year ended 31 December 2009 which comprise the Consolidated Income Statement, the Consolidated and Company Statements of Comprehensive Income, the Consolidated and Company Balance Sheets, the Consolidated and Company Statements of Changes in Equity, the Consolidated and Company Cash Flow Statements, the Accounting Policies and 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 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 auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

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 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 (APB'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 parent 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.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and the parent Company's affairs as at 31 December 2009 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 parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union 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.

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.

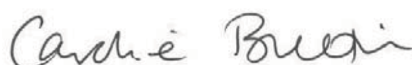
Opinion on other matter prescribed by the Companies Act 2006

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 parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the 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.



Caroline Britton (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditors
London, UK
27 April 2010

Consolidated Income Statement

For the years ended 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Interest and similar income		**3,805**	6,707
Interest expense and similar charges		**(3,429)**	(6,316)
Net interest income	2	**376**	391
Net fee and commission income	3	**25**	16
Net trading and other income	4	**250**	114
Total operating income		**651**	521
Administration expenses	5	**(162)**	(158)
Depreciation and amortisation	6	**(3)**	(3)
Total operating expenses excluding provisions and charges		**(165)**	(161)
Impairment losses on loans and advances	7	**(30)**	(26)
Total operating provisions and charges		**(30)**	(26)
Profit on continuing operations before tax		**456**	334
Tax on profit on continuing operations	10	**(78)**	(86)
Profit for the year from continuing operations		**378**	248
Profit for the year from discontinued operations	12	**-**	82
Profit for the year		**378**	330
Attributable to:			
Equity holders of the parent		**378**	330

The notes on pages 27 to 80 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Comprehensive Income

For the years ended 31 December 2009 and 2008

	2009 £m	2008 £m
Profit for the year	**378**	330
Other comprehensive income		
Exchange differences on translation of foreign operations	**(4)**	39
Tax on items taken directly to equity	**-**	(11)
Net (loss)/income recognised directly in equity	**(4)**	28
Total comprehensive income for the year	**374**	358
Attributable to:		
Equity holders of the parent	**374**	358

Consolidated Balance Sheet

As at 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Assets			
Cash and balances at central banks	13	**448**	8
Trading assets	14	**33,290**	26,268
Derivative financial instruments	15	**23,201**	32,866
Financial assets designated at fair value	16	**12,000**	11,005
Loans and advances to banks	17	**191,749**	147,089
Loans and advances to customers	18	**20,175**	24,204
Held-to-maturity securities	19	**300**	300
Loans and receivables securities	20	**896**	526
Macro hedge of interest rate risk		**682**	1,475
Intangible assets	22	**8**	6
Property, plant and equipment	23	**6**	9
Current tax assets		**3**	-
Deferred tax assets	25	**21**	77
Other assets	26	**67**	45
Total assets		**282,846**	243,878
Liabilities			
Deposits by banks	27	**166,305**	123,496
Deposits by customers	28	**9,461**	2,933
Derivative financial instruments	15	**24,455**	34,132
Trading liabilities	29	**46,139**	39,998
Financial liabilities designated at fair value	30	**4,340**	4,945
Debt securities in issue	31	**27,997**	33,927
Subordinated liabilities	32	**331**	432
Other liabilities	33	**147**	407
Provisions	34	**-**	-
Current tax liabilities		**167**	333
Deferred tax liabilities	25	**1**	1
Total liabilities		**279,343**	240,604
Equity			
Share capital	36	**2,549**	2,549
Retained earnings		**938**	704
Other reserves		**16**	21
Total shareholders' equity		**3,503**	3,274
Total liabilities and equity		**282,846**	243,878

The Notes on pages 27 to 80 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 12 to 80 were approved and authorised for issue by the Board on 27 April 2010 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 2009 and 2008

	Notes	Share Capital £m	Foreign currency translation reserve £m	Retained earnings £m	Total £m
1 January 2008		2,549	(7)	535	3,077
Total comprehensive income (gross)		-	39	433	472
Tax relating to components of other comprehensive income		-	(11)	(103)	(114)
Dividends declared and amounts representative of contractual obligations	37	-	-	(161)	(161)
31 December 2008		2,549	21	704	3,274
1 January 2009		**2,549**	**21**	**704**	**3,274**
Total comprehensive income (gross)		**-**	**(5)**	**378**	**373**
Tax relating to components of other comprehensive income		**-**	**-**	**-**	**-**
Dividends declared and amounts representative of contractual obligations	37	**-**	**-**	**(144)**	**(144)**
31 December 2009		**2,549**	**16**	**938**	**3,503**

Consolidated Cash Flow Statement

For the years ended 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Net cash flow from/(used) in operating activities			
Profit for the year		**378**	330
Adjustments for:			
Non cash items included in net profit		**791**	(1,108)
Change in operating assets		**(5,135)**	(104,692)
Change in operating liabilities		**41,163**	95,713
Income taxes paid		**-**	(4)
Effect of exchange rate differences		**(1,423)**	3,606
Net cash flow from/(used in) operating activities	38	**35,774**	(6,155)
Net cash flow (used in)/from investing activities			
Purchase of tangible and intangible fixed assets		**(3)**	(97)
Disposal of subsidiaries, net of cash disposed		**-**	1,604
Proceeds from sale of fixed assets		**1**	6
Net cash flow (used in)/from investing activities		**(2)**	1,513
Net cash flow used in financing activities			
Issue of long term debt		**-**	101
Dividends paid		**-**	(161)
Net cash flow used in financing activities		**-**	(60)
Net increase/(decrease) in cash and cash equivalents		**35,772**	(4,702)
Cash and cash equivalents at beginning of the year		**43,790**	45,450
Effect of exchange rate changes on cash and cash equivalents		**(1,052)**	3,042
Cash and cash equivalents at the end of the year	38	**78,510**	43,790

The Notes on pages 27 to 80 are an integral part of these Consolidated Financial Statements.

Company Balance Sheet

As at 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Assets			
Cash and balances at central banks	13	**448**	8
Trading assets	14	**24,976**	27,146
Derivative financial instruments	15	**23,129**	32,160
Financial assets designated at fair value	16	**12,000**	11,005
Loans and advances to banks	17	**166,020**	128,035
Loans and advances to customers	18	**20,266**	24,501
Loans and receivable securities	20	**896**	526
Macro hedge of interest rate risk		**682**	1,475
Investment in subsidiary undertakings	21	**2,185**	2,335
Intangible assets	22	**8**	6
Property, plant and equipment	23	**6**	9
Current tax assets		**3**	-
Deferred tax assets	25	**21**	75
Other assets	26	**67**	21
Total assets		**250,707**	227,302
Liabilities			
Deposits by banks	27	**166,169**	123,366
Deposits by customers	28	**17,601**	9,743
Derivative financial instruments	15	**24,330**	33,511
Trading liabilities	29	**13,315**	22,996
Financial liabilities designated at fair value	30	**4,282**	4,898
Debt securities in issue	31	**21,631**	29,692
Other liabilities	33	**136**	83
Current tax liabilities		**57**	236
Total liabilities		**247,521**	224,525
Equity			
Share capital	36	**2,549**	2,549
Retained earnings		**622**	211
Other reserves		**15**	17
Total shareholders equity		**3,186**	2,777
Total liabilities and equity		**250,707**	227,302

The Notes on pages 27 to 80 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 12 to 80 were approved and authorised for issue by the Board on 27 April 2010 and signed on its behalf by:

David Green
Director

Company Registered Number 2338548

Company Statement of Comprehensive Income

For the years ended 31 December 2009 and 2008

	2009 £m	2008 £m
Profit for the year	**555**	203
Other comprehensive (expense)/income:		
Exchange differences on translation of foreign operations	**(2)**	24
Tax on items taken directly to equity	**-**	(7)
Net (expense)/income recognised directly in equity	**(2)**	17
Total comprehensive income for the year	**553**	220
Attributable to:		
Equity holders of the parent	**553**	220

Company Statement of Changes in Equity

For the years ended 31 December 2009 and 2008

	Notes	**Share Capital £m**	**Foreign currency translation reserve £m**	**Retained earnings £m**	**Total £m**
1 January 2008		2,549	-	169	2,718
Total comprehensive income (gross)		-	24	284	308
Tax relating to components of other comprehensive income		-	(7)	(81)	(88)
Dividends declared and amounts representative of contractual obligations	37	-	-	(161)	(161)
31 December 2008		2,549	17	211	2,777
1 January 2009		**2,549**	**17**	**211**	**2,777**
Total comprehensive income (gross)		**-**	**(2)**	**555**	**553**
Tax relating to components of other comprehensive income		**-**	**-**	**-**	**-**
Dividends declared and amounts representative of contractual obligations	37	**-**	**-**	**(144)**	**(144)**
31 December 2009		**2,549**	**15**	**622**	**3,186**

Company Cash Flow Statement

For the years ended 31 December 2009 and 2008

	Notes	**2009 £m**	2008 £m
Net cash flow from operating activities			
Profit for the year		**555**	203
Adjustments for:			
Non cash items included in net profit		**676**	(1,224)
Change in operating assets		**(13,063)**	(97,861)
Change in operating liabilities		**24,852**	104,283
Income taxes received		**-**	(3)
Effects of exchange rate differences		**(870)**	1,260
Net cash flow from operating activities	38	**12,150**	6,658
Net cash flow from investing activities			
Capital repatriation		**129**	-
Purchase of tangible and intangible fixed assets		**(3)**	(9)
Proceeds from sale of tangible fixed assets		**-**	3
Proceed from sale and redemption of securities		**-**	44
Net cash flow from investing activities		**126**	38
Net cash flow used in financing activities			
Dividends paid		**-**	(161)
Net cash flow used in financing activities		**-**	(161)
Net decrease in cash and cash equivalents		**12,276**	6,535
Cash and cash equivalents at beginning of the year		**38,020**	29,137
Effect of exchange rate changes on cash and cash equivalents		**(969)**	2,348
Cash and cash equivalents at the end of the year	38	**49,327**	38,020

The Notes on pages 27 to 80 are an integral part of these Consolidated Financial Statements.

Accounting Policies

International Financial Reporting Standards

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards ('IFRS') as approved by the International Accounting Standards Board ('IASB'), and interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') of the IASB that, under European Regulations, are effective and available for early adoption at the Group's reporting date. Abbey National Treasury Services plc (the 'Company') and its subsidiaries (together 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 developments
In 2009, the Group adopted the following new or revised IFRS:

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

b) IAS 1 'Presentation of Financial Statements' - On 6 September 2007, the IASB issued an amendment to IAS 1 'Presentation of Financial Statements' which changes the way in which non-owner changes in equity are required to be presented. As a result, a 'Statement of Changes in Equity' has been included as a separate primary financial statement showing changes in equity during the periods presented. In addition, the Statement of Recognised Income and Expense has been replaced with a 'Statement of Comprehensive Income'. The adoption of the amendment to IAS 1 did not have any impact on the Group's profit or loss or financial position.

c) IFRS 7 'Financial Instruments: Disclosures - Improving Disclosures about Financial Instruments' - On 5 March 2009, the IASB issued an amendment to IFRS 7 'Financial Instruments: Disclosures' which requires enhanced disclosures about fair value measurements and liquidity risk. Among other things, the amendment (1) requires disclosure of any change in the method for determining fair value and the reasons for the change; (2) establishes a three-level hierarchy for making fair value measurement disclosures; (3) requires disclosure for each fair value measurement in the balance sheet of which level in the hierarchy was used, and any transfers between levels, with additional disclosures whenever level 3 of the hierarchy is used including a measure of sensitivity to a change in input data; (4) clarifies that the current maturity analysis for non-derivative financial liabilities should include issued financial guarantee contracts; and (5) amends the required disclosure of a maturity analysis for derivative financial liabilities. The disclosures required by the amendment to IFRS 7 may be found on pages 55 and 72 to 79.

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

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

b) IFRS 9 'Financial Instruments' - On 12 November 2009, the IASB issued IFRS 9 'Financial Instruments', which significantly overhauls the accounting requirements for financial instruments under IFRS. IFRS 9 is mandatory for annual periods beginning on or after 1 January 2013, with early application permitted. IFRS 9 requires that a financial asset be classified into one of three categories for measurement and income recognition: (1) Amortised cost, (2) Fair value through profit or loss (FVTPL) and (3) Fair value through other comprehensive income. The standard requires reclassification between amortised cost and FVTPL (or vice versa) if a financial asset no longer meets the criteria for its original classification. IFRS 9 replaces the existing classification and measurement requirements in IAS 39 for financial assets. It changes the manner in which entities classify and measure investments in debt and equity securities, loan assets, trade receivables and derivative financial assets by requiring entities to classify financial assets as being measured at either amortized cost or fair value depending on the entity's business model and the contractual cash flow characteristics of the asset. The Group is currently evaluating the requirements of IFRS 9.

Basis of preparation

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

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.

Accounting Policies continued

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 and Santander UK are going concerns, 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.

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, plus directly attributable acquisition costs. The excess of the cost of acquisition over the fair value of the tangible and intangible net assets of the subsidiary acquired is recorded as goodwill. Intercompany 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.

Foreign currency translation

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

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

Foreign currency transactions are translated into the functional currency of the 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.

The amount of exchange rate differences recognised in profit or loss on items not at fair value through profit and loss was £242m charge (2008: £820m charge). 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.

(b) Fee and commission income
Fees and commissions that are not an integral part of the effective interest rate are generally recognised when the service has been provided.

Accounting Policies continued

(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 fixed 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 designated hedging relationship are recognised in net trading and other income along with the fair value of the hedged item.

Pensions and other post retirement benefits

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 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.

Intangible assets

Software development costs are capitalised when they are associated with identifiable and unique software products that are expected to provide future economic benefits and the cost of these products can be measured reliably. Internally developed software meeting these criteria and externally purchased software are classified in intangible assets on the balance sheet 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. Costs associated with maintaining software programmes are expensed as incurred.

Property, plant and equipment

Property, plant and equipment include owner-occupied properties, office fixtures and equipment 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 other operating income. Repairs and renewals are charged to the income statement when the expenditure is incurred.

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

Owner-occupied properties	Not exceeding 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.

Accounting Policies continued

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 willing parties, knowledgeable parties, other than in a forced or liquidation sale.

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

Subsequent measurement

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

Accounting Policies continued

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

Level 1: Unadjusted quoted prices for identical assets or liabilities in an active market that the Group has the ability to access at the measurement date. Level 1 measurements include debt securities, equity securities, exchange rate derivatives, interest rate derivatives, equity and credit 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 measurements include loans and advances to banks, loans and advances to customers, exchange rate derivatives, interest rate derivatives, equity and credit derivatives, debt securities in issue, 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 measurements 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. All underlying assets and liabilities are reviewed to consider the appropriate adjustment to mark the mid price reported in the trading systems to a realisable value. This process takes into account the liquidity of the position in the size of the adjustment required. These liquidity adjustments are presented and discussed at the monthly Risk Forum.

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

Financial instruments valued using observable market prices
If a quoted market price in an active market is available for an instrument, the fair value is calculated based on the market price.

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

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

A regular way purchase is a purchase of a financial asset under a contract whose terms require delivery of the asset within the time frame 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.

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.

Accounting Policies continued

Sale and repurchase agreements (including stock borrowing and lending)

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

Derivative financial instruments

Transactions are undertaken in derivative financial instruments, ('derivatives'), which include interest rate, cross currency, 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 contracts or agreements whose value is derived from one or more underlying indices or asset values inherent in the contract or agreement, which require no or little initial net investment and are settled at a future date.

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

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

Hedge accounting

The Group designates certain derivatives as hedging instruments of the fair value of recognised assets or liabilities or firm commitments (fair value hedge). Hedge accounting is used for derivatives designated in this way provided certain criteria are met.

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

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

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

For fair value hedges, changes in the fair value of the 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 excluded from assessing hedge effectiveness are also included in net trading and other income.

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 and held to maturity have become impaired. Evidence of impairment may include indications that the borrower or group of borrowers have defaulted, are experiencing significant financial difficulty, or the debt has been restructured to reduce the burden to the borrower.

Accounting Policies continued

Financial assets carried at amortised cost

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

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

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

Once a financial asset or a group of financial assets has been written down as a result of an impairment loss, the assets are not placed onto a non-accrual status. Subsequent interest income continues to be recognised on an effective interest rate basis, though on the asset value after provisions have been deducted.

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 provisions for impairment.

(b) Loans and receivables securities
Loans and receivables securities are assessed individually for impairment. An impairment loss is incurred if there is objective evidence that an event has occurred since initial recognition of the assets that has an impact in the estimated future cash flows of the loans and receivables securities.

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. Net selling price is calculated by reference to the amount at which the asset could be disposed of in a binding sale agreement in an arm's length transaction evidenced by an active market or recent transactions for similar assets, less costs to sell. Value in use is calculated by discounting the expected future cash flows obtainable as a result of the asset's continued use, including those resulting from its ultimate disposal, at a market based discount rate on a pre tax basis.

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

Leases

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

Accounting Policies continued

Income taxes, including deferred income taxes

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

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

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

(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 selling or being unwound in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short term profit taking. Intercompany balances held by the Company with its trading subsidiaries are classified as held for trading.

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.

Accounting Policies continued

There are two principal product types.
(a) 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.
(b) 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.

Borrowings

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

Share capital

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

Provisions

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

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, and has raised valid expectations in those affected by the restructuring and has started to implement the plan or announce its main features.

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

Financial guarantee contracts

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

Dividends

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

Accounting Policies continued

Critical accounting policies and areas of significant management judgement

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

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

Valuation of financial instruments

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

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

The Group trades in a wide variety of financial instruments in the major financial markets and therefore considers a range of interest rates, volatility, exchange rates, counterparty credit ratings, valuation adjustments and other similar inputs, all of which vary across maturity bands. These are chosen to best reflect the particular characteristics of each transaction. Had management used different assumptions regarding the interest rates, volatility, exchange rates, the credit rating of the counterparty, and valuation adjustments, a larger or smaller change in the valuation of financial assets and financial liabilities including derivatives where quoted market prices are not available would have resulted that could have had a material impact on the Group's reported profit on continuing operations before tax in 2009. Detailed disclosures on financial instruments, including sensitivities, can be found in Note 45 on page 68. Further information about sensitivities (including value-at-risk) to market risk arising from financial instrument trading activities can be found in Note 44 on page 49.

Notes to the Financial Statements

1. Segments

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

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

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. Global Banking & Markets provides financial markets sales, trading and risk management services, as well as manufacturing retail structured products. Corporate Banking offers banking services principally to small and mid-sized (SME) UK companies. It also contains operations in run down. ALM provides asset and liability management services to Santander UK.

The segment information below is presented on the basis used by the Company's Board to evaluate performance, in accordance with IFRS 8. The Board reviews discrete financial information for each of its segments, including measures of operating results and assets. The segments are managed primarily on the basis of their results, which are measured on a 'trading' basis. The trading basis differs from the statutory basis (described in the Accounting Policies section on pages 17 to 26) 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 is:

> **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 from interest 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.

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

a) Segmental information

2009	Global Banking & Markets £m	Corporate Banking £m	ALM £m	Total £m	Adjustments £m	Group Total £m
Net interest income	-	125	251	376	-	376
Non-interest income	380	54	22	456	(181)	275
Total trading income	380	179	273	832	(181)	651
Administration expenses	(101)	(39)	(22)	(162)	-	(162)
Depreciation and amortisation	(3)	-	-	(3)	-	(3)
Total trading expenses	(104)	(39)	(22)	(165)	-	(165)
Impairment losses on loans and advances	-	(30)	-	(30)	-	(30)
Total operating provisions and charges	-	(30)	-	(30)	-	(30)
Trading profit before tax	276	110	251	637	(181)	456
Adjust for:						
Hedging and other mark to market variances	-	-	(181)	(181)		
Profit before tax	276	110	70	456		
Average number of staff	298	188	74	560		
Total assets	63,645	11,244	207,955	282,844		

Notes to the Financial Statements continued

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

2008	Global Banking & Markets £m	Corporate Banking £m	ALM £m	Total £m	Adjustments £m	Group Total £m
Net interest income	-	53	338	391	-	391
Non-interest income	326	21	(17)	330	(200)	130
Total trading income	326	74	321	721	(200)	521
Administration expenses	(104)	(32)	(22)	(158)	-	(158)
Depreciation and amortisation	(3)	-	-	(3)	-	(3)
Total trading expenses	(107)	(32)	(22)	(161)	-	(161)
Impairment losses on loans and advances	-	(25)	(1)	(26)	-	(26)
Total operating provisions and charges	-	(25)	(1)	(26)	-	(26)
Trading profit before tax	219	17	298	534	(200)	334
Adjust for:						
Hedging and other mark to market variances	-	-	(200)	(200)		
Profit before tax	219	17	98	334		
Average number of staff	300	226	28	554		
Total assets	52,590	10,217	181,070	243,877		

b) By geographical region

Total operating income/(expenses)	**2009 £m**	2008 £m
United Kingdom	**654**	491
Other	**(3)**	30
	651	521
Total assets other than financial instruments and deferred tax assets		
United Kingdom	**14**	15
Other	**-**	-
	14	15

2. Net interest income

	Group	
	2009 £m	2008 £m
Interest and similar income:		
Loans and advances to Group undertakings	**3,673**	6,156
Other interest earning financial assets	**132**	551
Total interest and similar income	**3,805**	6,707
Interest expense and similar charges:		
On deposits by Group undertakings	**2,218**	5,235
Other interest bearing financial liabilities	**1,211**	1,081
Total interest expense and similar charges	**3,429**	6,316
Net interest income	**376**	391

3. Net fee and commission income

	Group	
	2009 £m	2008 £m
Fee and commission income:		
Retail Products	**25**	16

Notes to the Financial Statements continued

4. Net trading and other income

	Group	
	2009	2008
	£m	£m
Net trading and funding of other items by the trading book	**128**	82
Income on assets designated at fair value through profit or loss	**69**	797
Expense on liabilities designated at fair value through profit or loss	**(117)**	(435)
Gains/(losses) on derivatives managed with assets/liabilities held at fair value through profit or loss	**225**	(373)
Hedge ineffectiveness and other	**(55)**	43
	250	114

5. Administration expenses

	Group	
	2009	2008
	£m	£m
Staff costs:		
Wages and salaries	**91**	96
Social security costs	**10**	5
Pensions costs:		
- defined contribution plans	**5**	4
Other personnel costs	**3**	4
	109	109
Property and equipment expenses	**4**	8
Information technology expenses	**40**	31
Other administrative expenses	**9**	10
	162	158

6. Depreciation and amortisation

	Group	
	2009	2008
	£m	£m
Depreciation of plant, property and equipment	**3**	3

7. Impairment losses/(recoveries) on loans and advances

	Group	
	2009	2008
	£m	£m
Impairment losses on loans and advances	**51**	26
Recoveries of loans and advances	**(21)**	-
	30	26

8. Audit services

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

	Group	
	2009	2008
	£m	£m
Fees payable to the Company's auditor for the audit of the Group's annual accounts	**0.4**	0.5
Fees payable to the Company's auditor and its associates for the audit of the Company's subsidiaries pursuant to legislation	**0.2**	0.4
Total audit fees	**0.6**	0.9

Notes to the Financial Statements continued

9. Directors' remuneration and interests

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

	Group	
	2009	2008
	£	£
Salaries and fees	**734,722**	518,892
Performance-related payments	**758,600**	1,062,768
Total remuneration excluding pension contributions	**1,493,322**	1,581,660
Pension contributions	**41,000**	31,876
	1,534,322	1,613,536

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 five (2008: five) Directors serving during the year.

Remuneration of highest paid Director

The remuneration, excluding pension contributions, of the highest paid Director was £801,791 (2008: £1,005,617) of which £500,000 (2008: £777,875) was performance-related. The amount paid with respect to a defined contribution scheme by the highest paid director was £nil (2008: £nil).

The accrued pension benefit for the highest paid Director was £nil (2008: £nil). The accrued lump sum of the highest paid director as at 31 December 2009 was £nil (2008: £nil). Two directors will be receiving benefits under a defined benefit scheme (2008: two) and no directors (2008: one) will be receiving benefits under a defined contribution ('money purchase') scheme.

Medium-Term Incentive Plan

Under the Medium-Term Incentive Plan granted on 20 October 2005, certain Executive Directors, Other Key Management Personnel and other nominated individuals were granted a conditional award of shares in Banco Santander, S.A.. The amount of shares participants would receive at the end of the three-year period depended on the performance of Santander UK in this period. The performance conditions were linked to Santander UK's three-year plan. Performance was measured in two ways, half of the award depended on Santander UK achieving an attributable profit target for the 2007 financial year, and the remainder depended on the achievement of a revenue target for the 2007 financial year. Both performance conditions were achieved, resulting in a full award of shares to participants in March 2008.

Long-Term Incentive Plan

In 2009, three Directors (2008: four) were granted conditional awards of shares in Banco Santander, S.A. under the Santander Long-Term Incentive Plan for a total fair value of £63,820 (2008: £116,787) based on a share price of euro 8.14 (2008: euro 11.96). The value attributable to the current year of these conditional awards is included in share-based payments. Under the Santander Long-Term Incentive Plans granted on 1 July 2009, 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 amount of shares participants will receive throughout a three year period (2008: a three year period) depends on the performance of Banco Santander, S.A. during this period. All awards under the 2009 Santander Long-Term Incentive Plan will depend 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. Subject to performance conditions being met, the remaining 60% of the 2007 conditional award will vest in July 2010, 100% of the 2008 conditional award will vest in July 2011 and 100% of the 2009 conditional award will vest in July 2012.

10. Taxation expense

	Group	
	2009	2008
	£m	£m
Current tax:		
UK corporation tax on profit for the year	**117**	138
Adjustments in respect of prior periods	**(95)**	5
Total current tax	**22**	143
Deferred tax (Note 25)		
Current year	**1**	(50)
Adjustments in respect of prior periods	**55**	(7)
Total deferred tax	**56**	(57)
Tax on profit for the year	**78**	86

Notes to the Financial Statements continued

UK income tax is calculated at 28% (2008: 28.5%) of the estimated assessable profits for the year. The standard rate of UK corporation tax was reduced from 30% to 28% with the effect from 1 April 2008. Taxation for other jurisdictions is calculated at the rates prevailing in the relevant jurisdictions. Further information about deferred income tax is presented in Note 25. The tax on the Group's profit before tax differs from the theoretical amount that would arise using the basic tax rate of the parent as follows:

	Group	
	2009 £m	2008 £m
Profit before tax	**456**	334
Tax calculated at a tax rate of 28% (2008: 28.5%)	**128**	92
Non-taxable dividend income	**(4)**	(5)
Effect of non-allowable provisions and other non-equalised items	**(3)**	2
Utilisation of capital losses for which credit not previously recognised	**(3)**	-
Adjustment in respect of prior periods	**(40)**	(3)
Income tax expense	**78**	86

11. Profit on ordinary activities after tax

The profit after tax of the Company attributable to the shareholders was £555m (2008: £203m). As permitted by Section 408 of the UK Companies Act 2006, the Company's profit and loss account has not been presented in these Consolidated Financial Statements.

12. Discontinued operations

On 8 December 2008 the Group completed the disposal of Porterbrook, its rolling stock leasing business, by the sale of 100% of Porterbrook Leasing Company Limited and its subsidiaries to a consortium of investors including Antin Infrastructure Partners (the BNP Paribas sponsored infrastructure fund), Deutsche Bank and Lloyds Banking Group plc, for a cash consideration of approximately £1.6bn.

The results, and profit on sale, of the discontinued operations were as follows:

	Group	
	2009 £m	2008 £m
Total income	**-**	185
Total operating expenses	**-**	(126)
Profit of discontinued operations before tax	**-**	59
Taxation expense	**-**	(17)
Profit of discontinued operations after tax	**-**	42
Profit on sale of discontinued operations before and after tax	**-**	40
Profit for the year from discontinued operations after tax	**-**	82

13. Cash and balances at central banks

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
	448	8	**448**	8

For regulatory purposes, certain minimum cash balances are required to be maintained with the Bank of England. At 31 December, these amounted to £nil (2008: £8m).

14. Trading assets

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Balances with central banks	**-**	2,498	**-**	-
Loans and advances to banks	**5,252**	4,947	**2,242**	4,239
Loans and advances to customers	**10,628**	1,316	**228**	856
Amounts due from Group undertakings	**-**	-	**19,023**	16,400
Debt securities	**15,932**	16,801	**3,124**	5,204
Equity securities	**1,478**	706	**359**	447
	33,290	26,268	**24,976**	27,146

Notes to the Financial Statements continued

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Issued by public bodies:				
Government securities	**2,856**	3,139	**2,098**	2,932
Issued by other issuers:				
- Bank and building society certificates of deposit: Government guaranteed	**205**	3,119	**-**	-
- Bank and building society certificates of deposit: Other	**1,730**	5,266	**52**	740
- Floating Rate Notes: Government guaranteed	**8,090**	553	**-**	-
- Floating Rate Notes	**3,038**	4,724	**961**	-
Other debt securities: Government guaranteed	**-**	-	**-**	-
Other debt securities: Other	**13**	-	**13**	1,532
	15,932	16,801	**3,124**	5,204

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Debt securities:				
- Listed UK	**12,803**	9,577	**912**	558
- Listed elsewhere	**3,129**	7,224	**2,212**	4,646
	15,932	16,801	**3,124**	5,204
Equity securities:				
- Listed UK	**1,183**	316	**73**	57
- Listed elsewhere	**295**	390	**286**	390
	1,478	706	**359**	447

15. Derivative financial instruments

The Company is the principal area of the Group actively trading derivative products and is additionally responsible for implementing Group derivative hedging with the external market. All derivatives are required to be classified as held for trading and held at fair value through profit or loss. Derivatives are held for trading or for risk management purposes. The Group chooses to designate certain derivatives as in a hedging relationship if they meet specific criteria.

Derivatives held for trading purposes
Global Banking & Markets is the only area of the Group actively trading derivative products and is additionally responsible for implementing Group derivative hedging with the external market. For trading activities, its objectives are to gain value by:

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

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

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

The derivatives table in the Market Risk discussion within the ALM section of Note 44 Financial Instruments and Risks summarises activities undertaken by the Group, the related risks associated with such activities and the types of derivatives used in managing such risks. Such risks may also be managed using natural offsets within balance sheet instruments as part of an integrated approach to risk management.

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

Notes to the Financial Statements continued

Derivatives classified as held for trading or held for risk management purposes that have not been designated as in a hedging relationship are classified as derivatives held for trading in the table below. Derivatives that have been designated as in a hedging relationship are classified as derivatives held for fair value hedging below.

			Group
2009 Derivatives held for trading	**Contract/notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Exchange rate contracts:			
- Cross-currency swaps	**122,743**	**3,927**	**4,074**
- Forward exchange swaps and forwards	**22,072**	**161**	**139**
	144,815	**4,088**	**4,213**
Interest rate contracts:			
- Interest rate swaps	**646,122**	**15,464**	**12,919**
- Caps, floors and swaptions	**79,629**	**1,676**	**2,562**
- Futures (exchange traded)	**89,379**	**4**	**-**
- Forward rate agreements	**77,170**	**56**	**61**
	892,300	**17,200**	**15,542**
Equity and credit contracts:			
- Equity index and similar products	**5,500**	**1,075**	**1,589**
- Equity index options (exchange traded)	**71,662**	**563**	**871**
- Credit default swaps and similar products	**3,884**	**40**	**55**
	81,046	**1,678**	**2,515**
Total derivative assets / liabilities held for trading	**1,118,161**	**22,966**	**22,270**

			Group
2009 Derivatives held for fair value hedging	**Contract/notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Interest rate contracts:			
- Interest rate swaps	**42,280**	**235**	**2,185**
Total derivative assets / liabilities held for fair value hedging	**42,280**	**235**	**2,185**
Total recognised derivative assets / liabilities	**1,160,441**	**23,201**	**24,455**

			Company
2009 Derivatives held for trading	**Contract/notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Exchange rate contracts:			
- Cross-currency swaps	**122,710**	**3,926**	**4,074**
- Forward exchange swaps and forwards	**13,134**	**114**	**93**
	135,844	**4,040**	**4,167**
Interest rate contracts:			
- Interest rate swaps	**626,155**	**15,433**	**12,878**
- Caps, floors and swaptions	**79,496**	**1,676**	**2,562**
- Futures (exchange traded)	**74,402**	**2**	**-**
- Forward rate agreements	**77,170**	**56**	**61**
	857,223	**17,167**	**15,501**
Equity and credit contracts:			
- Equity index and similar products	**4,390**	**1,084**	**1,588**
- Equity index options (exchange traded)	**71,662**	**563**	**841**
- Credit default swaps and similar products	**3,884**	**40**	**48**
	79,936	**1,687**	**2,477**
Total derivative assets / liabilities held for trading	**1,073,003**	**22,894**	**22,145**

			Company
2009 Derivatives held for fair value hedging	**Contract/notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**
Interest rate contracts:			
- Interest rate swaps	**42,280**	**235**	**2,185**
Total derivative assets / liabilities held for fair value hedging	**42,280**	**235**	**2,185**
Total recognised derivative assets / liabilities	**1,115,283**	**23,129**	**24,330**

Notes to the Financial Statements continued

2008 Derivatives held for trading	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Group
Exchange rate contracts:			
- Cross-currency swaps	58,209	7,188	6,872
- Forward exchange swaps and forwards	17,102	1,421	793
	75,311	8,609	7,665
Interest rate contracts:			
- Interest rate swaps	573,968	18,884	17,627
- Caps, floors and swaptions	44,093	1,773	1,841
- Futures (exchange traded)	55,534	232	-
- Forward rate agreements	250,324	604	599
	923,919	21,493	20,067
Equity and credit contracts:			
- Equity index and similar products	17,202	1,755	3,892
- Equity index options (exchange traded)	11,564	843	803
- Credit default swaps and similar products	1,829	110	167
	30,595	2,708	4,862
Total derivative assets / liabilities held for trading	1,029,825	32,810	32,594

2008 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	41,919	56	1,538
Total derivative assets / liabilities held for fair value hedging	41,919	56	1,538
Total recognised derivative assets / liabilities	1,071,744	32,866	34,132

2008 Derivatives held for trading	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Company
Exchange rate contracts:			
- Cross-currency swaps	57,790	7,193	6,922
- Forward exchange swaps and forwards	7,326	714	177
	65,116	7,907	7,099
Interest rate contracts:			
- Interest rate swaps	546,597	18,741	17,473
- Caps, floors and swaptions	44,093	1,773	1,841
- Futures (exchange traded)	51,308	232	-
- Forward rate agreements	250,074	604	599
	892,072	21,350	19,913
Equity and credit contracts:			
- Equity index and similar products	17,429	1,894	4,049
- Equity index options (exchange traded)	11,564	843	803
- Credit default swaps and similar products	1,340	110	109
	30,333	2,847	4,961
Total derivative assets / liabilities held for trading	987,521	32,104	31,973

2008 Derivatives held for fair value hedging	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
			Company
Interest rate contracts:			
- Interest rate swaps	41,919	56	1,538
Total derivative assets / liabilities held for fair value hedging	41,919	56	1,538
Total recognised derivative assets / liabilities	1,029,440	32,160	33,511

Net gains/(losses) arising from fair value hedges included in net trading and other income

		2009
	Group £m	**Company £m**
Net gains/(losses):		
- on hedging instruments	**661**	**(696)**
- on hedged items attributable to hedged risks	**(696)**	**661**
	(35)	**(35)**

Notes to the Financial Statements continued

	2008 Group £m	2008 Company £m
Net gains/(losses):		
On hedging instruments	(1,137)	(1,137)
On the hedged items attributable to hedged risk	1,221	1,221
	84	84

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.

16. Financial assets designated at fair value

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Loans and advances to customers	**6,334**	6,642	**6,334**	6,642
Debt securities	**5,666**	4,363	**5,666**	4,363
	12,000	11,005	**12,000**	11,005

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

a) Loans and advances to customers representing certain loans secured on residential property to housing associations. 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.

b) Debt securities representing holdings of asset-backed securities. At the date of their acquisition, they were managed, and their performance was evaluated, on a fair value basis in accordance with a documented investment strategy and information about them was provided internally on that basis to the Group's key management personnel. These securities are now managed on an accruals basis, but are not eligible for reclassification under IAS 39.

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 £6,217m (2008: £6,214m). The maximum exposure was mitigated by the Group having a charge over residential properties respect of lending to housing associations. Of the movement in the fair value of the loans and advances to customers and debt securities an amount of £247m (2008: £474m) was due to changes in credit spreads.

Debt securities can be analysed by listing status as follows:

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Listed elsewhere	**3,174**	4,083	**3,174**	4,083
Unlisted	**2,492**	280	**2,492**	280
	5,666	4,363	**5,666**	4,363

17. Loans and advances to banks

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Amounts due from Santander UK group undertakings	**185,560**	136,076	**162,911**	121,742
Amounts due from ultimate parent	**5,993**	8,348	**2,989**	3,630
Other loans and advances	**196**	2,665	**120**	2,663
	191,749	147,089	**166,020**	128,035

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Repayable:				
On demand	**10,120**	1,995	**10,116**	1,995
In not more than 3 months	**52,269**	31,101	**28,126**	18,140
In more than 3 months but not more than 1 year	**19,066**	29,630	**19,058**	23,538
In more than 1 year but not more than 5 years	**92,743**	52,201	**92,743**	52,201
In more than 5 years	**17,551**	32,162	**15,977**	32,161
	191,749	147,089	**166,020**	128,035

Notes to the Financial Statements continued

18. Loans and advances to customers

		Group		Company
	2009 £m	2008 £m	**2009 £m**	2008 £m
Amounts due from Santander group undertakings	**15,292**	19,572	**15,393**	19,881
Other loans and advances	**4,960**	4,658	**4,950**	4,646
Loans and advances to customers	**20,252**	24,230	**20,343**	24,527
Less: loan loss allowances	**(77)**	(26)	**(77)**	(26)
Loans and advances to customers, net of loan loss allowances	**20,175**	24,204	**20,266**	24,501

		Group		Company
	2009 £m	2008 £m	**2009 £m**	2008 £m
Repayable:				
On demand	**340**	1	**405**	-
In no more than 3 months	**5,451**	4,417	**5,451**	4,840
In more than 3 months but not more than a year	**572**	480	**571**	310
In more than 1 year but not more than 5 years	**4,133**	2,541	**4,155**	2,592
In more than 5 years	**9,756**	16,791	**9,761**	16,785
Loans and advances to customers	**20,252**	24,230	**20,343**	24,527
Less: loan loss allowance	**(77)**	(26)	**(77)**	(26)
Loans and advances to customers, net of loan loss allowances	**20,175**	24,204	**20,266**	24,501

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

		Group		Company
	2009 £m	2008 £m	**2009 £m**	2008 £m
Fixed rate	**4,179**	3,698	**4,188**	17,666
Variable rate	**16,073**	20,532	**16,155**	6,861
Less: loan loss allowances	**(77)**	(26)	**(77)**	(26)
	20,175	24,204	**20,266**	24,501

Movement in loan loss allowances:

	Group **£m**
As at 1 January 2009	**26**
Charge to the income statement:	
- Individually assessed	**50**
- Collectively assessed	**1**
	51
Write offs	**-**
At 31 December 2009	**77**
As at 1 January 2008	-
Charge to the income statement:	
- Individually assessed	13
- Collectively assessed	13
	26
Write offs	-
At 31 December 2008	26

	Company **£m**
As at 1 January 2009	**26**
Charge to the income statement	**51**
Write offs	**-**
At 31 December 2009	**77**
As at 1 January 2008	-
Charge to the income statement	13
Write offs	13
At 31 December 2008	26

Notes to the Financial Statements continued

19. Held to maturity securities

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
	300	300	**-**	-

The balance above represents two issuances of £150m each of subordinated bonds in pounds sterling made by a subsidiary company. The key terms of these subordinated bonds are:

- £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%.

20. Loans and receivable securities

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Loans and receivable securities	**896**	526	**896**	526

These securities have determinable payments and are not quoted in an active market. The securities consist of residential mortgage-backed securities issued by a fellow subsidiary of Santander UK plc, and a debenture issued by a fellow subsidiary in the Banco Santander, S.A., group.

21. Investment in subsidiary undertakings

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

			Company
	Cost	**Impairment**	**Net book value**
	£m	**£m**	**£m**
At 1 January 2009	**2,342**	**(7)**	**2,335**
Additions	**-**	**(21)**	**(21)**
Capital reduction of subsidiary	**(129)**	**-**	**(129)**
At 31 December 2009	**2,213**	**(28)**	**2,185**

The principal subsidiaries of Abbey National Treasury Services plc at 31 December 2009 are shown below, all of which are directly held 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 Sterling Capital plc	Funding	100	England & Wales
Abbey National North America LLC *	Funding	100	United States
Cater Allen Holdings Limited *	Holding company	100	England & Wales
Cater Allen International Limited *	Securities financing	100	England & Wales

* Held 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. Abbey National Treasury Services plc also has branch offices in the US and the Cayman Islands.

Notes to the Financial Statements continued

22. Intangible assets

	Group 2009 £m	Company 2009 £m
Cost		
At 1 January 2009	**22**	**6**
Additions	**2**	**2**
At 31 December 2009	**24**	**8**
Accumulated amortisation / impairment		
At 1 January and 31 December 2009	**16**	**-**
Net book value	**8**	**8**

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

	Group 2008 £m	Company 2008 £m
Cost		
At 1 January 2008	16	-
Additions	6	6
At 31 December 2008	22	6
Accumulated amortisation / impairment		
At 1 January and 31 December 2008	16	-
Net book value	6	6

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

	Owner-occupied properties £m	Office fixtures and equipment £m	Computer software £m	Group Total £m
Cost				
At 1 January 2009	**1**	**18**	**61**	**80**
Additions	**-**	**-**	**1**	**1**
Disposals	**-**	**(3)**	**(1)**	**(4)**
At 31 December 2009	**1**	**15**	**61**	**77**
Accumulated depreciation				
At 1 January 2009	**1**	**10**	**60**	**71**
Charge for the year	**-**	**3**	**-**	**3**
Disposals	**-**	**(3)**	**-**	**(3)**
At 31 December 2009	**1**	**10**	**60**	**71**
Net book value				
At 31 December 2009	**-**	**5**	**1**	**6**

	Owner-occupied properties £m	Office fixtures and equipment £m	Computer software £m	Group Total £m
Cost				
At 1 January 2008	2	19	61	82
Additions	-	3	-	3
Disposals	(1)	(4)	-	(5)
At 31 December 2008	1	18	61	80
Accumulated depreciation				
At 1 January 2008	2	8	60	70
Charge for the year	-	3	-	3
Disposals	(1)	(1)	-	(2)
At 31 December 2008	1	10	60	71
Net book value				
At 31 December 2008	-	8	1	9

Notes to the Financial Statements continued

	Owner-occupied properties £m	Office fixtures and equipment £m	Computer software £m	Company Total £m
Cost				
At 1 January 2009	**-**	**16**	**60**	**76**
Additions	**-**	**-**	**1**	**1**
Disposals	**-**	**(3)**	**(1)**	**(4)**
At 31 December 2009	**-**	**13**	**60**	**73**
Accumulated depreciation				
At 1 January 2009	**-**	**8**	**59**	**67**
Charge for the year	**-**	**3**	**-**	**3**
Disposals	**-**	**(3)**	**-**	**(3)**
At 31 December 2009	**-**	**8**	**59**	**67**
Net book value				
At 31 December 2009	**-**	**5**	**1**	**6**

	Owner-occupied properties £m	Office fixtures and equipment £m	Computer software £m	Company Total £m
Cost				
At 1 January 2008	-	17	60	77
Additions	-	3	-	3
Disposals	-	(4)	-	(4)
At 31 December 2008	-	16	60	76
Accumulated depreciation				
At 1 January 2008	-	5	59	64
Charge for the year	-	3	-	3
At 31 December 2008	-	8	59	67
Net book value				
At 31 December 2008	-	8	1	9

At 31 December 2009, capital expenditure contracted, but not provided for was £1m (2008: £3m) in respect of property, plant and equipment. Of the carrying value at the balance sheet date £99m (2008: £107m) related to assets under construction.

24. Operating lease assets

	Group 2009 £m	2008 £m
Cost		
At 1 January	**-**	3,473
Additions	**-**	88
Disposals	**-**	-
Disposed of subsidiary undertaking	**-**	(3,561)
At 31 December	**-**	-
Depreciation and impairment		
At 1 January	**-**	1,309
Charge for the year	**-**	117
Disposals	**-**	-
Disposed of subsidiary undertaking	**-**	(1,426)
At 31 December	**-**	-
Net book value	**-**	-

The operating lease assets of the Group consisted of trains and related assets and were sold in 2008 as described in Note 12. The Company had no operating lease assets.

Notes to the Financial Statements continued

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	
	2009 £m	2008 £m	**2009 £m**	2008 £m
At 1 January	**76**	(422)	**75**	18
Income statement (charge)/credit – continuing operations	**(56)**	57	**(54)**	57
Income statement charge – discontinued operations	**-**	(3)	**-**	-
Disposal of subsidiary undertaking	**-**	444	**-**	-
At 31 December	**20**	76	**21**	75

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Deferred income tax liabilities				
Capital allowances on operating lease receivables	**-**	-	**-**	-
Other temporary differences	**(1)**	(1)	**-**	-
	(1)	(1)	**-**	-
Deferred income tax assets				
Accelerated book depreciation	**2**	2	**2**	1
IAS 32 & 39 transition adjustments	**13**	15	**12**	14
Other temporary differences	**6**	60	**7**	60
	21	77	**21**	75

The deferred tax assets scheduled above have been recognised in both the Company and the Group on the basis that sufficient future taxable profits are forecast within the foreseeable future, in excess of the profits arising from the reversal of existing taxable temporary differences, to allow for the utilisation of the assets as they reverse. Under current UK tax legislation, the tax losses in respect of which deferred tax assets have been recognised do not expire.

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

	Group	
	2009 £m	2008 £m
Accelerated tax depreciation	**-**	-
IAS 32 & 39 transitional adjustments	**(2)**	(2)
Other temporary differences	**(54)**	59
	(56)	57

26. Other assets

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Trade and other receivables	**67**	30	**67**	6
Accrued income	**-**	15	**-**	15
	67	45	**67**	21

27. Deposits by banks

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Amounts due to Group undertakings	**165,487**	122,601	**165,448**	122,601
Sale and repurchase agreement	**-**	5	**-**	-
Amounts due to ultimate parent	**614**	662	**518**	649
Time and demand deposits	**204**	228	**203**	116
Total deposits by banks	**166,305**	123,496	**166,169**	123,366

Notes to the Financial Statements continued

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Repayable:				
On demand	**8,355**	7,400	**8,354**	7,276
In not more than 3 months	**65,753**	59,173	**65,623**	59,168
In more than 3 months but not more than 1 year	**28,250**	6,544	**28,235**	6,544
In more than 1 year but not more than 5 years	**38,697**	18,263	**38,706**	18,263
In more than 5 years	**25,250**	32,116	**25,251**	32,115
	166,305	123,496	**166,169**	123,366

28. Deposits by customers

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Retail deposits	**12**	17	**12**	14
Amounts due to Group undertakings	**5,900**	1,908	**14,040**	8,721
Wholesale funds and deposits	**3,549**	1,008	**3,549**	1,008
	9,461	2,933	**17,601**	9,743
Repayable:				
On demand	**1,416**	-	**1,400**	-
In no more than 3 months	**1,987**	1,869	**10,016**	8,360
In more than 3 months but no more than 1 year	**229**	55	**292**	245
In more than 1 year but no more than 5 years	**5,133**	477	**5,197**	606
In more than 5 years	**696**	532	**696**	532
	9,461	2,933	**17,601**	9,743

In 2008, issuances of commercial paper and certificates of deposit were used to fund commercial banking operations. As a result, such issuances have been classified as deposits by customers. In previous years, similar debt issuances were used to fund the Group's trading operations and therefore were classified as trading liabilities.

Wholesale deposits by customers are interest bearing.

29. Trading liabilities

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Deposits by banks	**40,824**	34,339	**5,873**	12,182
Deposits by customers	**4,102**	4,622	**4,102**	4,621
Amounts due to Group undertakings	**-**	-	**3,030**	5,156
Short positions in securities and unsettled trades	**1,071**	13	**168**	13
Debt securities in issue	**142**	1,024	**142**	1,024
	46,139	39,998	**13,315**	22,996

The total fair value of equity index-linked deposits included above at the balance sheet date was £2,144m (2008: £2,205m).

30. Financial liabilities designated at fair value

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
US$4bn Euro Commercial Paper Programme	**662**	-	**662**	-
US$20bn Euro Medium Term Note Programme	**3,578**	4,274	**3,520**	4,227
Other bonds	**100**	671	**100**	671
	4,340	4,945	**4,282**	4,898

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

Of the movements in the fair value of the above debt securities in issue £27m (2008: £88m) result from changes in the Group's own credit risk. This was calculated by applying current spreads at the next call date or maturity date to the nominal value of the security to determine the extra cost of the debt security for the remaining period of the debt security were it to have been issued at current spreads.

Notes to the Financial Statements continued

The amount that would be required to be contractually paid at maturity of the debt securities in issue above is £124m (2008: £39m) higher than the carrying value.

US$4bn Euro Commercial Paper Programme
Abbey National Treasury Services plc may from time to time issue the commercial paper under the US$4bn Euro-Commercial Paper Programme that may be denominated in any currency as agreed between Abbey National Treasury Services plc and the relevant dealer. The Notes rank at least pari passu with all other unsecured and unsubordinated obligations of Abbey National Treasury Services plc. The payments of all amounts due in respect of the Notes have been unconditionally and irrevocably guaranteed by the Company.

The Notes are issued in bearer form, subject to a minimum maturity of 1 day and a maximum maturity of 364 days. The Notes 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 Notes outstanding from time to time under the Programme will not exceed US$4bn (or its equivalent in other currencies). The Notes are not listed on any stock exchange.

US$20bn Euro Medium Term Note Programme
Abbey National Treasury Services plc 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.

31. Debt securities in issue

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Euro 25bn Global Covered Bond Programme	**10,276**	17,166	**10,277**	17,165
US$20bn Euro Medium Term Note Programme (see Note 30)	**1,567**	3,313	**1,566**	3,313
US$20bn Commercial Paper Programme	**6,366**	4,234	**-**	-
Euro 2bn structured notes	**600**	-	**600**	-
Certificates of deposit in issue	**9,188**	9,214	**9,188**	9,214
	27,997	33,927	**21,631**	29,692
Repayable:				
In not more than 3 months	**11,642**	10,380	**5,340**	6,366
In more than 3 months but no more than 1 year	**4,997**	4,922	**4,932**	4,701
In more than 1 year but no more than 5 years	**3,410**	2,211	**3,410**	2,211
In more than 5 years	**7,948**	16,414	**7,949**	16,414
	27,997	33,927	**21,631**	29,692

Euro 25bn Global Covered Bond Programme
Abbey National Treasury Services plc issues the Covered Bonds under the euro 25bn Global Covered Bond Programme that may be denominated in any currency as agreed between Abbey National Treasury Services plc 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's Regulated Market or any other stock exchanges or regulated or unregulated markets. Abbey National Treasury Services plc 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 have guaranteed payments of interest and principal under the Covered Bonds pursuant to a guarantee which is secured over its 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 25bn (or its equivalent in other currencies), subject to increase in accordance with the Programme.

On 2 July 2008, the size of the global covered bond programme established in 2005 was increased from euro 12bn to euro 25bn. 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, Abbey National Treasury Services plc 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).

Notes to the Financial Statements continued

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 are will rank at least pari passu with all other unsecured and unsubordinated indebtedness of Abbey National North America LLC and the Company. The payments of all amounts due in respect of the Notes have been unconditionally and irrevocably guaranteed by the Company. 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).

Euro 2bn structured notes

Abbey National Treasury Services plc may from time to time issue structured notes denominated in any currency as agreed between Abbey National Treasury Services plc and the relevant dealers under the euro 2bn structured note programme. Structured notes are direct, unsecured and unconditional obligations of Abbey National Treasury Services plc 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 Abbey National Treasury Services plc. 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 Abbey National Treasury Services plc 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 Abbey National Treasury Services plc 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 2bn (or its equivalent in other currencies).

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

			Group		Company	
	Interest Rate	Maturity	**2009 £m**	2008 £m	**2009 £m**	2008 £m
euro	0.00% - 3.99%	Up to 2010	**1,518**	2,990	**1,518**	2,990
		2011 - 2019	**3,372**	1,945	**3,372**	1,945
		2020 - 2029	**-**	1,469	**-**	1,469
	4.00% - 4.99%	2020 - 2029	**1,362**	-	**1,362**	-
US dollar	0.00% - 3.99%	Up to 2010	**14,279**	9,076	**7,913**	4,841
	4.00% - 5.99%	Up to 2010	**-**	170	**-**	170
Pounds sterling	0.00% - 3.99%	Up to 2010	**843**	2,874	**843**	2,874
		2011 - 2019	**990**	381	**990**	381
		2020 - 2029	**5,011**	-	**5,011**	-
	4.00% - 5.99%	Up to 2010	**-**	747	**-**	747
		2011 - 2019	**600**	603	**600**	603
		2020 - 2029	**-**	13,202	**-**	13,202
	6.00% - 6.99%	Up to 2010	**-**	447	**-**	447
Other currencies	0.00% - 5.99%	2011 - 2019	**9**	-	**9**	-
	6.00% - 6.99%	2011 - 2019	**13**	23	**13**	23
			27,997	33,927	**21,631**	29,692

32. Subordinated liabilities

	Group	
	2009 £m	2008 £m
Dated subordinated liabilities:		
11.50% subordinated guaranteed bond 2017	**166**	166
10.125% subordinated guaranteed bond 2023	**165**	165
6.89% subordinated guaranteed bond 2014	**-**	101
	331	432

In common with other debt securities issued by Group companies, the subordinated liabilities are 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 are guaranteed by Santander UK plc. In 2009, the 6.89% subordinated notes with a maturity date of 31 January 2014 were redeemed in full.

Notes to the Financial Statements continued

Subordinated liabilities including convertible debt securities in issue are repayable:

	Group	
	2009	2008
	£m	£m
In more than 5 years	**331**	432

The Company did not hold any subordinated liabilities during the year (2008: £nil).

33. Other liabilities

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Trade and other payables	**74**	340	**63**	16
Accrued expense	**73**	67	**73**	67
	147	407	**136**	83

34. Provisions

	Group	
	2009	2008
	£m	£m
At 1 January	**-**	7
Used during the year	**-**	(5)
Disposal of subsidiary undertaking	**-**	(2)
At 31 December	**-**	-
To be settled:		
Within 12 months	**-**	-
In more than 12 months	**-**	-
	-	-

The provision related to heavy maintenance costs on leased rolling stock within the Porterbrook group that was sold early in December 2008 as described in Note 12.

35. Contingent liabilities and commitments

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

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Guarantees given on behalf of the Company's UK parent, fellow subsidiaries and subsidiaries	**147,597**	100,780	**190,349**	128,440
Guarantees given to third parties	**57**	369	**57**	369
Formal standby facilities, credit lines and other commitments:				
– Original term to maturity of more than one year	**3,106**	2,983	**3,106**	2,983
	150,760	104,132	**193,512**	131,792

Overseas tax claim
Abbey National Treasury Services plc has received a demand from an overseas tax authority relating to the repayment of certain tax credits and related charges. Following modifications to the demand, its nominal amount stands at £74m at the balance sheet exchange rate (2008: £80m). At 31 December 2009, additional interest in relation to the demand could amount to £34m at the balance sheet exchange rate (2008: £34m). Abbey National Treasury Services plc received legal advice that it had strong grounds to challenge the validity of the demand. In September 2006, Abbey National Treasury Services plc won its case at the first stage of the litigation process. In January 2007, the tax authority appealed this decision. However, in December 2006, a ruling was published of a similar case unconnected to the Group but which might affect Abbey National Treasury Services plc's position. In this instance, the courts ruled against the taxpayer.

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.

Notes to the Financial Statements continued

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 £37,525m as at 31 December 2009 (2008: £17,139m) are offset by a contractual right to receive stock under other contractual agreements.

Operating lease commitments

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Rental commitments under operating leases expiring:				
No later than 1 year	**4**	5	**4**	4
Later than 1 year but no later than 5 years	**16**	22	**16**	18
Later than 5 years	**24**	45	**24**	39
	44	72	**44**	61

At 31 December 2009 the Group held various leases on land and buildings, many for extended periods, and other leases for equipment, which require the following aggregate minimum lease payments:

	Group	Company
	2009 £m	**2009 £m**
Year ended 31 December:		
2010	**4**	**4**
2011	**4**	**4**
2012	**4**	**4**
2013	**4**	**4**
2014	**4**	**4**
Total thereafter	**24**	**24**

Group rental expense comprises:

	Group	
	2009 £m	2008 £m
In respect of minimum rentals	**4**	9
Less: sub-lease rentals	**-**	-
	4	9

Appropriate provisions are maintained to cover the above matters.

36. Share capital

	Ordinary shares of £1 each £m	Tracker shares of £1 each £m	Total £m
Issued and fully paid share capital:			
At 1 January and 31 December 2009	**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 are not redeemable and do not confer any rights to participate in the assets of the company on winding up (beyond the amount subscribed). The Tracker Shares carry 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.

Notes to the Financial Statements continued

37. Dividends

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. Amounts representative of such contractual obligations in respect of the Tracker Shares during the year were nil (2008: £161,000 per share). Amounts representative of such contractual obligations in respect of the B Tracker shares during the year were £144,000 per share (2008: nil).

38. Consolidated cash flow statement

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Profit for the year	**378**	330	**555**	203
Non-cash items included in net profit				
Depreciation	**3**	121	**3**	5
Decrease/(Increase) in prepayments and accrued income	**1,097**	(1,243)	**943**	(1,118)
(Decrease)/increase in accruals and deferred income	**(1,257)**	1,112	**(1,187)**	1,048
Provision for impairment	**52**	26	**72**	26
Profit on the sale of subsidiary undertakings	**-**	(40)	**-**	-
Other non-cash items	**896**	(1,084)	**845**	(1,184)
Net cash flow from / (used in) trading activities	**1,169**	(778)	**1,231**	(1,020)
Changes in operating assets and liabilities				
Net (increase)/ decrease in financial assets held for trading	**(1,631)**	8,964	**(4,154)**	6,993
Net (increase)/decrease in financial assets designated at fair value	**(995)**	441	**(995)**	441
Net decrease/ (increase) in derivatives held for trading	**9,665**	982	**9,031**	1,252
Net increase in loans and advances to banks and customers	**(12,208)**	(90,983)	**(16,954)**	(82,853)
Net decrease/(increase) in other assets	**34**	(724)	**9**	(780)
Net increase/(decrease) in deposits by banks and customer accounts	**50,173**	71,888	**51,539**	72,646
Net decrease in derivative liabilities	**(9,677)**	-	**(9,181)**	-
Net increase/(decrease) in trading liabilities	**6,260**	-	**(9,674)**	-
Net decrease in financial liabilities held for trading	**-**	(14,792)	**-**	(10,758)
Net decrease in financial liabilities designated at fair value	**(588)**	(2,591)	**(599)**	(2,630)
Net (decrease)/increase in debt issued	**(4,344)**	18,033	**(6,921)**	22,231
Net decrease in other liabilities	**(661)**	(197)	**(312)**	(121)
Effects of exchange rate differences	**(1,423)**	3,606	**(870)**	1,260
Net cash flow from/(used in) from operating activities before tax	**35,774**	(6,151)	**12,150**	6,661
Income tax paid	**-**	(4)	**-**	(3)
Net cash flow from/(used in) operating activities	**35,774**	(6,155)	**12,150**	6,658

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Cash and balances at central banks	**448**	8	**448**	8
Debt securities - Trading	**1,966**	5,208	**779**	401
Loans and advances to banks - Trading	**4,881**	4,946	**2,193**	4,239
Loans and advances to customers - Trading	**8,827**	532	**7,665**	13,238
Net trading other cash equivalents	**15,674**	10,686	**10,637**	17,878
Loans and advances to banks - Non trading	**62,388**	33,096	**38,242**	20,134
Net non-trading other cash equivalents	**62,388**	33,096	**38,242**	20,134
Cash and cash equivalents at year end	**78,510**	43,790	**49,327**	38,020

Notes to the Financial Statements continued

c) Sale of subsidiaries

	Group	
	2009 £m	2008 £m
Net assets disposed of:		
Operating lease assets	-	2,134
Current tax accounts	-	8
Other assets	-	60
Deposits by banks	-	(8)
Other liabilities	-	(163)
Other provisions	-	(2)
Current tax liabilities	-	(19)
Deferred tax liabilities	-	(446)
Retirement benefit obligations	-	1
	-	1,565
Profit on disposal	-	40
	-	1,605
Satisfied by:		
Cash and cash equivalents	-	1,605
Less: Cash and cash equivalents in subsidiary sold	-	-
Net cash inflow of sale	-	1,605

On 8 December 2008, the Group completed the disposal of Porterbrook, its rolling stock leasing business, by the sale of 100% of Porterbrook Leasing Company Limited and its subsidiaries to a consortium of investors including Antin Infrastructure Partners (the BNP Paribas sponsored infrastructure fund), Deutsche Bank and Lloyds Banking Group plc, for a cash consideration of approximately £1.6bn.

d) Discontinued operations

The trains and related assets leasing businesses, which constituted the majority of the Corporate Banking segment, qualify as discontinued operations. The net cash flows attributable to the operating, investing and financing activities of discontinued operations were £nil (2008: £266m), £nil (2008: £(0.7)m), and £nil (2008: £0.4m), respectively.

39. Collateral pledged and received

The Group and its subsidiaries in the course of its business will pledge assets as collateral.

Collateral is also provided by the Company in the normal course of derivative business to counterparties. As at 31 December 2009 £2,014m (2008: £1,646m) of such collateral in the form of cash had been pledged.

As part of structured transactions entered into by subsidiaries of the Company, assets are pledged or received as collateral. At 31 December 2009 £253m (2008: £844m) of assets had been received (2008: pledged) in relation to these transactions.

Subsidiaries of the Company 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 subsidiaries provide collateral equal to 100%-105% of the borrowed amount. The carrying amount of assets that were so pledged at 31 December 2009 was £36,315m (2008: £30,134m).

Subsidiaries of the Company also enter into purchase and resale agreements and similar transactions, of debt and equity securities, which are accounted for as collateralised loans. Upon entering into such transactions, the 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 equal to the loan balance. The subsidiaries are permitted to sell or repledge the collateral held. At 31 December 2009, the fair value of such collateral was £58,589m (2008: £26,987m) of which £58,589m (2008: £26,987m) was sold or repledged. The subsidiaries have an obligation to return the collateral that it has sold or pledged with a fair value of £58,589m (2008: £26,987m).

40. Directors' emoluments and interests

Further details of Directors' emoluments and interests are included in Note 42. Details of loans, quasi loans and credit transactions entered into or agreed by the Company or its subsidiaries with persons who are or were Directors, other Key Management Personnel and connected persons of the Company during the year are included in Note 42.

Notes to the Financial Statements continued

41. 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 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 (2008: £4m) was recognised as an expense for these contributions and is included in staff costs within administration expenses in the income statement.

42. 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 and the Board and Executive Committee of Santander UK plc.

Remuneration of key management personnel
The remuneration of the Directors, and other Key Management Personnel of the Company, 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 9.

Key management compensation	**2009** **£**	2008 £
Short-term employee benefits	**1,493,322**	1,581,660
Post employment benefits	**41,000**	31,876
Share-based payments	**152,450**	104,824
Total key management compensation	**1,686,772**	1,718,360

Of the Directors that served during the year, five 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.

Medium-Term Incentive Plan
Under the Medium-Term Incentive Plan granted on 20 October 2005, certain Executive Directors, Other Key Management Personnel and other nominated individuals were granted a conditional award of shares in Banco Santander, S.A.. The amount of shares participants would receive at the end of the three-year period depended on the performance of the Group in this period. The performance conditions were linked to the Group's three-year plan. Performance was measured in two ways, half of the award depended on the Group achieving an attributable profit target for the 2007 financial year, and the remainder depended on the achievement of a revenue target for the 2007 financial year. Both performance conditions were achieved, resulting in a full award of shares to participants in March 2008.

Long-Term Incentive Plan
In 2009, three (2008: four) Directors were granted conditional awards of shares in Banco Santander, S.A. under the Santander Long-Term Incentive Plan for a total fair value of £63,820 (2008: £116,787) based on a share price on 1 July 2009 of euro 8.14 (2008: euro 11.96). The value attributable to the current year of these conditional awards is included in share based payments. Under the Santander Long-Term Incentive Plans granted on 1 July 2009, 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 amount of shares participants will receive throughout a three year period (2008: a three year period) depends on the performance of Banco Santander, S.A during this period. All awards under the 2009 Santander Long-Term Incentive Plan will depend 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. Subject to performance conditions being met, the remaining 60% of the 2007 conditional award will vest in July 2010, 100% of the 2008 conditional award will vest in July 2011 and 100% of the 2009 conditional award will vest in July 2012.

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, London NW1 3AN. A copy of the accounts of Banco Santander, S.A. may be obtained from Santander Shareholder Services, 2 Triton Square, London NW1 3AN.

Notes to the Financial Statements continued

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	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Ultimate parent company	**(67)**	(483)	**25**	509	**7,439**	9,885	**(1,921)**	(2,107)
Immediate parent	**(3,525)**	(5,561)	**2,645**	4,738	**126,485**	132,613	**(115,868)**	(130,214)
Fellow subsidiaries	**(1,151)**	(175)	**480**	120	**83,165**	44,066	**(66,156)**	(15,462)
	(4,743)	(6,219)	**3,150**	5,367	**217,089**	186,564	**(183,945)**	(147,783)

Company	Interest, fees and other income received		Interest, fees and other expense paid		Amounts owed by related parties		Amounts owed to related parties	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Ultimate parent company	**(13)**	(344)	**23**	484	**4,434**	5,163	**(1,824)**	(1,815)
Immediate parent	**(3,414)**	(5,400)	**2,643**	4,734	**115,377**	126,750	**(115,867)**	(130,111)
Subsidiaries	**(119)**	(549)	**61**	565	**19,143**	16,752	**(11,415)**	(12,076)
Fellow subsidiaries	**(965)**	(175)	**433**	120	**71,324**	26,309	**(65,887)**	(15,452)
	(4,511)	(6,468)	**3,160**	5,903	**210,278**	174,974	**(194,993)**	(159,454)

The balances above include debt securities in issue held by related parties. During the year, euro 315m of the Group's holdings of AAA rated prime mortgage backed securities were sold to the issuer, Banco Santander Totta, S.A.. Although Banco Santander Totta, S.A. is a related party of the Group, the transactions are considered to be commercial deals, with a normal sharing of profits.

The above transactions were typically made in the ordinary course of business and substantially on the same terms as for comparable transactions with third-party counterparties.

43. Events after the balance sheet date

Except as described in Note 36, no material events have occurred.

44. Financial risks and risk management

This Note contains audited financial information except principally for the discussion of Operational Risk on page 53 that, in accordance with the guidance in paragraph BC65 of IFRS 7, is unaudited.

Summary

The Group's risks are managed at a Santander UK level. This Risk Management section describes the Company and the Group's Risk Governance Framework, and includes more detail on 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 Group's Risk Governance Framework, including the three tiers of the Risk Governance structure. This can be found on page 51 to 52.

Financial Risks and Risk Management - Group-wide disclosures about specific risks which do not originate in any single operating segment, such as operational risk as well as Group-wide disclosures about market risk and concentrations of credit risk are described on pages 52 to 54.

Liquidity risk – A description of the liquidity risks the Group faces, along with their management and activity in 2009 and 2008, can be found on page 54 to 55.

Notes to the Financial Statements continued

Discussion of Key Risks by Operating Segment- Detailed discussions about risk exposures, measurement information and management policies presented by operating segment can be found on pages 56 to 62:

- **Risks in Global Banking & Markets** – The risks in this segment are described on pages 56 to 58, comprising:
  - **Credit risk**, including its management, mitigation and its disclosure of exposure by rating of counterparty.
  - **Market risk,** including its management and disclosures on short-term market risk, structural market risk and trading market risk.

- **Risks in Corporate Banking** – The risks in this segment are described on pages 58 to 61, comprising:
  - **Credit risk**, including its management, mitigation and the disclosure of exposure by rating of counterparty.
  - **Market risk**, including its management.

Risks in Asset & Liability Management – The risks in this segment are described on pages 61 to 62, comprising:
  - **Credit risk**, including its management, mitigation and its disclosure of exposure by rating of counterparty.
  - **Market risk**, including its management and disclosure of Net Interest Margin Sensitivity and the Market Value of Equity Sensitivity.
  - A description of the types of derivative contracts used to hedge risks in this segment**.**

The Impact of the Current Credit Environment – Detailed disclosures can be found on pages 63 to 67, including a description of the Group's exposures to certain classes of financial assets and off-balance sheet entities.

Introduction

The Group follows the same risk management structure of Santander UK. The Group is driven by the core Santander Global Banking & Markets UK businesses and UK Corporate Bank. 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 Group.

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 Santander UK is exposed to are Credit (Retail, Corporate & Commercial, Wholesale), Market (Traded and Non-Traded), Operational, Pension Obligation, Concentration, Residual Value, Liquidity, Asset Backed Funding (including Encumbrance), Reputational and Business Strategic. 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 Santander UK's long-term success.

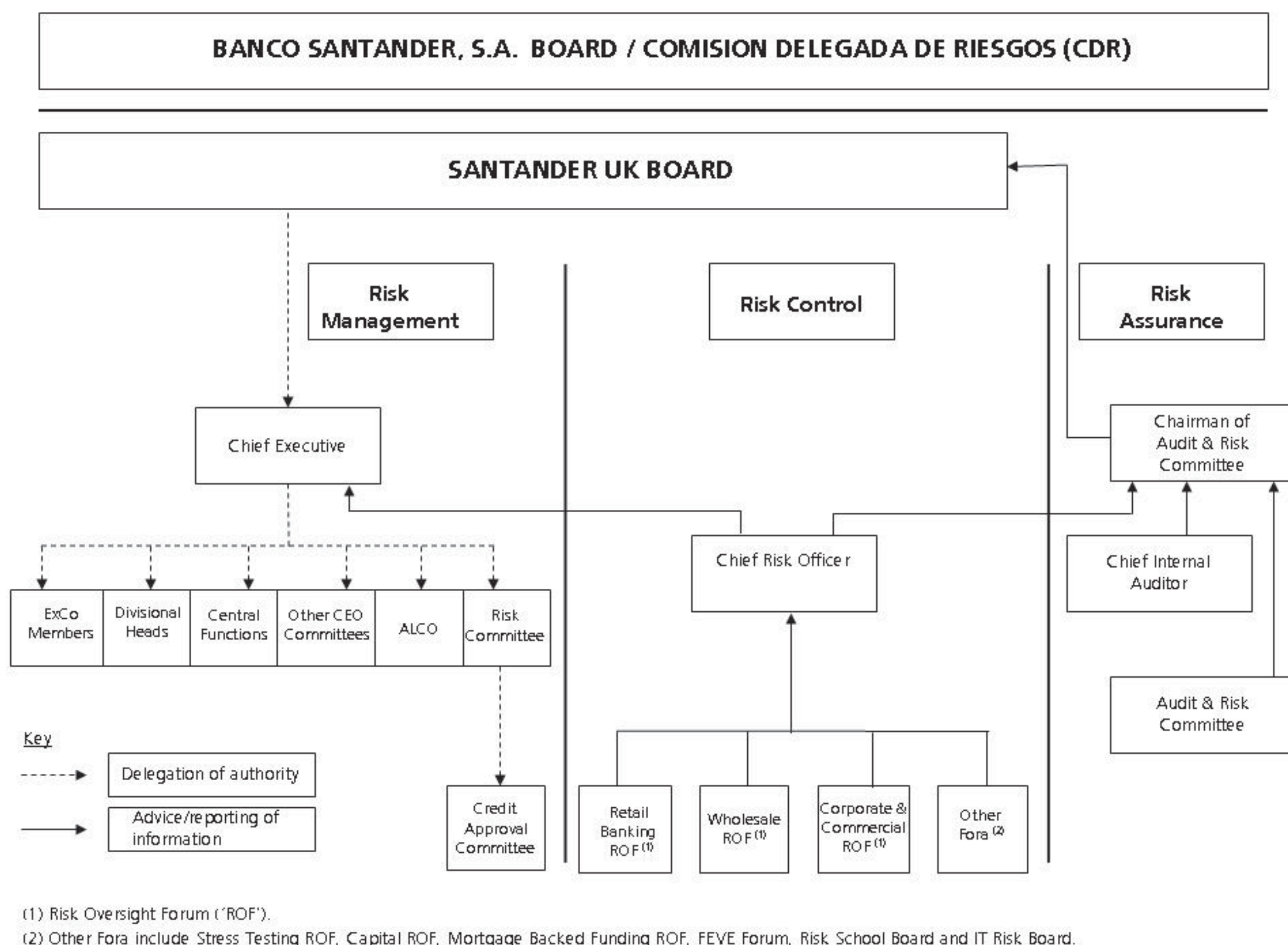
Understanding and controlling risk is critical for the effective management of the business. Santander UK's Risk Framework aims to ensure that risk is managed and controlled on behalf of shareholders, customers, depositors, employees and the Group's regulators. Effective and efficient risk governance 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 Group's strategic objectives.

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

Notes to the Financial Statements continued

Risk Governance Framework

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



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

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

First tier of risk governance in Santander UK

Risk management is provided by the Santander UK Board. It approves Santander UK's risk appetite in consultation with Banco Santander, S.A. as appropriate, 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 and Executive Management, who have primary responsibility for understanding, identifying and owning the risks generated by their lines of business and establishing a framework for managing those risks within the approved risk appetite of Santander UK. In addition understanding and identifying 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 Approval Committee. Transactions reviewed which exceed the threshold limits set are subject to prior review by Banco Santander, S.A.'s Risk Division before final approval by the Credit Approval Committee.

Risk Committee

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

Notes to the Financial Statements continued

Second tier of risk governance in Santander UK

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

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

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

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

Third tier of risk governance 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 Non-Executive Directors, the Audit and Risk Committee and the Internal Audit function.

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.

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

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

Internal Audit
The Internal Audit function supports the Audit and 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 audit of the controls established and operated by the "first tier" risk management functions and those exercised by the "second tier" risk control functions.

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

Financial Risks and Risk Management

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

Group-wide disclosures including those relating to specific risks which do not originate in any single operating segment, are described separately at the beginning of this section, apart from liquidity risk which is discussed at the end of the section, following the detailed disclosures about the impact of the current credit environment.
The Group-wide disclosures are followed by detailed discussions about risk exposures, measurement information and management policies presented by operating segment, being Corporate Banking, ALM and Global Banking & Markets.

The risk exposure and management information relating to the Company principally arise in Corporate Banking and ALM. Following the outsourcing of key IT and operations processes to group companies, risk governance of these entities is crucial. The use of service level agreements and key metrics support this governance.

Notes to the Financial Statements continued

Financial Instruments

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

Operational Risk (unaudited)

The Group's operational risks are managed at a Santander UK level.

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

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

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

Key operational risk activity in 2009 risk (unaudited)
During 2009, the Group has continued to respond to the developing operational risk environment with coordinated responses, and the Group continues to perform detailed control reviews in response to major industry events.

Following many high profile customer data security lapses experienced by other organisations in the UK, the Group has continued to take proactive steps to minimise similar risks. A corporate information security programme was established which involved the strengthening of controls for the management of sensitive data and included the implementation of encryption standards across the Group.

The Group continues to strengthen its point of sale compliance and control procedures to minimise risk and serve its customers. To this end, work continues to progress in implementing new systems which are already successfully operating in Banco Santander, S.A..

Internet frauds were greatly reduced throughout 2009 by developing and implementing improvements to fraud detection rates and introducing a Santander Group transactional model which increased the volume of cases that were intercepted.

In line with UK Financial Services Authority guidance and industry practice, the Group has crisis management and disaster recovery arrangements to ensure that critical business processes are maintained in the event of an unforeseen interruption. Insurance policies are also purchased to provide cover for a range of potential operational risk losses. In response to the increased threats of terrorism, flooding, and pandemic disasters, contingency strategies continue to be refined and key progress has included the development of dispersed contingency sites and automated system switch over facilities.

Corporate operational risk frameworks have been implemented throughout all Santander companies during the year integrating approaches across Bradford & Bingley, Alliance & Leicester and Santander UK plc. To highlight awareness of Operational Risk issues, appropriate training is available for management and staff involved in control functions throughout the Group.

Credit Risk – Group-wide

Significant concentrations of credit risk
During 2009, the Group's most significant exposures to credit risk derived from:

- unsecured lending and derivatives exposure to banks and other financial institutions in Global Banking & Markets; and
- secured lending and derivatives exposures to companies, real estate entities and social housing associations in Corporate Banking.

Although Global Banking & Markets' operations 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.

Notes to the Financial Statements continued

At 31 December 2009, 2% (2008: 9%) of Global Banking & Markets' credit exposures were to counterparties from the United States, and 77% (2008: 47%) were to counterparties from the UK. 2% (2008: 1%) of Global Banking & Markets' exposures were to countries that are not members of the Organisation for Economic Co-operation and Development ('OECD'). The remaining exposures were mainly to European counterparties.

Geographical exposures are governed by country limits set by Banco Santander, S.A. ('Santander') 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 and its gross domestic product. The Group is further constrained in its country risk exposure, within the group limits, and by its capital base.

Maximum exposure to credit risk

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

	2009 £m	2008 £m
Trading assets	**21,688**	24,230
Purchase and resale agreements	**14,673**	10,301
Derivatives	**18,457**	28,139
Financial assets designated at fair value	**12,000**	11,005
Loans and advances to customers	**9,264**	6,893
Loans and advances to banks	**4,530**	20,252
Other	**2,695**	2,669
Third party exposures(1) (2)	**83,307**	103,489

(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

(2) Excludes loan to other members of the Santander UK and Santander groups

In managing the gross exposures, the Group uses the policies and processes described in the Credit Risk sections below.

Basel II (unaudited)

A combination of 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 is underway. The standardised approach for Operational Risk continued to be applied during 2009.

The Group applied Basel II to its Internal Capital Adequacy Assessment Process (ICAAP) and to the risk and 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 in the Consolidated Financial Statements. The Pillar 3 disclosures for Santander UK, of which the Group is part, can be found in the Santander UK plc Consolidated Financial Statements.

Market Risk - Group-wide

Market risk is the potential for loss of income or decrease in the value of net assets caused by movements in the levels and prices of financial instruments including interest rate and foreign currency risks. The Group accepts that market risk arises from its full range of activities. The Group aims to actively manage and control market risk by limiting the adverse impact of market movements whilst seeking to enhance earnings within clearly defined parameters. The Market Risk Manual, which is reviewed and approved by the Head of Wholesale Risk on an annual basis, sets the framework under which market risks are managed and controlled. Business area policies, risk limits and mandates are established within the context of the Market Risk Manual.

Executive directors are responsible for ensuring that they have sufficient expertise to manage the risks originated and retained 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 Head of Wholesale Risk aims to ensure that risk-taking and risk control occur within the framework prescribed by the Market Risk Manual. The Risk function also provides oversight of all risk-taking activities through a process of reviews.

The Group aims to ensure that exposure to market risks is measured and reported on an accurate and timely basis to senior management. In addition to the regular reporting for the purposes of active risk management, the Santander UK Board also receives reporting of all significant market risk exposures on a monthly basis where actual exposure levels are measured against limits. Senior management recognise that different risk measures are required to best reflect the risks faced in different types of business activities. In measuring exposure to market risk, Santander UK uses a range of complementary measures, covering both value and income as appropriate.

Liquidity risk

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

Notes to the Financial Statements continued

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 cashflows 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. This table is not intended to show the liquidity of the Group.

						Group
At 31 December 2009	**Demand £m**	**Up to 3 months £m**	**3-12 months £m**	**1-5 years £m**	**Over 5 years £m**	**Total £m**
Deposits by banks	**8,355**	**66,042**	**28,587**	**40,077**	**26,358**	**169,419**
Deposits by customers	**1,416**	**1,996**	**240**	**5,202**	**712**	**9,566**
Trading liabilities	**2,851**	**37,554**	**3,204**	**2,430**	**443**	**46,482**
Financial liabilities designated at fair value	**-**	**996**	**590**	**2,279**	**487**	**4,352**
Loan commitments	**27,050**	**10,765**	**12**	**1,042**	**2,055**	**40,924**
Debt securities in issue	**-**	**11,852**	**5,175**	**2,620**	**10,604**	**30,251**
Subordinated liabilities	**-**	**40**	**24**	**130**	**457**	**651**
	39,672	**129,245**	**37,832**	**53,780**	**41,116**	**301,645**
Derivative financial instruments	**-**	**54**	**341**	**1,719**	**255**	**2,369**
Total financial liabilities	**39,672**	**129,299**	**38,173**	**55,499**	**41,371**	**304,014**

						Company
At 31 December 2009	**Demand £m**	**Up to 3 months £m**	**3-12 months £m**	**1-5 years £m**	**Over 5 years £m**	**Total £m**
Deposits by banks	**8,354**	**65,913**	**28,572**	**40,087**	**26,359**	**169,285**
Deposits by customers	**1,400**	**10,030**	**304**	**5,266**	**710**	**17,710**
Trading liabilities	**1,758**	**5,498**	**1,019**	**5,110**	**443**	**13,828**
Financial liabilities designated at fair value	**-**	**996**	**590**	**2,279**	**429**	**4,294**
Loan commitments	**98**	**32**	**12**	**1,042**	**2,055**	**3,239**
Debt securities in issue	**-**	**5,548**	**5,111**	**2,620**	**10,604**	**23,883**
Subordinated liabilities	**-**	**-**	**-**	**-**	**-**	**-**
	11,610	**88,017**	**35,608**	**56,404**	**40,600**	**232,239**
Derivative financial instruments	**-**	**54**	**341**	**1,719**	**255**	**2,369**
Total financial liabilities	**11,610**	**88,071**	**35,949**	**58,123**	**40,855**	**234,608**

						Group
At 31 December 2008	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	7,400	59,750	7,124	21,501	36,025	131,800
Deposits by customers	-	1,887	70	569	623	3,149
Trading liabilities	5,065	31,231	1,070	1,667	1,555	40,588
Financial liabilities designated at fair value	-	1,495	994	1,832	1,160	5,481
Loan commitments	30,347	661	-	-	-	31,008
Debt securities in issue	-	10,614	5,396	5,844	24,036	45,890
Subordinated liabilities	-	40	24	130	489	683
	42,812	105,678	14,678	31,543	63,888	258,599
Derivative financial instruments	61	58	119	507	1,505	2,250
Total financial liabilities	42,873	105,736	14,797	32,050	65,393	260,849

						Company
At 31 December 2008	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
Deposits by banks	7,276	59,745	7,124	21,501	36,024	131,670
Deposits by customers	-	8,409	265	705	620	9,999
Trading liabilities	6,500	13,136	563	1,667	1,685	23,551
Financial liabilities designated at fair value	-	1,495	994	1,832	1,160	5,481
Loan commitments	2,983	-	-	-	-	2,983
Debt securities in issue	-	6,995	5,172	5,845	24,036	42,048
	16,759	89,780	14,118	31,550	63,525	215,732
Derivative financial instruments	59	30	115	522	1,531	2,257
Total financial liabilities	16,818	89,810	14,233	32,072	65,056	217,989

Notes to the Financial Statements continued

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 contained within the individual loan agreements, as described in Note 32 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.

Risk Management in Global Banking & Markets

Credit risk in Global Banking & Markets

Credit risk is the risk that counterparties will not meet their financial obligations resulting in Global Banking & Markets losing the monies lent, including any interest accrued, or having to close out transactions prematurely, which may result in losses even after realising the value of any collateral held. Credit risk arises by Global Banking & Markets making loans, investing in debt securities or other financial instruments or entering into financing transactions or derivative contracts. Global Banking & Markets actively manages and controls credit risk.

Managing 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 Global Banking & Markets. 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 the Group 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 are accommodated under credit limits approved by the appropriate credit authority. Specific approval is usually required from the Credit Approval Committee (a specific committee established under the authority of the Chief Executive) for any transaction that falls outside the mandates.

Analysis of credit exposures and credit risk trends are provided each month to the 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 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.

Credit risk mitigation

(i) Netting arrangements

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

(ii) Collateralisation

The Group also mitigates its credit risk to counterparties with which it primarily transacts financial instruments through collateralisation, using industry standard collateral agreements. Under these agreements, net exposures with counterparties are collateralised with cash, securities or equities. Exposures and collateral are 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 (2008: £2.8bn), 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.

Notes to the Financial Statements continued

Global Banking & Markets net exposure by credit rating of the issuer or counterparty[1]

	2009 £m	2008 £m
AAA	**12,068**	5,904
AA	**512**	5,905
A	**2,596**	2,326
BBB	**403**	251
BB	**172**	91
B	**-**	1
Total	**15,751**	14,478

(1) External ratings are applied to all exposures, where available.

In the securities financing businesses, credit risk arises on both assets and liabilities and on both on and off balance sheet transactions. Consequently, the above credit risk exposure arises not only from the on balance sheet assets, but also from securities financing trades classified as liabilities and off balance sheet assets.

Market risk in Global Banking & 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 trading activities. Exposure to equity markets is generated by the creation and risk management of structured products by Global Banking & Markets for the Personal Financial Services market and trading activities. Credit spread exposure arises from credit risk management and trading activities within Global Banking & Markets.

Managing market risk in Global Banking & Markets
Risks are managed within limits approved with by the Head of Wholesale Risk 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 Global Banking & 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 credit derivatives (credit default swaps, total return swaps). 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 should be assigned to one of these 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 Global Banking & 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.

Global Banking & 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 Global Banking & Markets.

Trading market risk
For trading activities the standardised risk measure adopted is Value at Risk. From 1 January 2010, this has been calculated at a 99% confidence level over a one-day time horizon in accordance with the standard used throughout Santander. Prior to this date, a 95% confidence level was used. On a daily basis, market risk factor sensitivities, Value at Risk measures and stress tests are produced, reported and monitored against limits for each major activity and at the aggregate, Global Banking & Markets 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.

Trading market risks are managed on a continuous basis, and marked to market daily. The majority of trading risk exposure arises in the Company and Cater Allen International Limited, a subsidiary of the Company.

The following table shows the value at risk-based consolidated exposures for the major risk classes as at 31 December 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. For example, interest rate risks include the impact of absolute rate movements, movements between interest rate bases and movements in implied volatility on interest rate options. 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.

Notes to the Financial Statements continued

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 value at risk analysis. The 95% confidence interval means that the theoretical loss at a risk factor level is likely to be exceeded in one period in twenty. This risk is addressed by monitoring stress-testing measures across the different business areas. For trading instruments the actual, average, highest and lowest value at risk exposures shown below are all calculated to a 95% 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 amounts below represent the potential change in market values of trading instruments. Since trading instruments are recorded at market value, these numbers also represent the potential effect on income.

	Actual Exposure at 31 December		
Group trading instruments	**2009 £m**	2008 £m	2007 £m
Interest rate risks	**2.4**	5.3	3.0
Equity risks	**1.0**	1.2	2.2
Spread risks	**1.1**	1.9	1.9
Property risks	**6.0**	6.8	3.4
Other risks[1]	**0.4**	0.9	0.3
Correlation offsets[2]	**(2.3)**	(2.5)	(2.3)
Total correlated one-day Value at Risk	**8.6**	13.6	8.5

	Exposure for the year ended 31 December								
	Average exposure			Highest exposure			Lowest exposure		
Group trading instruments	**2009 £m**	2008 £m	2007 £m	**2009 £m**	2008 £m	2007 £m	**2009 £m**	2008 £m	2007 £m
Interest rate risks	**3.9**	3.6	1.7	**6.2**	5.6	3.7	**1.6**	2.5	0.9
Equity risks	**1.4**	2.0	2.4	**2.7**	3.5	3.7	**0.8**	1.0	1.6
Spread risks	**2.5**	1.3	0.9	**3.4**	2.8	2.0	**1.1**	0.5	0.4
Property risks	**6.1**	4.7	2.3	**6.7**	7.4	3.5	**5.5**	3.2	1.0
Other risks[1]	**0.7**	0.6	0.3	**1.0**	1.0	1.2	**0.3**	0.2	0.1
Correlation offsets[2]	**(3.1)**	(2.2)	(1.6)	**-**	-	-	**-**	-	-
Total correlated one-day Value at Risk	**11.5**	10.0	6.0	**14.0**	14.5	8.8	**8.3**	8.0	4.1

(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 table.

Property risks have increased over the last two years. The largest factor in the Value at Risk increase is from an equity release business funded by the Group, as total equity advances increased over the three-year period. A secondary factor is the significant fall in interest rates in the same period. The present value of all the cash flows has increased significantly as a result of the lower discount rates, increasing sensitivity and hence Value at Risk.

Derivatives held for Trading Purposes

Global Banking & Markets is the only area of the Group actively trading derivative products and is additionally responsible for implementing most Group derivative hedging with the external market. For trading activities, the Global Banking & Markets 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, 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.

Credit Derivatives

Previously, Global Banking & Markets also operated a credit derivatives business. The business traded in single-name credit derivatives, credit derivative indices and a limited number of portfolio credit derivative transactions. The credit derivatives trading function operated within the same framework as other trading functions. Risk limits were established and monitored. Given the lack of activity in the credit markets in 2007 and early 2008, the business was closed and its activities consolidated in Spain with the equivalent Banco Santander, S.A. business area with effect from 1 January 2008. Any residual positions have been hedged with Banco Santander, S.A..

Risk Management in Corporate Banking

Credit risk in Corporate Banking

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

Notes to the Financial Statements continued

Managing 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 required by the Credit Approvals Committee (a specific committee established under the authority of the Chief Executive) for any transaction that falls outside the mandates.

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

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

Corporate Banking has been targeted as an area where the Group aims to achieve controlled growth, mainly through the expansion of a regional network supporting lending to the Real Estate, Corporate (including SME), Education and Health sectors. Focus is being given to the control of credit risks within this expansion with, amongst other things, the development and implementation of robust Credit Policy Mandates and models covering both risk appetite and ratings.

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

2009	Corporate £m	Real Estate £m	Social Housing £m	Total £m
AAA	**-**	**60**	**-**	**60**
AA	**156**	**-**	**997**	**1,153**
A	**708**	**463**	**5,483**	**6,654**
BBB	**1,691**	**1,499**	**1,791**	**4,981**
BB	**165**	**842**	**101**	**1,108**
B	**7**	**70**	**-**	**77**
D	**40**	**69**	**-**	**109**
Total	**2,767**	**3,003**	**8,372**	**14,142**

2008	Corporate £m	Real Estate £m	Social Housing £m	Total £m
AAA	29	95	-	124
AA	100	-	1,008	1,108
A	180	270	5,222	5,672
BBB	1,346	1,670	1,821	4,837
BB	151	675	100	926
B	41	-	9	50
D	-	22	-	22
Total	1,847	2,732	8,160	12,739

(1) All exposures are internally rated. External ratings are taken into consideration in the rating process, where available.

Corporate Banking committed facilities exposure by geographical area

2009	Corporate £m	Real Estate £m	Social Housing £m	Total £m
United Kingdom	**2,551**	**2,796**	**8,372**	**13,719**
US	**-**	**65**	**-**	**65**
Rest of world	**216**	**142**	**-**	**358**
Total	**2,767**	**3,003**	**8,372**	**14,142**

2008	Corporate £m	Real Estate £m	Social Housing £m	Total £m
United Kingdom	1,737	2,427	8,160	12,324
US	-	72	-	72
Rest of world	110	233	-	343
Total	1,847	2,732	8,160	12,739

The increase in Corporate and Real Estate exposures in 2009 arose from the continued development of a UK corporate banking franchise and was offset by a reduction in the non growth portfolios, both in the UK and overseas. There are no significant exposures to Dubai, Portugal, Greece, Spain, Argentina and Iceland within the Corporate Banking book.

Notes to the Financial Statements continued

Corporate Banking – Watchlist

The entire corporate risk portfolio of new, emerging and serious cases in the portfolio (i.e. those loans on a 'Watchlist') and those in Collections are managed at the FEVE Corporate Risk forum. FEVE is a Spanish acronym for "Firmas En Vigilancia Especial", which means businesses under special watch.

A summary of the Watchlist cases at 31 December 2009 by portfolio and assessment of risk is as follows:

	Portfolio £m	Watch £m	Watch %	Workout £m	Workout %
Corporate	**2,335**	**42**	**2%**	**42**	**2%**
Real Estate	**3,002**	**249**	**8%**	**249**	**8%**
Total	**5,337**	**291**	**5%**	**291**	**5%**

Exposures are classified as "workout" if they are being actively managed by Risk Division.

Corporate Banking arrears

	2009 £m	2008 £m
Total Corporate lending arrears	**123**	54
Total Corporate lending assets	**11,291**	10,673
Corporate lending arrears as a % of assets	**1.1%**	0.5%

Corporate Banking analysis of provisions on loans and advances to customers

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

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Observed provisions					
Corporate advances - UK	**63**	13	-	-	-
Total observed provisions	**63**	13	-	-	-
Incurred but not yet observed provisions					
Corporate advances - UK	**14**	13	-	-	-
Total incurred but not yet observed provisions	**14**	13	-	-	-
Total provisions	**77**	26	-	-	-

Corporate Banking movements in provisions for impairment losses on loans and advances:

	2009 £m	2008 £m
Provisions at the start of the year	**26**	-
Amounts written off:		
- Corporate Loans	**-**	**-**
- Finance Leases	**-**	**-**
Total amounts written off	**-**	-
Observed provisions charged against profit:		
- Corporate Loans	**50**	13
- Finance Leases	**-**	-
Total observed provisions charged against profit	**50**	13
Incurred but not yet observed provisions charged against profit	**1**	13
Total provisions charged against profit	**51**	26
Provisions at the end of the year	**77**	26

Corporate Banking recoveries

	2009 £m	2008 £m
Corporate Loans	**21**	-
Total amount recovered	**21**	-

Corporate Banking non-performing loans and advances(1)

	2009 £m	2008 £m
Non-performing loans and advances that are impaired	**122**	54
Non-performing loans and advances that are not impaired	**76**	-
Total non-performing loans and advances(2)	**198**	54

	2009	2008
Non-performing loans and advances as a percentage of loans and advances to customers	**1.75%**	0.51%
Provision as a percentage of total non-performing loans and advances	**39.55%**	48.15%

(1) Loans and advances are classified as non-performing typically when the counterparty fails to make payments when contractually due for three months or longer
(2) All non-performing loans are UK loans

Notes to the Financial Statements continued

In 2009, non-performing loans and advances as a percentage of loans and advances to customers increased to 1.75%. This reflects the impact of the deteriorating market environment on the performance of the corporate and real estate portfolios. Interest income recognised on impaired loans amounted to £3m (2008: £2m).

Credit risk mitigation
Collateralisation
The corporate portfolio is largely unsecured but typically incorporates guarantee structures underpinned by both financial and non-financial covenants. The Social Housing portfolio is secured on residential real estate owned and let by UK Housing Associations. In the real estate portfolio, collateral is in the form of commercial real estate assets. There are also a small number of PFI transactions where collateral is held in the form of a charge over the underlying concession contract.

Restructured loans
Loans may be restructured or renegotiated by capitalising the arrears where customers in arrears have maintained an agreed monthly repayment for a period of five months. Loans have been restructured during 2009 by way of debt for equity swaps, through new equity being raised or in some cases, an exit has been achieved through the sale of debt.

Market risk in Corporate Banking

Market risks arising 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 Head of Wholesale Risk.

Risk Management in ALM

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

Credit risk in ALM

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

Managing credit risk
Credit risk arises in ALM with respect to the division's holdings of externally rated asset-backed securities and residential mortgage-backed securities principally issued by Santander entities, bank floating rate notes, other assets held for liquidity purposes, and lending to fellow subsidiaries of Santander.

All credit risk meets the criteria approved by the Santander UK Board in respect to risk appetite parameters and all exposure, including intra-group, is captured on the global risk management systems and falls within limits approved by Santander Risk Division. The exposure is managed by Santander UK´s Wholesale Risk Team.

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

	2009 £m	2008 £m
AAA	**4,728**	9,130
AA	**6,175**	5,094
A	**3,659**	4,001
BBB+	**1,341**	1,174
D	**-**	10
Total	**15,903**	19,409

(1) External ratings are applied to all exposures, where available.

Notes to the Financial Statements continued

Market risk in ALM

Most market risks arising from Santander UK's Retail Banking, Corporate Banking, and Private 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 risks in ALM are interest rate and credit spread 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. Credit spread risk arises principally on ALM's holdings of mortgage-backed securities. 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.

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 risks in ALM

The Asset and Liability Management Committee 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 Global Banking & Markets. The Treasurer, Head of ALM, is responsible for managing risks in accordance with the Asset and Liability Management Committee's direction.

Risks are managed within limits approved either by the Head of Wholesale Risk or Banco Santander, S.A.'s Board Risk Committee, and within the risk control framework defined by the Market Risk Manual. The key risk limits relate to yield curve risk. They are:

- Net Interest Margin sensitivity: the sensitivity of annual net interest margin to an instantaneous and unexpected adverse 100 basis point parallel shock to the yield curve.
- Market Value of Equity sensitivity: the sensitivity of the net present value of interest rate sensitive positions to an instantaneous and unexpected adverse 100 basis point parallel shock to the yield curve.

These two measures provide complementary views of potential losses from interest rate movements. Market Value of Equity sensitivity provides a long-term view covering the present value of all future cash flows, whereas Net Interest Margin sensitivity considers only the impact on net interest margin over the next 12 months. Calculation of these two measures requires modelling of expected customer and other behaviours. These models are regularly reviewed and updated.

The following table shows the results of these measures as at 31 December 2009 and 2008:

	2009 **£m**	2008 £m
Net interest margin sensitivity (100 basis points adverse parallel shock)	**(38)**	(64)
Market value of equity sensitivity (100 basis points adverse parallel shock)	**2**	(153)

Market risk on the Group's Santander-issued mortgage-backed securities portfolio is managed against credit spread triggers approved by the Head of Wholesale Risk and sensitivity analysis is disclosed within 'critical accounting policies and areas of significant management judgement' within the Accounting Policies.

Derivatives

Derivative financial instruments ('derivatives') are contracts or agreements whose value is derived from one or more underlying indices or asset values inherent in the contract or agreement, which require no or little initial net investment and are settled at a future date. They include interest rate, cross-currency and equity related swaps, forward rate agreements, caps, floors, options and swaptions (see below). In ALM, derivatives are used for economic hedging.

All derivatives are classified as held at fair value through profit or loss. For accounting purposes, the Group chooses to designate certain derivatives as in a hedging relationship if they meet specific criteria. The main hedging derivatives 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.

Derivative products that are combinations of more basic derivatives (such as swaps with embedded option features), or that 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 economically hedged.

The following table summarises the activities undertaken within ALM, 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. Further information is contained in Note 15 of the Consolidated Financial Statements.

Notes to the Financial Statements continued

Activity	Risk	Type of hedge
Management of the return on variable rate assets financed by shareholders' funds and net non-interest-bearing liabilities.	Reduced profitability due to falls in interest rates.	Receive fixed interest rate swaps.
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 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.

Impact of the Current Credit Environment

The Group aims to actively manage its exposure to financial institutions and non-bank financial institutions such as pension and investment funds, monoline insurers and general insurers. This exposure arises from investment in floating rate notes, short-term money market placements, derivative transactions and margin posting on securities borrowing transactions.

The Group is not exposed to sovereign debt of countries currently experiencing liquidity problems. Details of the Group's investing and lending arrangements with respect to floating rate notes ('FRNs'), asset-backed securities ('ABS') including mortgage-backed securities ('MBS'), Structured Investment Vehicles ('SIVs'), monoline insurers, off-balance sheet entities, other holdings for liquidity purposes, and lending activities are set out below.

Classification in the Consolidated Balance Sheet

The classification of these assets in the Group consolidated balance sheet is as follows:

31 December 2009

		Type of Financial Instrument analysed further						**OECD Govt**	**Bank & building**	
Balance sheet line item	Note	**FRN**	**ABS**	**CDO**	**CLO**	**Other**	**Sub-total**	**debts**	**society CDs**	**Total**
		£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Trading assets – debt securities	14	**11,128**	**-**	**-**	**-**	**13**	**11,141**	**2,856**	**1,935**	**15,932**
Financial assets designated at fair value – debt securities	16	**-**	**3,446**	**-**	**-**	**-**	**3,446**	**-**	**2,220**	**5,666**
Loans and receivables securities	20	**-**	**736**	**-**	**-**	**160**	**896**	**-**	**-**	**896**
		11,128	**4,182**	**-**	**-**	**173**	**15,483**	**2,856**	**4,155**	**22,494**

31 December 2008

		Type of Financial Instrument analysed further						OECD Govt	Bank & building	
Balance sheet line item	Note	FRN	ABS	CDO	CLO	Other	Sub-total	debts	society CDs	Total
		£m	£m	£m	£m	£m	£m	£m	£m	£m
Trading assets – debt securities	14	5,277	-	-	-	-	5,277	3,139	8,385	16,801
Financial assets designated at fair value – debt securities	16	-	4,363	-	-	-	4,363	-	-	4,363
Loans and receivables securities	20	-	366	-	-	160	526	-	-	526
		5,277	4,729	-	-	160	10,166	3,139	8,385	21,690

Additional analysis is presented below of the above financial instruments, except for the category "Other assets" which consists of the Group's holdings of Government debt securities, and bank and building society certificates of deposit. Further detail on those assets is set out in Note 14 to the Consolidated Financial Statements.

Notes to the Financial Statements continued

Summary

	Nominal	2009 Fair value movement[1] Income statement	Reserves	Provisions[1]	Book value	Fair value
	£m	£m	£m	£m	£m	£m
Floating rate notes	**11,077**	**141**	**-**	**-**	**11,128**	**11,128**
Asset backed securities	**4,187**	**131**	**-**	**-**	**4,182**	**4,182**
Other investments	**173**	**2**	**-**	**-**	**173**	**173**
Total	**15,437**	**274**	**-**	**-**	**15,483**	**15,483**

(1) Amounts in respect of assets held at the balance sheet date i.e. not including amounts relating to assets sold during the year.

	Nominal	2008 Fair value movement[1] Income statement	Reserves	Provisions[1]	Book value	Fair value
	£m	£m	£m	£m	£m	£m
Floating rate notes	5,277	(25)	-	-	5,277	5,277
Asset backed securities	4,883	(328)	-	-	4,729	4,729
Other investments	160	-	-	-	160	160
Total	10,320	(353)	-	-	10,166	10,166

(1) Amounts in respect of assets held at the balance sheet date i.e. not including amounts relating to assets sold during the year.

Fair value of debt securities by credit rating of the issuer or counterparty[1]

31 December 2009	FRNs £m	Others £m	Total £m
AAA	**10,449**	**3,304**	**13,753**
AA+	**83**	**-**	**83**
AA	**559**	**378**	**937**
A	**32**	**531**	**563**
BBB	**4**	**142**	**146**
Below BBB	**1**	**-**	**1**
Total	**11,128**	**4,355**	**15,483**

31 December 2008	FRNs £m	Others £m	Total £m
AA and above	4,238	4,635	8,873
A and below	1,039	254	1,293
Total	5,277	4,889	10,166

(1) External ratings are applied to all exposures, where available.

Floating Rate Notes

(a) Fair value movements by geographical location of issuer or counterparty

2009

	Nominal value		2009 movement Income statement	Reserves	Provisions	Book value	Fair value	Value as % of nominal
Country	**£m**	**%**	**£m**	**£m**	**£m**	**£m**	**£m**	**%**
UK	**8,975**	**81**	**95**	**-**	**-**	**9,025**	**9,025**	**101**
Italy	**-**	**-**	**1**	**-**	**-**	**-**	**-**	**-**
Spain	**44**	**-**	**4**	**-**	**-**	**44**	**44**	**100**
Rest of Europe	**1,482**	**14**	**30**	**-**	**-**	**1,482**	**1,482**	**100**
US	**22**	**-**	**-**	**-**	**-**	**4**	**4**	**18**
Rest of World	**554**	**5**	**11**	**-**	**-**	**573**	**573**	**103**
Total	**11,077**	**100**	**141**	**-**	**-**	**11,128**	**11,128**	**100**

2008

	Nominal value		2008 movement Income statement	Reserves	Provisions	Book value	Fair value	Value as % of nominal
Country	£m	%	£m	£m	£m	£m	£m	%
UK	2,195	42	(4)	-	-	2,195	2,195	100
Italy	215	4	(1)	-	-	215	215	100
Spain	571	11	(2)	-	-	571	571	100
Rest of Europe	1,767	33	(15)	-	-	1,767	1,767	100
US	142	3	-	-	-	142	142	100
Rest of World	387	7	(3)	-	-	387	387	100
	5,277	100	(25)	-	-	5,277	5,277	100

Notes to the Financial Statements continued

(b) Fair value movements by credit rating of issuer or counterparty

2009

	Nominal value		2009 movement Income statement	Reserves	Provisions	Book value	Fair value	Value as % of nominal
Credit rating	**£m**	**%**	**£m**	**£m**	**£m**	**£m**	**£m**	**%**
AAA	**10,385**	**94**	**136**	**-**	**-**	**10,449**	**10,449**	**101**
AA+	**83**	**1**	**-**	**-**	**-**	**83**	**83**	**100**
AA	**566**	**5**	**4**	**-**	**-**	**559**	**559**	**99**
A	**32**	**-**	**1**	**-**	**-**	**32**	**32**	**100**
BBB	**4**	**-**	**-**	**-**	**-**	**4**	**4**	**100**
Below BBB	**7**	**-**	**-**	**-**	**-**	**1**	**1**	**14**
	11,077	**100**	**141**	**-**	**-**	**11,128**	**11,128**	**100**

2008

	Nominal value		2008 movement Income statement	Reserves	Provisions	Book value	Fair value	Value as % of nominal
Credit rating	£m	%	£m	£m	£m	£m	£m	%
AA and above	4,238	80	(17)	-	-	4,238	4,238	100
A and below	1,039	20	(8)	-	-	1,039	1,039	100
	5,277	100	(25)	-	-	5,277	5,277	100

The FRNs held are principally issued by banks and other financial institutions. On average, the FRNs have 3 months to maturity (2008: 7 months).

Structured Investment Vehicles
The Group has insignificant holdings in SIVs, with a nominal value of £14m (2008: £17m) against which provisions of £11m (2008: £12m) are held, giving a book value of £3m (2008: £5m). The holdings in SIVs are classified as FRNs in the balance sheet and are included in the tables above.

Asset-Backed Securities

The Group has acquired highly rated, European asset-backed securities ('ABS') and residential mortgage-backed securities with a total value of £3,886m (2008: £4,087m). The Group's portfolios of ABS and MBS are of high quality, containing no sub-prime element and consist almost entirely of AAA rated prime exposures.

(a) Fair value movements by geographical location of issuer or counterparty

2009

Country	**Nominal value £m**	**%**	**2009 movement Income statement £m**	**Reserves £m**	**Provisions £m**	**Book value £m**	**Fair value £m**	**Value as % of nominal %**
UK								
MBS	**1,012**	**24**	**9**	**-**	**-**	**1,012**	**1,012**	**100**
	1,012	**24**	**9**	**-**	**-**	**1,012**	**1,012**	**100**
US								
MBS	**23**	**1**	**-**	**-**	**-**	**23**	**-**	**-**
	23	**1**	**-**	**-**	**-**	**23**	**-**	**-**
Rest of Europe								
ABS	**232**	**5**	**14**	**-**	**-**	**227**	**227**	**98**
MBS	**2,920**	**70**	**108**	**-**	**-**	**2,920**	**2,943**	**101**
	3,152	**75**	**122**	**-**	**-**	**3,147**	**3,170**	**101**
Total	**4,187**	**100**	**131**	**-**	**-**	**4,182**	**4,182**	**100**

2008

Country	Nominal value £m	%	2008 movement Income statement £m	Reserves £m	Provisions £m	Book value £m	Fair value £m	Value as % of nominal %
Europe (excluding UK)								
ABS	363	7	(23)	-	-	336	336	93
MBS	4,520	93	(305)	-	-	4,393	4,393	97
	4,883	100	(328)	-	-	4,729	4,729	97

Notes to the Financial Statements continued

(b) Vintage of asset-backed securities by geographical location of issuer or counterparty

2009	Nominal	Original credit enhancements	Original sub-prime exposure	Original vintage Pre-2005	2005	2006	2007	2008	2009
	£m	£m	£m	%	%	%	%	%	%
UK									
MBS	**1,012**	**-**	**-**	**25**	**16**	**26**	**33**	**-**	**-**
	1,012	**-**	**-**	**25**	**16**	**26**	**33**	**-**	**-**
US									
MBS	**23**	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
	23	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
Rest of Europe									
ABS	**232**	**-**	**-**	**22**	**-**	**42**	**36**	**-**	**-**
MBS	**2,920**	**-**	**-**	**88**	**-**	**7**	**5**	**-**	**-**
	3,152	**-**	**-**	**83**	**-**	**10**	**7**	**-**	**-**
Total	**4,187**	**-**	**-**	**69**	**4**	**14**	**13**	**-**	**-**

(c) Fair value movements by credit rating of issuer or counterparty

2009			2009 movement					
	Nominal value		Income statement	Reserves	Provisions	Book value	Fair value	Value as % of nominal
Credit rating	£m	%	£m	£m	£m	£m	£m	%
AAA								
ABS	**230**	**5**	**14**	**-**	**-**	**225**	**225**	**98**
MBS	**3,056**	**73**	**110**	**-**	**-**	**3,056**	**3,079**	**101**
	3,286	**78**	**124**	**-**	**-**	**3,281**	**3,304**	**101**
AA								
MBS	**218**	**5**	**5**	**-**	**-**	**218**	**218**	**100**
	218	**5**	**5**	**-**	**-**	**218**	**218**	**100**
A								
MBS	**531**	**13**	**2**	**-**	**-**	**531**	**531**	**100**
	531	**13**	**2**	**-**	**-**	**531**	**531**	**100**
BBB								
ABS	**2**	**-**	**-**	**-**	**-**	**2**	**2**	**100**
MBS	**127**	**3**	**-**	**-**	**-**	**127**	**127**	**100**
	129	**3**	**-**	**-**	**-**	**129**	**129**	**100**
Below BBB								
MBS	**23**	**1**	**-**	**-**	**-**	**23**	**-**	**-**
	23	**1**	**-**	**-**	**-**	**23**	**-**	**-**
Total	**4,187**	**100**	**131**	**-**	**-**	**4,182**	**4,182**	**100**

2008			2008 movement					
	Nominal value		Income statement	Reserves	Provisions	Book value	Fair value	Value as % of nominal
Credit rating	£m	%	£m	£m	£m	£m	£m	%
AAA								
ABS	352	8	(23)	-	-	325	325	92
MBS	4,220	86	(266)	-	-	4,138	4,138	98
	4,572	94	(289)	-	-	4,463	4,463	98
AA+								
ABS	11	-	(1)	-	-	10	10	91
MBS	300	6	(38)	-	-	256	256	85
	311	6	(39)	-	-	266	266	86
	4,883	100	(328)	-	-	4,729	4,729	97

The fair value movements above exclude the effects of changes in foreign exchange rates.

Notes to the Financial Statements continued

(d) Vintage of asset-backed securities by credit rating of issuer or counterparty

2009	Nominal	Original credit enhancements	Original sub-prime exposure	Original vintage Pre-2005	2005	2006	2007	2008	2009
	£m	£m	£m	%	%	%	%	%	%
AAA									
ABS	**230**	**-**	**-**	**22**	**-**	**44**	**34**	**-**	**-**
MBS	**3,056**	**-**	**-**	**75**	**5**	**8**	**12**	**-**	**-**
	3,286	**-**	**-**	**71**	**5**	**10**	**14**	**-**	**-**
AA									
MBS	**218**	**-**	**-**	**-**	**-**	**89**	**11**	**-**	**-**
	218	**-**	**-**	**-**	**-**	**89**	**11**	**-**	**-**
A									
MBS	**531**	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
	531	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
BBB									
ABS	**2**	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
MBS	**127**	**-**	**-**	**-**	**-**	**16**	**84**	**-**	**-**
	129	**-**	**-**	**2**	**-**	**16**	**82**	**-**	**-**
Below BBB									
MBS	**23**	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
	23	**-**	**-**	**100**	**-**	**-**	**-**	**-**	**-**
Total	**4,187**	**-**	**-**	**69**	**4**	**14**	**13**	**-**	**-**

The following table shows the vintages of the collateral assets supporting the Group's holdings of asset-backed securities and mortgage-backed securities at 31 December 2009.

Asset Type	Nominal	Original vintage Pre-2005	2005	2006	2007	2008	2009
	£m	%	%	%	%	%	%
Prime lending	**4,187**	**69**	**4**	**14**	**13**	**-**	**-**

Monoline Insurers

The Group has a £42m exposure to securitisations which is wrapped by a monoline insurer. The principal risk exposure is recorded against the securitisations, with the monoline wrap being viewed as contingent exposure. The exposures to monoline insurers are classified as asset-backed securities in the balance sheet and are included in the tables above.

Collateralised Debt and Loan Obligations

The Group has no investments in Collateralised Debt Obligations or Collateralised Loan Obligations.

However, 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 2009 was £100m (2008: £186m).

Other investments

	Book value 2009 £m	Fair value 2009 £m	Book value 2008 £m	Fair value 2008 £m
Loans and receivable securities	**160**	**160**	160	160
Other	**13**	**13**	-	-
	173	**173**	160	160

Loans and receivable securities consist of a debenture issued by a fellow subsidiary in the Banco Santander, S.A., group.

Exposure to Off-Balance Sheet Entities sponsored by the Group

The only Special Purpose Entities ('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. The total value of products issued by the SPEs is £5,798m (2008: £3,213m), and the total value of repurchases held by the Group is £234m (2008: £254m).

Notes to the Financial Statements continued

Credit Derivatives
As noted above, previously, Global Banking & Markets operated a credit derivatives business. The business traded in single-name credit derivatives, credit derivative indices and a limited number of portfolio credit derivative transactions. The credit derivatives trading function operated within the same framework as other trading functions. Risk limits were established and monitored. There is a limited number of remaining credit derivative transactions with a nominal value of £772m (2008: £1.1bn) where the Group faces external counterparties and the risk has been hedged with Banco Santander, S.A. in Spain.

Liquidity
In addition to funding customer loans and advances, the Group also holds available liquid assets, in the form of cash and short term deposits, to manage the day-to-day requirements of the business. The Group holds a higher level of liquid assets than in 2008, in recognition of the current market conditions.

45. Financial instruments

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The Accounting Policies Note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised.

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:

Classification of financial assets and liabilities

At 31 December 2009

Group

	Held at fair value				Held at amortised cost			
	Trading	Derivatives held for hedging	Designated at fair value through profit or loss	Available-for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash and balances at central banks	-	-	-	-	448	-	-	448
Trading assets	33,290	-	-	-	-	-	-	33,290
Derivative financial instruments	22,044	1,157	-	-	-	-	-	23,201
Financial assets designated at FV	-	-	12,000	-	-	-	-	12,000
Loans and advances to banks	-	-	-	-	191,749	-	-	191,749
Loans and advances to customers	-	-	-	-	20,175	-	-	20,175
Held-to-maturity	-	-	-	-	300	-	-	300
Loans and receivables securities	-	-	-	-	896	-	-	896
Macro hedge of interest rate risk	-	-	-	-	682	-	-	682
Intangible assets	-	-	-	-	-	-	8	8
Property, plant and equipment	-	-	-	-	-	-	6	6
Current tax assets	-	-	-	-	-	-	3	3
Deferred tax assets	-	-	-	-	-	-	21	21
Other assets	-	-	-	-	67	-	-	67
	55,334	1,157	12,000	-	214,317	-	38	282,846
Liabilities								
Deposits by banks	-	-	-	-	-	166,305	-	166,305
Deposits by customers	-	-	-	-	-	9,461	-	9,461
Derivative financial liabilities	22,270	2,185	-	-	-	-	-	24,455
Trading liabilities	46,139	-	-	-	-	-	-	46,139
Financial liabilities at FVTPL	-	-	4,340	-	-	-	-	4,340
Debt securities in issue	-	-	-	-	-	27,997	-	27,997
Subordinated liabilities	-	-	-	-	-	331	-	331
Other liabilities	-	-	-	-	-	147	-	147
Current tax liabilities	-	-	-	-	-	-	167	167
Deferred tax liabilities	-	-	-	-	-	-	1	1
	68,409	2,185	4,340	-	-	204,241	168	279,343

Notes to the Financial Statements continued

At 31 December 2009

	Held at fair value				Held at amortised cost			Company
	Trading	Derivatives held for hedging	Designated at fair value through profit or loss	Available-for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash and balances at central banks	-	-	-	-	448	-	-	448
Trading assets	24,976	-	-	-	-	-	-	24,976
Derivative financial instruments	21,972	1,157	-	-	-	-	-	23,129
Financial assets designated at FV	-	-	12,000	-	-	-	-	12,000
Loans and advances to banks	-	-	-	-	166,020	-	-	166,020
Loans and advances to customers	-	-	-	-	20,266	-	-	20,266
Loans and receivables securities	-	-	-	-	896	-	-	896
Macro hedge of interest rate risk	-	-	-	-	682	-	-	682
Investment in subsidiary undertakings	-	-	-	-	-	-	2,185	2,185
Intangible assets	-	-	-	-	-	-	8	8
Property, plant and equipment	-	-	-	-	-	-	6	6
Current tax assets	-	-	-	-	-	-	3	3
Deferred tax assets	-	-	-	-	-	-	21	21
Other assets		-	-	-	67	-	-	67
	46,948	1,157	12,000	-	188,379	-	2,223	250,707
Liabilities								
Deposits by banks	-	-	-	-	-	166,169	-	166,169
Deposits by customers	-	-	-	-	-	17,601	-	17,601
Derivative financial liabilities	22,146	2,184	-	-	-	-	-	24,330
Trading liabilities	13,315	-	-	-	-	-	-	13,315
Financial liabilities at FVTPL	-	-	4,282	-	-	-	-	4,282
Debt securities in issue	-	-	-	-	-	21,631	-	21,631
Other liabilities	-	-	-	-	-	136	-	136
Current tax liabilities	-	-	-	-	-	-	57	57
	35,461	2,184	4,282	-	-	205,537	57	247,521

At 31 December 2008

	Held at fair value				Held at amortised cost				Group
	Trading	Derivatives held for hedging	Designated at fair value through profit or loss	Available-for-sale	Held to maturity	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m		£m	£m	£m	£m
Assets									
Cash and balances at central banks	-	-	-	-	-	8	-	-	8
Trading assets	26,268	-	-	-	-	-	-	-	26,268
Derivative financial instruments	32,810	56	-	-	-	-	-	-	32,866
Financial assets designated at FV	-	-	11,005	-	-	-	-	-	11,005
Loans and advances to banks	-	-	-	-	-	147,089	-	-	147,089
Loans and advances to customers	-	-	-	-	-	24,204	-	-	24,204
Held to maturity securities	-	-	-	-	300	-	-	-	300
Loans and receivables securities	-	-	-	-	-	526	-	-	526
Macro hedge of interest rate risk	-	-	-	-	-	1,475	-	-	1,475
Intangible assets	-	-	-	-	-	-	-	6	6
Property, plant and equipment	-	-	-	-	-	-	-	9	9
Deferred tax assets	-	-	-	-	-	-	-	77	77
Other assets	-	-	-	-	-	45	-	-	45
	59,078	56	11,005	-	300	173,347	-	92	243,878
Liabilities									
Deposits by banks	-	-	-	-	-	-	123,496	-	123,496
Deposits by customers	-	-	-	-	-	-	2,933	-	2,933
Derivative financial liabilities	32,594	1,538	-	-	-	-	-	-	34,132
Trading liabilities	39,998	-	-	-	-	-	-	-	39,998
Financial liabilities at FVTPL	-	-	4,945	-	-	-	-	-	4,945
Debt securities in issue	-	-	-	-	-	-	33,927	-	33,927
Subordinated liabilities	-	-	-	-	-	-	432	-	432
Other liabilities	-	-	-	-	-	-	407	-	407
Current tax liabilities	-	-	-	-	-	-	-	333	333
Deferred tax liabilities	-	-	-	-	-	-	-	1	1
	72,592	1,538	4,945	-	-	-	161,195	334	240,604

Notes to the Financial Statements continued

At 31 December 2008

Company

	Held at fair value				Held at amortised cost			
	Trading	Derivatives held for hedging	Designated at fair value through profit or loss	Available -for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash and balances at central banks	-	-	-	-	8	-	-	8
Trading assets	27,146	-	-	-	-	-	-	27,146
Derivative financial instruments	32,104	56	-	-	-	-	-	32,160
Financial assets designated at FV	-	-	11,005	-	-	-	-	11,005
Loans and advances to banks	-	-	-	-	128,035	-	-	128,035
Loans and advances to customers	-	-	-	-	24,501	-	-	24,501
Macro hedge of interest rate risk	-	-	-	-	1,475	-	-	1,475
Investment in subsidiary undertakings	-	-	-	-	-	-	2,335	2,335
Loans and receivables securities	-	-	-	-	526	-	-	526
Intangible assets	-	-	-	-	-	-	6	6
Property, plant and equipment	-	-	-	-	-	-	9	9
Deferred tax assets	-	-	-	-	-	-	75	75
Other assets	-	-	-	-	21	-	-	21
	59,250	56	11,005	-	154,566	-	2,425	227,302
Liabilities								
Deposits by banks	-	-	-	-	-	123,366	-	123,366
Deposits by customers	-	-	-	-	-	9,743	-	9,743
Derivative financial liabilities	31,973	1,538	-	-	-	-	-	33,511
Trading liabilities	22,996	-	-	-	-	-	-	22,996
Financial liabilities at FVTPL	-	-	4,898	-	-	-	-	4,898
Debt securities in issue	-	-	-	-	-	29,692	-	29,692
Other liabilities	-	-	-	-	-	83	-	83
Current tax liabilities	-	-	-	-	-	-	236	236
	54,969	1,538	4,898	-	-	162,884	236	224,525

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

Group

2009	Carrying value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	**448**	**448**	**-**
Loans and advances to banks	**191,749**	**195,449**	**3,700**
Loans and advances to customers	**20,175**	**20,629**	**454**
Held-to-maturity	**300**	**458**	**158**
Loans and receivable securities	**896**	**907**	**11**
Liabilities			
Deposits by banks	**166,305**	**168,109**	**(1,804)**
Deposits by customers	**9,461**	**9,527**	**(66)**
Debt securities in issue	**27,997**	**27,820**	**177**
Subordinated liabilities	**331**	**488**	**(157)**

Company

2009	Carrying value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	**448**	**448**	**-**
Loans and advances to banks	**166,020**	**169,720**	**3,700**
Loans and advances to customers	**20,266**	**20,721**	**455**
Loans and receivable securities	**896**	**896**	**-**
Liabilities			
Deposits by banks	**166,169**	**167,973**	**(1,804)**
Deposits by customers	**17,601**	**17,667**	**(66)**
Debt securities in issue	**21,631**	**21,454**	**177**
Subordinated liabilities	**-**	**-**	**-**

Notes to the Financial Statements continued

			Group
2008	Carrying value £m	Fair value £m	Surplus/(deficit) £m
Assets			
Cash and balances at central banks	8	8	-
Loans and advances to banks	147,089	148,980	1,891
Loans and advances to customers	24,204	24,733	529
Loans and receivable securities	526	526	-
Liabilities			
Deposits by banks	123,496	123,786	(290)
Deposits by customers	2,933	2,817	116
Debt securities in issue	33,927	33,788	139
Subordinated liabilities	432	268	164

			Company
2008	Carrying value £m	Fair value £m	Surplus/(deficit) £m
Assets			
Cash and balances at central banks	8	8	-
Loans and advances to banks	128,035	129,926	1,891
Loans and advances to customers	24,501	25,030	529
Loans and receivable securities	526	526	-
Liabilities			
Deposits by banks	123,366	123,656	(290)
Deposits by customers	9,743	9,627	116
Debt securities in issue	29,692	29,553	139

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.

Fair value measurement
The fair value of financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. Where quoted market prices are not available, fair value is determined using pricing models which use a mathematical methodology based on accepted financial theories, depending on the product type and its components. Further information on fair value measurement can be found in the Group's Accounting Policies on pages 20 and 21 and the Valuation techniques section below on page 73 to the Consolidated Financial Statements.

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

Assets

Cash and balances at central banks/Loans and advances to banks
The carrying amount is deemed a reasonable approximation of the fair value, because the loans are at variable rates.

Loans and advances to customers
The carrying amount is deemed a reasonable approximation of the fair value, because the loans are at variable rates.

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

Liabilities

Deposits by banks
The carrying amount is deemed a reasonable approximation of the fair value, because the deposits are at variable rates.

Notes to the Financial Statements continued

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

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

Intra Group balances
Included in the Asset & Liability categories on the Group and Company balance sheet are outstanding intra group balances. The fair value of these balances has been estimated using in-house pricing models.

Fair value valuation bases
The following tables summarise the fair values at 31 December 2009 and 2008 of the asset and liability classes accounted for at fair value, by the valuation methodology used by the Group to determine their fair value. The 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:

At 31 December 2009

Balance sheet category		Quoted prices in active markets		Internal models based on Market observable data		Internal models based on Significant unobservable data		Total		Valuation technique
		£m	%	£m	%	£m	%	£m	%	
Assets										
Trading assets	Loans and advances to banks	-	-	5,252	8	-	-	5,252	8	A
	Loans and advances to customers	-	-	10,628	16	-	-	10,628	16	A
	Debt securities	15,932	23	-	-	-	-	15,932	23	-
	Equity securities	1,471	2	-	-	7	-	1,478	2	B
Derivative assets	Exchange rate contracts	-	-	4,051	6	37	-	4,088	6	A
	Interest rate contracts	4	-	17,431	25	-	-	17,435	25	A & C
	Equity & credit contracts	259	-	1,073	2	346	1	1,678	3	B
Financial assets at FVTPL	Loans and advances to customers	-	-	6,072	9	262	-	6,334	9	A
	Debt securities	-	-	4,497	6	1,169	2	5,666	8	A
Total assets at fair value		17,666	25	49,004	72	1,821	3	68,491	100	
Liabilities										
Trading liabilities	Deposits by banks	-	-	40,824	54	-	-	40,824	54	A
	Deposits by customers	-	-	4,102	5	-	-	4,102	5	A
	Short positions	1,071	1	-	-	-	-	1,071	1	-
	Debt securities in issue	-	-	142	-	-	-	142	-	A
Derivative liabilities	Exchange rate contracts	-	-	4,213	6	-	-	4,213	6	A
	Interest rate contracts	-	-	17,727	24	-	-	17,727	24	A & C
	Equity & credit contracts	28	-	2,227	3	260	1	2,515	4	B
Financial liabilities at FVTPL	Debt securities in issue	-	-	4,231	6	109	-	4,340	6	A
Total liabilities at fair value		1,099	1	73,466	98	369	1	74,934	100	

Notes to the Financial Statements continued

At 31 December 2008

Balance sheet category		Quoted prices in active markets		Internal models based on Market observable data		Internal models based on Significant unobservable data		Total		Valuation technique
		£m	%	£m	%	£m	%	£m	%	
Assets										
Trading assets	Loans and advances to banks	-	-	4,947	7	-	-	4,947	7	A
	Loans and advances to customers	-	-	1,316	2	-	-	1,316	2	A
	Debt securities	16,798	25	3	-	-	-	16,801	25	A
	Equity securities	669	1	-	-	37	-	706	1	B
Derivative assets	Exchange rate contracts	-	-	8,604	13	5	-	8,609	13	A
	Interest rate contracts	232	-	21,317	32	-	-	21,549	32	A & C
	Equity & credit contracts	843	1	1,560	2	305	1	2,708	4	B
Financial assets at FVTPL	Loans & advances to customers	-	-	6,360	10	282	-	6,642	10	A
	Debt securities	-	-	280	-	4,083	6	4,363	6	A
Total assets at fair value		18,542	27	44,387	66	4,712	7	67,641	100	
Liabilities										
Trading liabilities	Deposits by banks	-	-	34,339	43	-	-	34,339	43	A
	Deposits by customers	-	-	4,622	6	-	-	4,622	6	A
	Short positions	13	-	-	-	-	-	13	-	-
	Debt securities in issue	-	-	1,024	1	-	-	1,024	1	A
Derivative liabilities	Exchange rate contracts	-	-	7,665	10	-	-	7,665	10	A
	Interest rate contracts	-	-	21,605	27	-	-	21,605	27	A & C
	Equity & credit contracts	803	1	3,910	5	149	-	4,862	6	B
Financial liabilities at FVTPL	Debt securities in issue	-	-	4,698	6	247	1	4,945	7	A
Total liabilities at fair value		816	1	77,863	98	396	1	79,075	100	

Valuation techniques

The main valuation techniques employed in the Group's internal models to measure the fair value of the financial instruments disclosed above at 31 December 2009 and 2008 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 2009, 2008 and 2007, except for the technique applied in 2009 to the holdings of Portuguese mortgage-backed securities classified as FVTPL – Debt securities, as described on page 75 for Instrument 6.

A In the valuation of financial instruments requiring static hedging (for example interest rate and currency derivatives) 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. 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.

B In the valuation of equity financial instruments requiring dynamic hedging (principally equity securities, options and other structured instruments), proprietary stochastic volatility models are used. These types of models are widely accepted in the financial services industry. Observable market inputs are used in these models to generate variables such as the bid-offer spread, foreign currency exchange rates, credit risk, volatility, correlation between indices and market liquidity as appropriate. 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 Markov functional model (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 the Halifax's UK House Price Index ('HPI') volatility, HPI forward growth, HPI spot rate, mortality, and the specific credit spread for that instrument.

In determining fair value, the Group also considers the credit risk of its counterparties, as well as its own creditworthiness, on all over-the-counter (OTC) derivatives in the trading book. The Group attempts to mitigate credit risk to third parties by entering into netting and collateral arrangements. Net counterparty exposure (counterparty positions netted by offsetting transactions and both cash and securities collateral) is then valued for counterparty creditworthiness and this resultant value is incorporated into the fair value of the respective instruments.

Notes to the Financial Statements continued

The credit risk adjustment is measured as a lifetime expected loss for each counterparty based on the probability of default, the loss given default and the expected exposure of the OTC derivative position with the counterparty. The probability of default is calculated at the counterparty level through the use of internal rating models. The loss given default ("LGD") is calculated at the facility level and takes into account the counterparty characteristics as well as the instrument traded. 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 expected exposure is calculated on a portfolio level and is based on the underlying risks of the portfolio. The main drivers of the expected exposure are the size of the risk position with the counterparty along with the prevailing market environment.

Residential property derivative contracts, where the underlying is a specific property, are referenced to regional property indices for valuation. The indexing of the contracts is appropriate due to the number and wide geographical dispersion of the portfolio. In these circumstances, an adjustment to fair value is made to take account of specific risk against the index. Illiquid commercial property assets are written down with reference to actual and anticipated declines in the commercial property index to reflect a realistic estimate of realisable value.

Broker quotes and external consensus market data are used for validating the fair values of some items in the trading portfolio, or designated at fair value through profit or loss. All derivatives pricing models are validated independently by the Quantitative Risk Group ('QRG'). A validation report is produced for each model-derived payment 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 source of pricing data is considered as part of the process that determines the classification of the level of a financial instrument.

The Group also considers its own creditworthiness when determining the fair value of an instrument, including over-the-counter ('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 contracts. 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.

The fair values of the financial instruments arising from the Group's internal models take into account, among other things, contract terms and observable market data, which include such factors as bid/offer spread, interest rates, credit risk, exchange rates, the quoted market price of raw materials and equity securities, volatility and prepayments. The main assumptions taken into account when internal models use information other than market data can be found in the table below. In all cases, when it is not possible to derive a valuation for a particular feature of an instrument, management uses judgement to determine the fair value of the particular feature. In exercising this judgement, a variety of tools are used including proxy observable data, historical data and extrapolation techniques. Extrapolation techniques take into account behavioural characteristics of equity markets that have been observed over time, and for which there is a strong case to support an expectation of a continuing trend in the future. Estimates are calibrated to observable market prices when they become available.

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

Internal models based on observable market data

During 2008 and 2009, there were no transfers between Level 1 and Level 2 financial instruments.

Notes to the Financial Statements continued

Internal models based on information other than market data

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)	
Balance sheet line item	Category	Financial instrument product type	2009 £m	2008 £m	2009 £m	2008 £m
1. Trading assets	Equity securities	Property unit trusts	**7**	37	**(1)**	16
2. Derivative assets	Exchange rate contracts	Cross-currency swaps	**37**	5	**14**	5
3. Derivative assets	Equity and credit contracts	Reversionary property interests	**73**	77	**(4)**	3
4. Derivative assets	Equity contracts	Options and forwards	**273**	228	**(5)**	91
5. FVTPL	Loans and advances to customers	Roll-up mortgage portfolio	**262**	282	**(36)**	58
6. FVTPL	Debt securities	Portuguese mortgage-backed securities	**-**	2,475	**-**	(144)
		Other asset-backed securities	**1,169**	1,608	**62**	(184)
7. Derivative liabilities	Equity contracts	Options and forwards	**(260)**	(149)	**(82)**	(94)
8. FVTPL	Debt securities in issue	Power-reverse dual currency (PRDC) debt securities	**(109)**	(247)	**(23)**	(5)
Total net assets			**1,452**	4,316	**-**	-
Total income/(expense)			**-**	-	**(75)**	(254)

Valuation technique

1. Trading assets - Equity securities

These unit trusts are valued using Net Asset Values, which are regular third party asset valuations, with an adjustment for the estimated discount to asset value inherent in current similar market prices, reflecting the specific asset characteristics and degree of leverage in each unit trust.

2. Derivative assets - Exchange rate contracts

These derivatives are valued using a valuation model with interest rates, foreign exchange rates and long-dated foreign exchange volatility as inputs to derive valuations. Long-dated foreign exchange volatility is extrapolated from the shorter-dated foreign exchange volatilities which are directly observable in the market.

3. Derivative assets - Equity and credit contracts

These reversionary property derivatives are valued using a probability weighted set of the Halifax's UK House Price Index ('HPI') forward prices. These are determined using HPI Spot Rates adjusted to reflect estimated forward growth. Launched in 1984, the Halifax House Price Index is based on the lending of the UK's largest mortgage lender and provides the longest unbroken monthly data series of any UK housing index. The indices calculated are standardised and represent the price of a typically transacted house. Regional and national HPI indices are published, which are similar except that the former reflects the national HPI indices disaggregated into 12 UK regions and is published quarterly. The national indices are published monthly.

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 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 changes in the national HPI spot rate (which is also observable market data and published monthly) to the most recently available regional HPI spot rate. An adjustment is made to reflect the specific property risk i.e. the difference in the actual regional composition of the property underlying the Group's reversionary interest portfolio and the composition of the published regional indices. 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.

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.

Notes to the Financial Statements continued

4. Derivative assets - Equity contracts
There are three types of derivatives within this category:
European derivatives (vanilla call and put options)
These derivatives are valued using a modified Black-Scholes model where the HPI index 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. Discussion of the HPI spot and HPI forward growth rates for these financial instruments is the same as for Instrument 3 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
Roll-up mortgages are an equity release scheme, where the property owner takes out a loan secured against their home. The loan is repaid upon the owner's vacation of the property. 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 loan. These roll-up mortgages are valued using a probability-weighted set of European option prices (puts) determined using the Black-Scholes model, where the put represents the values of the no negative pledges.

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. Discussion of the HPI spot rate, HPI forward growth rate, and mortality rates for this financial instrument is the same as for Instrument 3 above. Discussion of the HPI volatility rate is the same as for Instrument 4 above.

Repayment rates
The costs to the Group arising from early repayment by customers (inherent specifically to this financial instrument) are estimated from prices of swaptions which reflect the costs associated with unwinding the swap hedges held by the Group against these roll-up mortgages in the event of early repayment. Early repayment most typically occurs following a fall in market interest rates. Prepayment rates were taken from the academic paper 'Pricing and Risk Capital in the Equity Release Market', presented to the Institute and Faculty of Actuaries in 2007.

6. FVTPL – Debt securities
There are three types of debt securities within this category:
Portuguese mortgage-backed securities
In December 2009, Euro 190m of the Group's holdings of these securities were purchased by the issuer. As a result, the Group's remaining positions in these securities have been transferred to Level 2. Prior to 2009, these securities were valued using a valuation model with reference to the most relevant generic curve (in this case, Portuguese residential mortgage-backed securities) from a consensus pricing service and an assumption with respect to the specific credit spread for that instrument as inputs to derive valuations.
Other asset-backed securities
These other asset-backed securities consist of residential mortgage backed securities, securities backed by small business and automotive loans and other collateralised debt obligations almost all of which are AAA rated, and issued by Santander entities. Each instrument was 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 an insignificant difference between the two sources.

7. Derivative liabilities - Equity and credit 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 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.

Notes to the Financial Statements continued

Internal valuation review

In all instances, risk control teams review positions to assess a realistic realisable value for the position and develop a methodology for any adjustment to fair value which marks the position to that value using information relevant to that asset. 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.

Unrecognised gains as a result of the use of valuation models using unobservable inputs ("Day One profits")

The table below shows the amount that has yet to be recognised in the income statement that relates to the difference between the 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. This is calculated and reported on a portfolio basis:

	2009 £m	2008 £m
At 1 January	**55**	45
New transactions	**42**	12
Amounts recognised in profit or loss during the year	**(5)**	(2)
At 31 December	**92**	55

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**		
	Trading Assets £m	**Derivatives £m**	**Fair value through profit or loss £m**	**Total £m**	**Derivatives £m**	**Fair value through profit or loss £m**	**Total £m**
At 1 January 2009	**37**	**310**	**4,365**	**4,712**	**(149)**	**(247)**	**(396)**
Total gains/(losses) recognised in profit/(loss):							
- Fair value movements	**(1)**	**5**	**26**	**30**	**(82)**	**(23)**	**(105)**
- Foreign exchange and other movements	**(3)**	**75**	**(122)**	**(50)**	**(38)**	**5**	**(33)**
Sales	**(26)**	**-**	**(90)**	**(116)**	**-**	**-**	**-**
Settlements	**-**	**(7)**	**(487)**	**(494)**	**9**	**156**	**165**
Transfers out	**-**	**-**	**(2,261)**	**(2,261)**	**-**	**-**	**-**
At 31 December 2009	**7**	**383**	**1,431**	**1,821**	**(260)**	**(109)**	**(369)**
Total gains/(losses) recognised in profit/(loss) relating to those assets and liabilities held at the end of the year	**(4)**	**80**	**(96)**	**(20)**	**(120)**	**(18)**	**(138)**

	Assets				Liabilities		
	Trading Assets £m	Derivatives £m	Fair value through profit or loss £m	Total £m	Derivatives £m	Fair value through profit or loss £m	Total £m
At 1 January 2008	-	118	4,247	4,365	(148)	(276)	(424)
Total gains/(losses) recognised in profit/(loss):							
- Fair value movements	16	99	(270)	(155)	(94)	(5)	(99)
- Foreign exchange and other movements	-	44	291	335	93	17	110
Purchases	21	49	139	209	-	-	-
Settlements	-	-	(42)	(42)	-	17	17
At 31 December 2008	37	310	4,365	4,712	(149)	(247)	(396)
Total gains/(losses) recognised in profit/(loss) relating to those assets and liabilities held at the end of the year	16	143	21	180	(1)	12	11

Financial instrument assets and liabilities at 31 December 2009

Financial instrument assets valued using internal models based on information other than market data were 2% (2008: 7%) of total assets measured at fair value and 1% (2008: 2%) of total assets at 31 December 2009.

Trading assets valued using internal models based on information other than market data decreased in 2009 principally due to assets being sold.

Derivatives valued using internal models based on information other than market data increased in 2009 principally due to gains reflecting changes in foreign exchange rates.

Notes to the Financial Statements continued

Assets designated at fair value through profit or loss valued using internal models based on information other than market data decreased in 2009 principally due to transfers to Level 2. During December 2009, euro 190m of the Group's holdings of AAA rated prime mortgage backed securities were sold to the issuer. As a result, the Group's remaining positions in these securities of £2,261m were transferred to Level 2. During 2009, there were no acquisitions of financial instrument assets valued using internal models based on information other than market data.

Financial instrument liabilities valued using internal models based on information other than market data were 0.5% (2008: 0.5%) of total liabilities measured at fair value and 0.1% (2008: 0.1%) of total liabilities at 31 December 2009.

Derivative liabilities valued using internal models based on information other than market data increased in 2009 principally due to losses reflecting changes in credit spreads, the HPI index and foreign exchange rates.

Liabilities designated at fair value through profit or loss valued using internal models based on information other than market data decreased in 2009 principally due to maturities of debt securities in issue.

Gains and losses for the year ended 31 December 2009

Losses of £4m in respect of trading assets valued using internal models based on information other than market data principally reflected the lack of market liquidity during the year.

Gains of £80m in respect of derivatives assets valued using internal models based on information other than market data principally reflected movements in foreign exchange rates.

Losses of £96m in respect of assets designated at fair value through profit or loss valued using internal models based on information other than market data principally reflected changes in foreign exchange rates partly offset by an increase in the value of the prime securities due to tightening of credit spreads of asset-backed and mortgage-backed securities.

Losses of £120m in respect of derivatives liabilities valued using internal models based on information other than market data principally reflected changes in credit spreads, the HPI index and foreign exchange rates.

Losses of £18m in respect of liabilities designated at fair value through profit or loss valued using internal models based on information other than market data principally reflected changes in credit spreads, foreign exchange and interest rates. They are fully matched with derivatives.

Gains and losses on assets and liabilities classified as held for trading are presented in the income statement under "Net trading and other income".

Fair value changes on long-term debt designated at fair value and related derivatives are presented in the income statement under 'Changes in fair value of long-term debt issued and related derivatives'. The income statement line item 'Net income/(expense) from other financial instruments designated at fair value' captures fair value movements on all other financial instruments designated at fair value and related derivatives.

Gains and losses for the year ended 31 December 2008

The value of the prime securities classified as FVTPL - Debt securities decreased due to an increase in credit spreads reflecting a general lack of demand for asset-backed and mortgage-backed securities, exacerbated by the collapse of wholesale funding activity which led to a significant decline in wider asset demand. The Group believes that the fair values of these instruments have diverged materially from the amounts it currently anticipates realising on maturity, because the mortgages underlying these securities continue to perform adequately.

The values of the HPI-related loans and advances to customers, debt securities and associated derivatives declined due to a further lack of market liquidity.

The terms of the instruments presented as FVTPL - debt securities in issue (instrument 8) and related exchange rate derivatives (instrument 2) are fully matched. The movement in these financial instruments reflects changes in foreign exchange rates and interest rates.

The Group risk manages the unit trusts using derivative positions valued using quoted prices in active markets, or internal models based on observable market data. The effects of these risk management activities are not reflected in the gains and losses included in the table above.

Effect of changes in significant unobservable assumptions to reasonably possible alternatives

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 may have a significant risk of causing a material adjustment to the carrying amount.

Notes to the Financial Statements continued

The following tables show the potential income statement effects of using reasonably possible alternative assumptions. The potential effects do not take into effect any offsetting or hedged positions.

At 31 December 2009

Balance sheet note line item and product	Fair value £m	Assumptions	Shift	Reflected in income statement: Favourable changes £m	Reflected in income statement: Unfavourable changes £m
1. Trading assets – Equity securities: – Property unit trusts	**7**	Estimated discount to asset value	**10%**	1	(1)
3. Derivative assets – Equity and credit contracts: – Reversionary property derivatives	**73**	HPI Forward growth rate	**1%**	11	(11)
		HPI Spot rate	**10%**	8	(8)
		Mortality rate	**2 yrs**	1	(1)
4. Derivative assets – Equity and credit contracts: – Options and forwards	**273**	HPI Forward growth rate	**1%**	3	(3)
		HPI Spot rate	**10%**	3	(2)
		HPI Volatility	**1%**	1	(1)
5. FVTPL – Loans and advances to customers: – Roll-up mortgage portfolio	**281**	HPI Forward growth rate	**1%**	28	(28)
		HPI Spot rate	**10%**	9	(11)
		HPI Volatility	**1%**	5	(5)
		Mortality rate	**2 yrs**	7	(6)
6. FVTPL – Debt securities: – Other asset-backed securities	**1,169**	Credit spread	**75 bps**	15	(15)
7. Derivative liabilities - Equity and credit contracts: – Options and forwards	**(260)**	HPI Forward growth rate	**1%**	14	(14)
		HPI Spot rate	**10%**	32	(37)
		HPI Volatility	**1%**	2	(2)

No sensitivities are presented for the FVTPL - debt securities in issue (instrument 8) per page 76 and related exchange rate derivatives (instrument 2) per page 75 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.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or most unfavourable change from varying the assumptions individually.

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 and from him to specific individuals who are members of Santander UK's Asset and Liability Management Committee ('ALCO').

ALCO adopts 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 ALCO and as part of the ICAAP process. To support its capital and senior debt issuance programmes, Santander UK is rated on a standalone 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 2009, the Group held capital over and above its regulatory requirements, and managed internal capital allocations and targets in accordance with its capital and risk management policies.

Notes to the Financial Statements continued

Group Capital

	31 December 2009 £m	31 December 2008 £m
Tier 1 capital	**3,483**	3,210
Deductions from Tier 1 capital	**(243)**	(69)
Total Tier 1 capital	**3,240**	3,141
Tier 2 capital – subordinated debt	**-**	100
Deductions from Tier 2 capital	**-**	(62)
Total Tier 2 capital	**-**	38
Total Capital Resources	**3,240**	3,179

Regulatory Capital Base

The Group's Tier 1 capital consists of shareholders' equity and audited profits for the years ended 31 December 2009 and 31 December 2008 after adjustment to comply with UK Financial Services Authority rules. The increase in Tier 1 capital primarily represents the inclusion of audited profits for the year ended 31 December 2009. Deductions from Tier 1 relate to intangible assets recognised during the year and expected losses in excess of credit provisions for portfolios on the IRB approach for measuring credit risk.

The decrease in Tier 2 capital represents subordinated debt redeemed during the year.