

## Contents to Financial Statements

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

We have audited the group and parent company financial statements (the "financial statements") of Abbey National Treasury Services plc for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated and Company Balance Sheets, the Consolidated and Company Statements of Recognised Income and Expense, the Consolidated and Company Cash Flow Statements, the Accounting Policies and the related Notes 1 to 42. These financial statements have been prepared under the accounting policies set out therein.

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

### Respective responsibilities of directors and auditors

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

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

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

### Basis of audit opinion

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

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

### Opinion

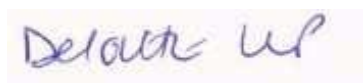
In our opinion:

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

### Separate opinion in relation to IFRSs

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

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



### Deloitte LLP

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

## Consolidated Income Statement

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007 £m
Interest and similar income		<b>6,707</b>	3,299
Interest expense and similar charges		<b>(6,316)</b>	(3,074)
<b>Net interest income</b>	2	<b>391</b>	225
Net fee and commission income		<b>16</b>	8
Net trading and other income	3	<b>114</b>	229
<b>Total operating income</b>		<b>521</b>	462
Administration expenses	4	<b>(158)</b>	(148)
Depreciation and amortisation	5	<b>(3)</b>	(3)
<b>Total operating expenses excluding provisions and charges</b>		<b>(161)</b>	(151)
Impairment (losses)/recoveries on loans and advances	6	<b>(26)</b>	4
<b>Operating profit</b>		<b>334</b>	315
<b>Profit on continuing operations before tax</b>		<b>334</b>	315
Tax on profit on continuing operations	9	<b>(86)</b>	(66)
<b>Profit for the year from continuing operations</b>		<b>248</b>	249
Profit for the year from discontinued operations	11	<b>82</b>	76
<b>Profit for the year</b>		<b>330</b>	325
<b>Attributable to:</b>			
Equity holders of the parent		<b>330</b>	325


The notes on pages 30 to 66 are an integral part of these consolidated financial statements.

## Consolidated Balance Sheet

As at 31 December 2008 and 2007

	Notes	2008 £m	2007 £m
<b>Assets</b>			
Cash and balances at central banks	12	8	7
Trading assets	13	25,486	56,427
Derivative financial instruments	14	32,866	10,476
Financial assets designated at fair value	15	11,005	11,446
Loans and advances to banks	16	147,089	57,711
Loans and advances to customers	17	24,730	4,632
Held-to-maturity securities	18	300	300
Intangible assets	20	6	-
Property, plant and equipment	21	9	13
Operating lease assets	22	-	2,164
Macro hedge of interest rate risk		1,475	220
Current tax assets		-	7
Deferred tax assets	23	77	19
Other assets	24	827	221
<b>Total assets</b>		<b>243,878</b>	<b>143,643</b>
<b>Liabilities</b>			
Deposits by banks	25	123,496	51,788
Deposits by customers	26	2,933	1,844
Derivative financial instruments	14	34,132	10,760
Trading liabilities	27	39,998	54,914
Financial liabilities designated at fair value	28	4,945	7,538
Debt securities in issue	29	33,927	11,929
Subordinated liabilities	30	432	331
Provisions	31	-	7
Other liabilities	32	407	804
Current tax liabilities		333	210
Deferred tax liabilities	23	1	441
<b>Total liabilities</b>		<b>240,604</b>	<b>140,566</b>
<b>Equity</b>			
Share capital	34	2,549	2,549
Retained earnings	35	725	528
<b>Total shareholders equity</b>		<b>3,274</b>	<b>3,077</b>
<b>Total liabilities and equity</b>		<b>243,878</b>	<b>143,643</b>

The Financial Statements on pages 12 to 66 were approved and authorised for issue by the Board on 19 March 2009 and signed on its behalf by:



Brian Morrison  
Director

## Consolidated Statement of Recognised Income and Expense

For the years ended 31 December 2008 and 2007

	2008 £m	2007 £m
Exchange differences on translation of foreign operations	28	(1)
Actuarial gains and losses on defined benefit pension plans	-	1
Net income recognised directly in equity	28	-
Profit for the year	330	325
<b>Total recognised income and expense for the year</b>	<b>358</b>	<b>325</b>
Attributable to:		
Equity holders of the parent	358	325

## Consolidated Cash Flow Statement

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007 <sup>(1)</sup> £m
<b>Net cash flow used in operating activities</b>			
Profit for the year		330	325
Adjustments for:			
Non cash items included in net profit		(1,108)	10
Change in operating assets		(104,692)	(12,951)
Change in operating liabilities		95,713	(2,376)
Income taxes paid		(4)	(5)
Effect of exchange rate differences		3,606	220
<b>Net cash flow used in operating activities</b>	36	<b>(6,155)</b>	<b>(14,777)</b>
<b>Cash flow from investing activities</b>			
Purchase of fixed assets		(98)	(222)
Disposal of subsidiaries, net of cash disposed		1,605	
Proceeds from sale of fixed assets		6	5
<b>Net cash flow used in investing activities</b>		<b>1,513</b>	<b>(217)</b>
<b>Cash flow from financing activities</b>			
Issue of long term debt		101	-
Dividends paid		(161)	-
<b>Net cash flow used in financing activities</b>		<b>(60)</b>	<b>-</b>
<b>Net decrease in cash and cash equivalents</b>		<b>(4,702)</b>	<b>(14,994)</b>
Cash and cash equivalents at beginning of the year		45,450	60,718
Effect of exchange rate changes on cash and cash equivalents		3,042	(274)
<b>Cash and cash equivalents at the end of the year</b>	36	<b>43,790</b>	<b>45,450</b>


(1) Amended for the change in accounting policy for cash equivalents described in the Accounting Policies on page 22.

## Company Balance Sheet

As at 31 December 2008 and 2007

	Notes	2008 £m	2007 £m
<b>Assets</b>			
Cash and balances at central banks	12	8	7
Trading assets	13	26,389	32,760
Derivative financial instruments	14	32,160	10,358
Financial assets designated at fair value	15	11,005	11,446
Loans and advances to banks	16	128,035	57,021
Loans and advances to customers	17	25,027	6,181
Held-to-maturity securities	18	-	45
Investment in subsidiary undertakings	19	2,335	2,336
Intangible assets	20	6	-
Property, plant and equipment	21	9	13
Macro hedge of interest rate risk		1,475	220
Deferred tax assets	23	75	18
Other assets	24	778	57
<b>Total assets</b>		<b>227,302</b>	<b>120,462</b>
<b>Liabilities</b>			
Deposits by banks	25	123,366	49,847
Deposits by customers	26	9,743	9,714
Derivative financial instruments	14	33,511	10,457
Trading liabilities	27	22,996	33,926
Financial liabilities designated at fair value	28	4,898	7,530
Debt securities in issue	29	29,692	5,840
Other liabilities	32	83	254
Current tax liabilities		236	176
<b>Total liabilities</b>		<b>224,525</b>	<b>117,744</b>
<b>Equity</b>			
Share capital	34	2,549	2,549
Retained earnings	35	228	169
<b>Total shareholders equity</b>		<b>2,777</b>	<b>2,718</b>
<b>Total liabilities and equity</b>		<b>227,302</b>	<b>120,462</b>

The Financial Statements on pages 12 to 66 were approved and authorised for issue by the Board on 19 March 2009 and signed on its behalf by:



Brian Morrison  
Director

## Company Statement of Recognised Income and Expense

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007 £m
Exchange differences on translation of foreign operations		17	(1)
Net income recognised directly in equity		17	(1)
Profit for the year		203	107
<b>Total recognised income and expense for the year</b>		<b>220</b>	<b>106</b>
Attributable to:			
Equity holders of the parent		220	106

## Company Cash Flow Statement

For the years ended 31 December 2008 and 2007

	Notes	2008 £m	2007 <sup>(1)</sup> £m
<b>Net cash flow used in operating activities</b>			
Profit for the year		203	107
Adjustments for:			
Non cash items included in net profit		(1,224)	(259)
Change in operating assets		(97,861)	1,347
Change in operating liabilities		104,283	(3,408)
Income taxes received		(3)	1
Effects of exchange rate differences		1,260	338
<b>Net cash flow used in operating activities</b>	36	<b>6,658</b>	<b>(1,874)</b>
<b>Cash flow from investing activities</b>			
Purchase of tangible and intangible fixed assets		(10)	(7)
Proceeds from sale of tangible fixed assets		3	-
Purchase of securities		-	(2)
Proceed from sale and redemption of securities		45	-
<b>Net cash flow (used in)/from investing activities</b>		<b>38</b>	<b>(9)</b>
<b>Cash flow from financing activities</b>			
Dividends paid		(161)	-
<b>Net cash flows used in financing activities</b>		<b>(161)</b>	<b>-</b>
<b>Net decrease in cash and cash equivalents</b>		<b>6,535</b>	<b>(1,883)</b>
Cash and cash equivalents at beginning of the year		29,137	31,020
Effect of exchange rate changes on cash and cash equivalents		2,348	-
<b>Cash and cash equivalents at the end of the year</b>	36	<b>38,020</b>	<b>29,137</b>

(1) Amended for the change in accounting policy for cash equivalents described in the Accounting Policies on page 22.

## Notes to the Financial Statements

### 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'), interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') of the IASB that, under European Regulations, are effective or available for early adoption at the Group's reporting date. The Group has complied with IFRS as issued by the IASB in addition to complying with its legal obligation to comply with IFRS as adopted for use in the European Union.

#### Recent developments

In 2008, the Group adopted the revised International Accounting Standard ('IAS') 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'. On 13 October 2008, the IASB issued amendments to IAS 39 and IFRS 7 regarding the reclassification of financial instruments. The changes to IAS 39 permit an entity to reclassify, in limited circumstances, certain non-derivative financial assets out of the 'fair value through profit and loss' and 'available-for-sale' categories into 'loans and receivables', 'available-for-sale' and 'held to maturity'. In addition, the amendments to IFRS 7 require expanded disclosures about these assets. The amendments became effective on 1 July 2008. The adoption of the amendments to IAS 39 and IFRS 7 had no impact on the Group's profit or loss or financial position, because the Group did not reclassify any of its financial instruments in 2008.

#### Future developments

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

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

### Basis of preparation

The Consolidated Financial Statements have been prepared under the historical cost convention, as modified by the revaluation of available for sale financial assets, financial assets and financial liabilities held at fair value through profit or loss and all derivative contracts, and on the going concern basis as disclosed in the Directors' statement of going concern set out in the Directors' Report on pages 3 to 9.

### 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 leasing, 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.



## Notes to the Financial Statements continued

### 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 £820m charge (2007: £219m charge). This was offset by income/charges on items held at fair value.

### Revenue recognition

#### (a) Interest income and expense

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 and similar expense 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.

#### (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 financial liabilities held for trading, together with related interest income, expense and dividends. It also includes income from operating lease assets, and profits/(losses) on the sale of fixed assets and subsidiary undertakings.

#### (e) Financial assets and liabilities held at fair value through profit or loss

Financial assets and liabilities held for trading, and financial assets and financial liabilities designated as fair value through profit or loss are recorded at fair value. Changes in fair value of trading assets and liabilities including trading derivatives are recognised in the income statement as net trading and other income together with dividends and interest receivable and payable. Changes in fair value of assets and liabilities designated as fair value through profit or loss are recognised in net trading and other income together with dividends, interest receivable and payable and changes in fair value of derivatives managed in conjunction with these assets and liabilities. Changes in fair value of derivatives in a designated hedging relationship are recognised in net trading and other income along with the fair value of the hedged item.

### Pensions and other post retirement benefits

Pensions are provided by means of various defined benefit schemes in operation throughout the Group. Details of the schemes are disclosed in the Annual Report and Accounts of Abbey National plc. Where the scheme is a multi-employer plan and it has not been possible to identify the Group's share of the underlying assets and liabilities of these schemes on a consistent and reasonable basis, the contributions have therefore been accounted for as if they were defined contribution schemes. 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. The Group also participates in the Abbey National plc group defined benefit pension schemes in operation. There is no contractual agreement of stated policy for charging the net defined benefit cost. The contribution to be paid by the Group is calculated as the contributions made by Abbey National plc to the schemes in respect of the Group's employees.

**Notes to the Financial Statements** continued**Intangible assets**

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

## Notes to the Financial Statements continued

### (c) Held to maturity

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

### Regular way purchases of financial assets

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.

### Sale and repurchase agreements (including stock borrowing and lending)

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

### Derivative financial instruments

Transactions are undertaken in derivative financial instruments, ('derivatives'), which include interest rate, cross currency, 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.

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.

### 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.

## Notes to the Financial Statements continued

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 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.

Corporate assets carried at amortised cost

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, with a particular focus on the following scenarios: (1) where an asset has a payment default which has been outstanding for 90 days or more; (2) where non-payment defaults have occurred and/or where it has become evident that some sort of workout or rescheduling exercise is to be undertaken; or (3) where, for example with Real Estate Finance, it has become evident that the value of the Bank's security is no longer considered adequate.

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

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

### Impairment of non-financial assets

At each balance sheet date, or more frequently when events or changes in circumstances dictate, property plant and equipment and intangible assets 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. 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.

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

The 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.

In 2008, the Group voluntarily changed its accounting policy for cash equivalents to exclude trading liabilities from its determination of cash equivalents. The Group believes that this new policy is preferable because it provides for consistency with industry practice. The Group considers this a change in accounting policy to be applied retrospectively as required by IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. As a result, the Group and the Company's cash flow statements for 2007 on pages 14 and 16 have been amended to reclassify £(5,235m) and £(6,379m) between Net cash flow from/(used in) operating activities ('Net (decrease)/increase in operating liabilities') and Cash and cash equivalents ('Net trading other cash equivalents' and 'Net non trading other cash equivalents' in the Group and the Company respectively). There was no impact on the income statements or balance sheets of any period or as at any date presented.

### Financial liabilities

Financial liabilities are initially recognised when the Group becomes contractually bound to the transfer of economic benefits in the future. Financial liabilities are classified 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. All other financial liabilities are initially recognised at fair value net of transaction costs incurred. They are subsequently stated at amortised cost and the redemption value recognised in the income statement over the period of the liability using the effective interest method.

Derivative financial instruments, Trading liabilities and Financial liabilities designated at fair value are classified as fair value through profit or loss. Deposits by banks, Deposits by customers, Debt securities in issue (unless designated at fair value), and Subordinated liabilities are classified as amortised cost.

## Notes to the Financial Statements continued

### Borrowings

Borrowings 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.

### 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 Consolidated Financial Statements and the reported amount of income and expenses during the reporting period. Management evaluates its estimates and judgements on an ongoing basis.

Management bases its estimates and judgements on historical experience and on 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

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, 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.

## Notes to the Financial Statements continued

### Subsequent measurement

#### Fair value hierarchy

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

Level 1: Unadjusted quoted prices for identical assets or liabilities in an active market that the Group has the ability to access at the measurement date. Level 1 measurements include 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, 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. If trades are not observed, the bid/offer spread is disregarded as a sign of liquidity and the position is regarded as illiquid. Changes in the observability of significant valuation inputs during the reporting period may result in a reclassification of certain assets and liabilities within the fair value hierarchy.

#### Financial instruments valued using observable market prices

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

#### Financial instruments valued using a valuation technique

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

The Group did not make any material changes to the valuation techniques and internal models it used during the years ended 31 December 2008 and 2007.

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

## Notes to the Financial Statements continued

## At 31 December 2008

Balance sheet category		Quoted prices in active markets		Internal models based on				Total		Valuation technique
				market observable data		other than market observable data				
		£m	%	£m	%	£m	%	£m	%	
<b>Assets</b>										
Trading assets	Loans and advances to banks	-	-	4,947	8	-	-	4,947	8	A
	Loans and advances to customers	-	-	534	1	-	-	534	1	A
	Debt securities	16,798	25	2	-	-	-	16,800	25	-
	Equity securities	670	1	-	-	37	-	707	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 and 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		18,543	27	43,604	66	4,712	7	66,859	100	
<b>Liabilities</b>										
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	1	4,862	7	B
Financial liabilities at FVTPL	Debt securities in issue	-	-	4,698	6	247	-	4,945	6	A
Total liabilities at fair value		816	1	77,863	98	396	1	79,075	100	

## At 31 December 2007

Balance sheet category		Quoted prices in active markets		Internal models based on				Total		Valuation technique
				market observable data		other than market observable data				
		£m	%	£m	%	£m	%	£m	%	
<b>Assets</b>										
Trading assets	Loans and advances to banks	-	-	8,847	11	-	-	8,847	11	A
	Loans and advances to customers	-	-	17,255	22	-	-	17,255	22	A
	Debt securities	19,118	25	9,713	12	-	-	28,831	37	A
	Equity securities	1,494	2	-	-	-	-	1,494	2	
Derivative assets	Exchange rate contracts	-	-	790	1	-	-	790	1	A
	Interest rate contracts	88	-	7,006	9	-	-	7,094	9	A & C
	Equity & credit contracts	556	1	1,918	3	118	-	2,592	4	B
Financial assets at FVTPL	Loans and advances to customers	-	-	5,521	7	126	-	5,647	7	A
	Debt securities	-	-	1,678	2	4,121	5	5,799	7	A
Total assets at fair value		21,256	28	52,728	67	4,365	5	78,349	100	
<b>Liabilities</b>										
Trading liabilities	Deposits by banks	-	-	19,630	27	-	-	19,630	27	A
	Deposits by customers	-	-	20,499	28	-	-	20,499	28	A
	Short positions	2,252	3	-	-	-	-	2,252	3	-
	Debt securities in issue	-	-	12,533	17	-	-	12,533	17	A
Derivative liabilities	Exchange rate contracts	-	-	971	1	-	-	971	1	A
	Interest rate contracts	-	-	7,279	10	-	-	7,279	10	A & C
	Equity & credit contracts	215	-	2,147	3	148	-	2,510	4	B
Financial liabilities at FVTPL	Debt securities in issue	-	-	7,262	10	276	1	7,538	10	A
Total liabilities at fair value		2,467	3	70,321	96	424	1	73,212	100	



## Notes to the Financial Statements continued

### Valuation techniques

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

- A** In the valuation of financial instruments requiring static hedging (for example interest rate and currency derivatives) 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 instrument 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 considers both the credit risk of its counterparties, as well as its own creditworthiness. 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. The Group generally calculates the credit risk adjustment for derivatives on observable credit data.

Credit risk is measured using dynamic models that calculate the probability and potential future exposure given default. The main inputs used in these models are generally data relating to individual issuers in the portfolio and correlations thereto. The main inputs used in determining the underlying cost of credit for credit risk derivatives are quoted credit spreads and the correlation between individual issuers' quoted credit derivatives.

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 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, of an instrument 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.

## Notes to the Financial Statements continued

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 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:

Instrument	Valuation technique	Balance sheet value		Amount recognised in income	
		31 December 2008 £m	31 December 2007 £m	31 December 2008 £m	31 December 2007 £m
<b>1. Trading assets - Equity securities</b>	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.	<b>37</b>	-	<b>16</b>	-
<b>2. Derivative assets - Exchange rate contracts</b>	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.	<b>5</b>	-	<b>5</b>	4
<b>3. Derivative assets - Equity and credit contracts</b>	These property derivatives are valued using a valuation model with Halifax's UK House Price Index ('HPI') volatility, HPI forward growth, HPI spot rate, and mortality as inputs to derive valuations.	<b>77</b>	98	<b>3</b>	17
<b>4. Derivative assets - Equity and credit contracts</b>	These property derivatives are valued using a valuation model with HPI spot rate, HPI forward growth, and HPI volatility as inputs to derive valuations.	<b>228</b>	20	<b>39</b>	11
<b>5. FVTPL - Loans and advances to customers</b>	These loans are valued using a valuation model with HPI spot rate, HPI forward growth, HPI volatility, and mortality as inputs to derive valuations.	<b>282</b>	126	<b>121</b>	12
<b>6. FVTPL - Debt securities</b>	These prime mortgage backed securities (almost all of which are AAA rated) are valued using a valuation model with reference to the most relevant generic curve from a consensus pricing service, and an assumption with respect to the specific credit spread for that instrument as inputs to derive valuations.	<b>4,082</b>	4,121	<b>(328)</b>	(72)
<b>7. Derivative liabilities - Equity and credit contracts</b>	These derivatives are valued using a valuation model with HPI spot rate, HPI forward growth, and HPI volatility as inputs to derive valuations.	<b>(149)</b>	(148)	<b>(35)</b>	(14)
<b>8. FVTPL - Debt securities in issue</b>	These debt securities in issue are valued using a valuation model with interest rates, foreign exchange rates and long-dated foreign exchange volatility as inputs to derive valuations.	<b>(247)</b>	(276)	<b>(5)</b>	(4)
<b>Total assets</b>		<b>4,711</b>	4,365	-	-
<b>Total liabilities</b>		<b>(396)</b>	(424)	-	-
<b>Total income/(expense)</b>		-	-	<b>(184)</b>	(46)

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.

## Notes to the Financial Statements continued

**Financial instrument assets and liabilities at 31 December 2008**

Financial instrument assets valued using internal models based on information other than market data were 7% (2007: 5%) of total assets measured at fair value and 2% (2007: 3%) of total assets at 31 December 2008.

Financial instrument assets valued using internal models based on information other than market data increased £346m in 2008 principally due to exchange rate movements on euro-denominated investments. During 2008, there were no acquisitions or sales 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 1% (2007: 1%) of total liabilities measured at fair value and 0.2% (2007: 0.3%) of total liabilities at 31 December 2008. During 2008, there were no redemptions or transfers of financial instrument liabilities valued using internal models based on information other than market data.

**Gains and losses for the year ended 31 December 2008**

The value of the prime securities classified as FVTPL - Debt securities (Instrument 6) 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.

**Gains and losses for the year ended 31 December 2007**

The value of the prime securities classified as FVTPL - Debt securities (Instrument 6) decreased due to an increase in credit spreads reflecting reduced demand for asset-backed and mortgage backed securities.

The values of the HPI-related loans and advances to customers, debt securities and associated derivatives increased/(decreased) due to a 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.

**Sensitivity analysis**

The impacts of changes in the valuation inputs that are assumptions rather than observable, such as interest rates, foreign exchange rates, and the HPI spot rate, are shown below:

<b>2008</b>		<b>Impact on profit or loss before tax for the year for instrument number</b>					
<b>Input</b>	<b>Assumed change</b>	<b>1</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
		<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>Discount to asset value</b>	<b>10%</b>	<b>7</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>
<b>HPI forward growth</b>	<b>1%</b>	<b>n/a</b>	<b>16</b>	<b>-</b>	<b>39</b>	<b>n/a</b>	<b>(11)</b>
<b>HPI volatility</b>	<b>1%</b>	<b>n/a</b>	<b>1</b>	<b>-</b>	<b>(6)</b>	<b>n/a</b>	<b>(1)</b>
<b>Mortality</b>	<b>1 year</b>	<b>n/a</b>	<b>-</b>	<b>n/a</b>	<b>(6)</b>	<b>n/a</b>	<b>n/a</b>
<b>Credit spread</b>	<b>100 basis points</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>90</b>	<b>n/a</b>

<b>2007</b>		<b>Impact on profit or loss before tax for the year for instrument number</b>					
<b>Input</b>	<b>Assumed change</b>	<b>1</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
		<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>HPI forward growth</b>	<b>1%</b>	<b>n/a</b>	<b>12</b>	<b>-</b>	<b>15</b>	<b>n/a</b>	<b>(12)</b>
<b>HPI volatility</b>	<b>1%</b>	<b>n/a</b>	<b>-</b>	<b>-</b>	<b>(2)</b>	<b>n/a</b>	<b>-</b>
<b>Mortality</b>	<b>1 year</b>	<b>n/a</b>	<b>(1)</b>	<b>n/a</b>	<b>(2)</b>	<b>n/a</b>	<b>n/a</b>
<b>Credit spread</b>	<b>100 basis points</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>110</b>	<b>n/a</b>

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

## Notes to the Financial Statements continued

**Day one profits**

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, was as follows. This is calculated and reported on a portfolio basis:

	<b>2008</b>	2007
	<b>£m</b>	£m
At 1 January	<b>45</b>	18
Additions	<b>12</b>	27
Amortisation and releases	<b>(2)</b>	-
At 31 December	<b>55</b>	45

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 2008. Due to the individual nature of these contracts, the Group does not believe generally it is appropriate to apply a global adjustment to management's estimates, as it would not give a meaningful sensitivity with respect to financial instrument fair values based on data other than market prices. Sensitivities have been given with respect to key management estimates where they can be separately identified. Further information about sensitivities (including value-at-risk) to market risk arising from financial instrument trading activities can be found in Note 42 on page 50.

## Notes to the Financial Statements continued

## 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
- > 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 UK companies. ALM provides asset and liability management services to the Abbey group.

The segment information below is presented on the basis used by the Company's board of directors (the '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 Directors' Report on pages 3 to 9) as a result of the application of various adjustments. Management considers that the trading basis provides the most appropriate way of reviewing the performance of the business. The adjustments are:

- > **Reorganisation and other costs** - Comprise implementation costs in relation to the strategic change cost reduction projects, as well as certain remediation administration expenses and credit provisions. Management needs to understand the underlying drivers of the cost base that will remain after these exercises are complete, and does not want this view to be clouded by these costs, which are managed independently.
- > **Hedging and certain other mark-to-market variances** - The Balance Sheet and Income Statement are subject to mark-to-market volatility including that arising from the accounting for elements of derivatives deemed under IFRS 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

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

## Notes to the Financial Statements continued

	Net interest income £m	Non interest income £m	Admin expenses £m	Depreciation and amortisation £m	Impairment losses on loans and advances £m	Profit on continuing ops before tax £m
<b>Adjustments comprise:</b>						
Hedging and certain other mark to market variances	-	(200)	-	-	-	(200)
	-	(200)		-	-	(200)

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.

2007	Global Banking & Markets £m	Corporate Banking £m	ALM £m	Total £m	Adjustments £m	Group Total £m
Net interest income	-	20	205	225	-	225
Non-interest income	260	11	55	326	(89)	237
<b>Total trading income</b>	260	31	260	551	(89)	462
Administration expenses	(101)	(16)	(25)	(142)	(6)	(148)
Depreciation and amortisation	(3)	-	-	(3)	-	(3)
<b>Total trading expenses</b>	(104)	(16)	(25)	(145)	(6)	(151)
Impairment recoveries on loans and advances	-	4	-	4	-	4
<b>Trading profit on continuing operations before tax</b>	156	19	235	410	(95)	315
Adjust for:						
Reorganisation and other costs	(6)	-	-	(6)		
Hedging and other mark to market variances	-	-	(89)	(89)		
<b>Profit from continuing operations before tax</b>	150	19	146	315		
<b>Average number of employee numbers</b>	389	73	33	495	-	495
<b>Total assets</b>	54,029	9,391	80,223	143,643	-	143,643

	Net Interest income £m	Non interest income £m	Admin expenses £m	Depreciation and amortisation £m	Impairment losses on loans and advances £m	Profit on continuing ops before tax £m
<b>Adjustments comprise:</b>						
Reorganisation and other costs	-	-	(6)	-	-	(6)
Hedging and certain other mark to market variances	-	(89)	-	-	-	(89)
	-	(89)	(6)	-	-	(95)

## b) By geographical region

	2008 £m	2007 £m
<b>Total operating income</b>		
United Kingdom	491	425
Other	30	37
	521	462
<b>Total assets other than financial instruments and deferred tax assets</b>		
United Kingdom	15	2,177
Other	-	-
	15	2,177

## 2. Net interest income

	2008 £m	Group 2007 £m
<b>Interest and similar income:</b>		
On loans and advances to Group undertakings	6,156	3,012
Other interest earning financial assets	551	287
<b>Total interest and similar income</b>	6,707	3,299
<b>Interest and similar charges:</b>		
On deposits by Group undertakings	5,235	2,511
Other interest bearing financial liabilities	1,081	563
<b>Total interest expense and similar charges</b>	6,316	3,074
<b>Net interest income</b>	391	225

## Notes to the Financial Statements continued

## 3. Net trading and other income

	Group	
	2008	2007
	£m	£m
Net trading and funding of other items by the trading book	82	260
Income on assets held at fair value through profit or loss	797	350
Funding of liabilities held at fair value through profit or loss	(435)	(382)
Loss on derivatives managed in conjunction with financial assets and liabilities designated at fair value	(373)	(19)
Hedge ineffectiveness and other	43	20
	<b>114</b>	<b>229</b>

## 4. Administration expenses

	Group	
	2008	2007
	£m	£m
<b>Staff costs:</b>		
Wages and salaries	96	85
Social security costs	5	4
<b>Pensions costs:</b>		
- defined benefit plans	4	4
Other personnel costs	4	6
	<b>109</b>	<b>99</b>
Property and equipment expenses	8	8
Information technology expenses	31	31
Other administrative expenses	10	10
	<b>158</b>	<b>148</b>

## 5. Depreciation and amortisation

	Group	
	2008	2007
	£m	£m
Depreciation of plant, property and equipment	3	3

## 6. Impairment losses/(recoveries) on loans and advances

	Group	
	2008	2007
	£m	£m
Impairment losses on loans and advances to customers	26	-
Recoveries of loan and advances to customers	-	(4)
	<b>26</b>	<b>(4)</b>

## 7. Audit and other services

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

	Group	
	2008	2007
	£m	£m
<b>Audit fees:</b>		
Fees payable to the Company's auditor for the audit of the Company's annual accounts	0.5	0.5
Fees payable to the Company's auditor and its associates for the audit of the Company's subsidiaries pursuant to legislation	0.4	0.5
Total audit fees	<b>0.9</b>	<b>1.0</b>

## Notes to the Financial Statements continued

## 8. Directors' remuneration and interests

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

	2008	Group 2007
	£	£
Salaries and fees	518,892	478,821
Performance-related payments	1,062,768	1,908,738
Total remuneration excluding pension contributions	1,581,660	2,387,559
Pension contributions	31,876	57,984
	<b>1,613,536</b>	<b>2,445,543</b>

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 Abbey National plc. Salaries and performance-related payments comprise payments to five (2007: four) Directors serving during the year.

## Remuneration of highest paid Director

The remuneration, excluding pension contributions, of the highest paid Director was £1,005,617 (2007: £1,474,374) of which £777,875 (2007: £1,312,500) was performance-related. The amount paid with respect to a defined contribution scheme by the highest paid director was £nil (2007: £nil).

The accrued pension benefit for the highest paid Director was £nil (2007: £nil). The accrued lump sum of the highest paid director as at 31 December 2008 was £nil (2007: nil). Two directors will be receiving benefits under a defined benefit scheme (2007: three) and one director (2007: 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 Abbey in this period. The performance conditions were linked to Abbey's three-year plan. Performance was measured in two ways, half of the award depended on Abbey 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 2008, four Directors (2007: three) were granted conditional awards of shares in Banco Santander, S.A. under the Santander Long-Term Incentive Plan for a total fair value of £116,787 (2007: £52,081) based on the closing share price on 20 June 2008 of Euro 11.96 (2007: Euro 14.79). 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 21 June 2008 and 31 December 2007, certain Executive Directors, Key Management Personnel (as defined above) and other nominated individuals were granted conditional awards of shares in Banco Santander, S.A.. The amount of shares participants will receive throughout a three year period (2007: a three year period) depends on the performance of Banco Santander, S.A. during this period. All awards under the Santander Long-Term Incentive Plan will depend on Santander's Total Shareholder Return and Earnings Per Share performance against a competitor benchmark group. Provided the performance conditions are met, 100% of the 2008 conditional award of shares will vest in 2011. 40% of the 2007 conditional award of shares will vest in July 2009 with the remaining 60% vesting in July 2010.

## 9. Taxation expense

	2008	Group 2007
	£m	£m
<b>Current tax:</b>		
UK corporation tax on profit for the year	138	56
Adjustments in respect of prior periods	5	5
<b>Total current tax</b>	<b>143</b>	<b>61</b>
<b>Deferred tax (Note 23)</b>		
Current year	(50)	5
Adjustments in respect of prior periods	(7)	-
<b>Total deferred tax</b>	<b>(57)</b>	<b>5</b>
<b>Tax on profit for the year</b>	<b>86</b>	<b>66</b>



## Notes to the Financial Statements continued

Domestic income tax is calculated at 28.5% (2007: 30%) of the estimated assessable profits for the year. The standard rate of UK corporation tax was reduced from 30% to 28% with 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 23. The tax on Group's profit before tax differs from the theoretical amount that would arise using the basic tax rate of the parent as follows:

	Group	
	2008	2007
	£m	£m
<b>Profit before tax</b>	<b>334</b>	<b>315</b>
<b>Tax calculated at a tax rate of 28.5% (2007: 30%)</b>	<b>92</b>	<b>95</b>
Non-taxable dividend income	(5)	(3)
Effect of non-allowable provisions and other non-equalised items	2	(21)
Utilisation of capital losses for which credit not previously recognised	-	(11)
Effect of change in tax rate on deferred tax provision	-	1
Adjustment in respect of prior periods	(3)	5
<b>Income tax expense</b>	<b>86</b>	<b>66</b>

## 10. Profit on ordinary activities after tax

The profit after tax of the Company attributable to the shareholders was £203m (2007: £107m). As permitted by Section 230 of the Companies Act 1985, the Company's income statement has not been presented in these Consolidated Financial Statements.

## 11. 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 TSB, for a cash consideration of approximately £1.6bn.

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

	Group	
	2008	2007
	£m	£m
Total income	185	200
Total operating expenses	(126)	(137)
<b>Profit of discontinued operations before tax</b>	<b>59</b>	<b>63</b>
Taxation (expense)/credit	(17)	13
<b>Profit of discontinued operations after tax</b>	<b>42</b>	<b>76</b>
Profit on sale of discontinued operations before and after tax	40	-
<b>Profit for the year from discontinued operations after tax</b>	<b>82</b>	<b>76</b>

## 12. Cash and balances at central banks

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
	<b>8</b>	<b>7</b>	<b>8</b>	<b>7</b>

For regulatory purposes, certain minimum cash balances are required to be maintained with the Bank of England. At 31 December, these amounted to £8m (2007: £7m).

## 13. Trading assets

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Balances with central banks	2,498	-	-	-
Loans and advances to banks	4,947	8,847	4,239	3,790
Loans and advances to customers	534	17,255	99	-
Amounts due from Group undertakings	-	-	16,400	10,954
Debt securities	16,800	28,831	5,204	17,574
Equity securities	707	1,494	447	442
	<b>25,486</b>	<b>56,427</b>	<b>26,389</b>	<b>32,760</b>

## Notes to the Financial Statements continued

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

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Issued by public bodies:				
Government securities	<b>3,139</b>	3,723	<b>2,932</b>	2,546
	<b>3,139</b>	3,723	<b>2,932</b>	2,546
Issued by other issuers:				
Bank and building society certificates of deposit	<b>8,032</b>	9,679	<b>740</b>	4,282
	<b>8,032</b>	9,679	<b>740</b>	4,282
Other debt securities	<b>5,629</b>	15,429	<b>1,532</b>	10,746
	<b>16,800</b>	28,831	<b>5,204</b>	17,574

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

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Debt securities:				
- Listed UK	<b>9,576</b>	8,054	<b>558</b>	1,749
- Listed elsewhere	<b>7,224</b>	11,064	<b>4,646</b>	6,112
- Unlisted	-	9,713	-	9,713
	<b>16,800</b>	28,831	<b>5,204</b>	17,574
Equity securities:				
- Listed UK	<b>317</b>	965	<b>57</b>	118
- Listed elsewhere	<b>390</b>	529	<b>390</b>	324
	<b>707</b>	1,494	<b>447</b>	442

#### 14. 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, exchange rates and credit spread movements. 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 following table summarises activities undertaken by the Group, the related risks associated with such activities and the types of derivatives used in managing such risks. Such risks may also be managed using 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		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2008 Derivatives held for trading</b>			
Exchange rate contracts:			
Cross-currency swaps	58,209	7,188	6,872
Forward exchange swaps and forwards	17,102	1,421	793
	<b>75,311</b>	<b>8,609</b>	<b>7,665</b>
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
	<b>923,919</b>	<b>21,493</b>	<b>20,067</b>
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
	<b>30,595</b>	<b>2,708</b>	<b>4,862</b>
<b>Total derivative assets / liabilities held for trading</b>	<b>1,029,825</b>	<b>32,810</b>	<b>32,594</b>

	Group		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2008 Derivatives held for fair value hedging</b>			
Interest rate contracts:			
Interest rate swaps	41,919	56	1,538
<b>Total derivative assets / liabilities held for fair value hedging</b>	<b>41,919</b>	<b>56</b>	<b>1,538</b>
<b>Total recognised derivative assets / liabilities</b>	<b>1,071,744</b>	<b>32,866</b>	<b>34,132</b>

	Company		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2008 Derivatives held for trading</b>			
Exchange rate contracts:			
Cross-currency swaps	57,790	7,193	6,922
Forward exchange swaps and forwards	7,326	714	177
	<b>65,116</b>	<b>7,907</b>	<b>7,099</b>
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
	<b>892,072</b>	<b>21,350</b>	<b>19,913</b>
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
	<b>30,333</b>	<b>2,847</b>	<b>4,961</b>
<b>Total derivative assets / liabilities held for trading</b>	<b>987,521</b>	<b>32,104</b>	<b>31,973</b>

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

## Notes to the Financial Statements continued

	Group		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2007 Derivatives held for trading</b>			
Exchange rate contracts:			
Cross-currency swaps	27,188	534	711
Forward exchange swaps and forwards	21,544	256	260
	48,732	790	971
Interest rate contracts:			
Interest rate swaps	531,340	6,278	6,342
Caps, floors and swaptions	42,438	650	656
Futures (exchange traded)	29,383	88	-
Forward rate agreements	148,742	76	77
	751,903	7,092	7,075
Equity and credit contracts:			
Equity index and similar products	16,263	1,016	2,109
Equity index options (exchange traded)	6,009	556	215
Credit default swaps and similar products	35,588	1,020	186
	57,860	2,592	2,510
<b>Total derivative assets / liabilities held for trading</b>	<b>858,495</b>	<b>10,474</b>	<b>10,556</b>

	Group		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2007 Derivatives held for fair value hedging</b>			
Interest rate contracts:			
Interest rate swaps	37,027	2	204
<b>Total derivative assets / liabilities held for fair value hedging</b>	<b>37,027</b>	<b>2</b>	<b>204</b>
<b>Total recognised derivative assets / liabilities</b>	<b>895,552</b>	<b>10,476</b>	<b>10,760</b>

	Company		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2007 Derivatives held for trading</b>			
Exchange rate contracts:			
Cross-currency swaps	26,876	530	711
Forward exchange swaps and forwards	7,384	53	55
	34,260	583	766
Interest rate contracts:			
Interest rate swaps	481,639	6,316	6,290
Caps, floors and swaptions	42,328	651	657
Futures (exchange traded)	26,309	47	-
Forward rate agreements	148,741	76	77
	699,017	7,090	7,024
Equity and credit contracts:			
Equity index and similar products	10,742	1,140	2,069
Equity index options (exchange traded)	6,009	523	216
Credit default swaps and similar products	35,514	1,020	177
	52,265	2,683	2,462
<b>Total derivative assets / liabilities held for trading</b>	<b>785,542</b>	<b>10,356</b>	<b>10,252</b>

	Company		
	Contract/notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>2007 Derivatives held for fair value hedging</b>			
Interest rate contracts:			
Interest rate swaps	37,027	2	205
<b>Total derivative assets / liabilities held for fair value hedging</b>	<b>37,027</b>	<b>2</b>	<b>205</b>
<b>Total recognised derivative assets / liabilities</b>	<b>822,569</b>	<b>10,358</b>	<b>10,457</b>

## Gains or losses arising from fair value hedges

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

## Notes to the Financial Statements continued

	Group £m	2007 Company £m
Gains/(losses):		
On hedging instruments	(292)	(292)
On the hedged items attributable to hedged risk	324	324
	32	32

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.

## 15. Financial assets designated at fair value

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Loans and advances to customers	<b>6,642</b>	5,647	<b>6,642</b>	5,647
Debt securities	<b>4,363</b>	5,799	<b>4,363</b>	5,799
	<b>11,005</b>	11,446	<b>11,005</b>	11,446

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

- a) Loans and advances to customers representing 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 in issue 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 £6,214m (2007: £5,534m). 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 banks, loans and advances to customers and debt securities an amount of £474m (2007: £83m) was due to changes in credit spreads.

Debt securities can be analysed by listing status as follows:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Debt securities:				
- Listed elsewhere	<b>4,083</b>	5,522	<b>4,083</b>	5,522
- Unlisted	<b>280</b>	277	<b>280</b>	277
	<b>4,363</b>	5,799	<b>4,363</b>	5,799

## 16. Loans and advances to banks

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Amounts due from Santander group undertakings	<b>136,076</b>	56,558	<b>121,742</b>	56,516
Amounts due from ultimate parent	<b>8,348</b>	826	<b>3,630</b>	500
Other loans and advances	<b>2,665</b>	327	<b>2,663</b>	5
	<b>147,089</b>	57,711	<b>128,035</b>	57,021

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Repayable:				
On demand	<b>1,995</b>	629	<b>1,995</b>	551
In not more than 3 months	<b>31,101</b>	14,006	<b>18,140</b>	13,581
In more than 3 months but not more than 1 year	<b>29,630</b>	8,037	<b>23,537</b>	7,834
In more than 1 year but not more than 5 years	<b>52,201</b>	35,039	<b>52,201</b>	35,055
In more than 5 years	<b>32,162</b>	-	<b>32,162</b>	-
	<b>147,089</b>	57,711	<b>128,035</b>	57,021

## Notes to the Financial Statements continued

## 17. Loans and advances to customers

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Amounts due from Santander group undertakings	20,098	3,315	20,407	4,878
Other loans and advances	4,658	1,317	4,646	1,303
<b>Loans and advances to customers</b>	<b>24,756</b>	<b>4,632</b>	<b>25,053</b>	<b>6,181</b>
Less: loan loss allowances	(26)	-	(26)	-
	<b>24,730</b>	<b>4,632</b>	<b>25,027</b>	<b>6,181</b>

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Repayable:				
On demand	1	101	-	171
In no more than 3 months	4,417	1,074	4,840	2,536
In more than 3 months but not more than a year	480	57	310	19
In more than 1 year but not more than 5 years	2,541	600	2,592	677
In more than 5 years	17,317	2,800	17,311	2,778
<b>Loans and advances to customers</b>	<b>24,756</b>	<b>4,632</b>	<b>25,053</b>	<b>6,181</b>
Less: loan loss allowance	(26)	-	(26)	-
<b>Loans and advances to customers, net of loan loss allowances</b>	<b>24,730</b>	<b>4,632</b>	<b>25,027</b>	<b>6,181</b>

Movement in loan loss allowances:

	Group
	Total
	£m
As at 1 January 2008	-
Charge/(release) to the income statement:	
- Individually assessed	13
- Collectively assessed	13
	<b>26</b>
Write offs	-
At 31 December 2008	<b>26</b>
As at 1 January 2007	-
Charge/(release) to the income statement:	
- Individually assessed	-
- Collectively assessed	-
	-
Write offs	-
At 31 December 2007	-

	Company
	Total
	£m
As at 1 January 2008	-
Charge/(release) to the income statement	13
Write offs	13
At 31 December 2008	<b>26</b>
As at 1 January 2007	-
Charge/(release) to the income statement	-
Write offs	-
At 31 December 2007	-

## 18. Held to maturity securities

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Issued by other issuers:				
Other debt securities	300	300	-	45
	<b>300</b>	<b>300</b>	<b>-</b>	<b>45</b>

## Notes to the Financial Statements continued

## 19. Investment in subsidiary undertakings

	2008 Net book value £m	2007 Net book value £m
Subsidiary undertakings:		
Non-banks	2,335	2,336
	<b>2,335</b>	<b>2,336</b>

The movement in shares in subsidiary undertakings was as follows:

	Total £m
At 1 January 2008	2,336
Capital contribution	1
Liquidation of investment	(2)
<b>At 31 December 2008</b>	<b>2,335</b>

The principal subsidiaries of Abbey National Treasury Services plc at 31 December 2008 are shown below, all of which are directly held, except where indicated, 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 s.231(5) of the Companies Act 1985 the following information relates to those subsidiary undertakings whose results or financial position, in the opinion of the directors, principally affect the results of the Group. Full particulars of all subsidiary undertakings will be annexed to the Company's next annual return in accordance with s.231(6)(b) Companies Act 1985.

	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
AN Structured Issues Limited	Funding	100%	Jersey
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.

## 20. Intangible assets

	Group 2008 £m	Company 2008 £m
<b>Cost</b>		
At 1 January 2008	-	-
Additions	6	6
At 31 December 2008	<b>6</b>	<b>6</b>
<b>Accumulated amortisation / impairment</b>		
At 1 January 2008	-	-
Charge for the year	-	-
At 31 December 2008	-	-
<b>Net book value</b>	<b>6</b>	<b>6</b>

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

## Notes to the Financial Statements continued

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

				Group
	Owner-occupied properties £m	Office fixtures and equipment £m	Computer software £m	Total £m
<b>Cost</b>				
At 1 January 2008	2	19	61	82
Additions	-	3	-	3
Disposals	(1)	(4)	-	(5)
At 31 December 2008	1	18	61	80
<b>Accumulated depreciation</b>				
At 1 January 2008	2	8	60	70
Depreciation charge	-	3	-	3
Disposals	(1)	(1)	-	(2)
At 31 December 2008	1	10	60	71
<b>Net book value</b>				
At 31 December 2008	-	8	1	9
At 31 December 2007	-	12	1	13

				Company
	Owner-occupied properties £m	Office fixtures and equipment £m	Computer software £m	Total £m
<b>Cost</b>				
At 1 January 2008	-	17	60	77
Additions	-	3	-	3
Disposals	-	(4)	-	(4)
At 31 December 2008	-	16	60	76
<b>Accumulated depreciation</b>				
At 1 January 2008	-	5	59	64
Depreciation charge	-	3	-	3
At 31 December 2008	-	8	59	67
<b>Net book value</b>				
At 31 December 2008	-	8	1	9
At 31 December 2007	-	12	1	13

## 22. Operating lease assets

	Group	
	2008 £m	2007 £m
<b>Cost</b>		
At 1 January	3,473	3,275
Additions	88	214
Disposals	-	(16)
Disposed of subsidiary undertaking	(3,561)	-
At 31 December	-	3,473
<b>Depreciation and impairment</b>		
At 1 January	1,309	1,191
Charge for the year	117	133
Disposals	-	(15)
Disposed of subsidiary undertaking	(1,426)	-
At 31 December	-	1,309
<b>Net book value</b>	-	2,164

The operating lease assets of the Group consisted of trains and related assets and were sold in 2008 as described in Note 11. The Company had no operating lease assets.



## Notes to the Financial Statements continued

## 23. 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 effective rate for 2008 is 28% (2007: 28.1%).

The movement on the deferred tax account is as follows:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	<b>(422)</b>	(431)	<b>18</b>	22
Income statement charge – continuing operations	<b>57</b>	(5)	<b>57</b>	(4)
Income statement charge – discontinuing operations	<b>(3)</b>	14	-	-
Disposal of subsidiary undertaking	<b>444</b>	-	-	-
At 31 December	<b>76</b>	(422)	<b>75</b>	18

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

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred income tax liabilities				
Capital allowances on operating lease receivables	-	(463)	-	-
IAS 32 & 39 transition adjustments	-	23	-	-
Other temporary differences	<b>(1)</b>	(1)	-	-
	<b>(1)</b>	(441)	-	-
Deferred income tax assets				
Accelerated book depreciation	<b>2</b>	2	<b>1</b>	2
IAS 32 & 39 transition adjustments	<b>15</b>	17	<b>14</b>	16
Other temporary differences	<b>60</b>	-	<b>60</b>	-
	<b>77</b>	19	<b>75</b>	18

The deferred tax assets scheduled above have been recognised in both the Company and the Group on the evidence that sufficient future taxable profits are forecast within the foreseeable future sufficient to allow for the utilisation of the assets as they reverse.

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

	Group	
	2008 £m	2007 £m
Accelerated tax depreciation	-	(1)
IAS 32 & 39 transitional adjustments	<b>(2)</b>	(4)
Other temporary differences	<b>59</b>	-
	<b>57</b>	(5)

## 24. Other assets

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Receivables	<b>812</b>	207	<b>763</b>	55
Prepayments	-	2	-	2
Accrued income	<b>15</b>	12	<b>15</b>	-
	<b>827</b>	221	<b>778</b>	57

Receivables primarily relate to financial transactions which have not yet reached their contractual settlement date within the Global Banking & Markets business.

## Notes to the Financial Statements continued

## 25. Deposits by banks

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Amounts due to Group undertakings	122,601	44,732	122,601	44,731
Sale and repurchase agreement	5	-	-	-
Amounts due to Ultimate parent	662	6,660	649	4,789
Time and demand deposits	228	396	116	327
<b>Total deposits by banks</b>	<b>123,496</b>	<b>51,788</b>	<b>123,366</b>	<b>49,847</b>
Repayable:				
On demand	7,400	5,243	7,276	5,144
In not more than 3 months	59,173	15,762	59,167	13,920
In more than 3 months but not more than 1 year	6,544	4,077	6,544	4,086
In more than 1 year but not more than 5 years	18,263	21,199	18,263	21,035
In more than 5 years	32,116	5,507	32,116	5,662
	<b>123,496</b>	<b>51,788</b>	<b>123,366</b>	<b>49,847</b>

## 26. Deposits by customers

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Amounts due to Group undertakings	1,908	1,819	8,721	9,703
Wholesale funds and deposits	1,025	25	1,022	11
	<b>2,933</b>	<b>1,844</b>	<b>9,743</b>	<b>9,714</b>
Repayable:				
In no more than 3 months	1,869	1,745	8,360	9,359
In more than 3 months but no more than 1 year	55	18	245	274
In more than 1 year but no more than 5 years	477	4	606	4
In more than 5 years	532	77	532	77
	<b>2,933</b>	<b>1,844</b>	<b>9,743</b>	<b>9,714</b>

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.

## 27. Trading liabilities

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Deposits by banks	34,339	19,630	12,182	9,736
Deposits by customers	4,622	20,499	8,760	5,349
Amounts due to Group undertakings	-	-	1,017	6,229
Short positions in securities	13	2,252	13	141
Debt securities in issue	1,024	12,533	1,024	12,471
	<b>39,998</b>	<b>54,914</b>	<b>22,996</b>	<b>33,926</b>

In 2007, issuances of commercial paper and certificates of deposit were used to fund the Group's trading operations and were classified as trading liabilities. In 2008, such issuances were used to fund commercial banking operations and therefore have been classified as deposits by customers.

## 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. The total fair value of equity index-linked deposits was £2,205m at 31 December 2008 (2007: £2,455m).

## Notes to the Financial Statements continued

## 28. Financial liabilities designated at fair value

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Debt securities in issue	<b>4,945</b>	7,538	<b>4,898</b>	7,530

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 £88m (2007: £nil) result from changes in the Group's own credit risk. The amount that would be required to be contractually paid at maturity of the debt securities in issue above is £39m (2007: £257m) higher than the carrying value.

## 29. Debt securities in issue

	Group		Company	
	2008	2007	2008	2007
	£m	£m	£m	£m
Bonds, notes and commercial papers	<b>33,927</b>	11,929	<b>29,692</b>	5,840
Repayable:				
In not more than 3 months	<b>10,380</b>	6,020	<b>6,366</b>	-
In more than 3 months but no more than 1 year	<b>4,922</b>	1,178	<b>4,701</b>	1,110
In more than 1 year but no more than 5 years	<b>2,211</b>	2,124	<b>2,211</b>	2,123
In more than 5 years	<b>16,414</b>	2,607	<b>16,414</b>	2,607
	<b>33,927</b>	11,929	<b>29,692</b>	5,840

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

			Group	Company
	Interest Rate	Maturity	2008	2008
			£m	£m
Euro	0.00% - 1.99%	Up to 2011	<b>2,859</b>	<b>2,859</b>
	2.00% - 3.99%	Up to 2011	<b>63</b>	<b>63</b>
		2011 - 2016	<b>1,945</b>	<b>1,945</b>
	4.00% - 4.99%	Up to 2011	<b>69</b>	<b>69</b>
US Dollar	0.00% - 1.99%	2011 - 2022	<b>1,469</b>	<b>1,469</b>
		Up to 2011	<b>4,603</b>	<b>745</b>
	2.00% - 3.99%	Up to 2011	<b>3,826</b>	<b>3,449</b>
	4.00% - 5.99%	Up to 2011	<b>595</b>	<b>595</b>
Pounds Sterling	6.00% - 7.99%	Up to 2011	<b>221</b>	<b>221</b>
	0.00% - 1.99%	Up to 2012	<b>960</b>	<b>960</b>
		Up to 2012	<b>169</b>	<b>169</b>
	4.00% - 5.99%	Up to 2012	<b>2,553</b>	<b>2,553</b>
		2012 - 2020	<b>603</b>	<b>603</b>
	2020 - 2025	<b>13,203</b>	<b>13,203</b>	
Other Currencies	6.00% - 6.99%	Up to 2011	<b>767</b>	<b>767</b>
	6.00% - 7.00%	2010 - 2013	<b>22</b>	<b>22</b>
			<b>33,927</b>	<b>29,692</b>

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 Abbey National plc. There were no new issuances in 2007.

## Notes to the Financial Statements continued

## 30. Subordinated liabilities

	2008 £m	Group 2007 £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	-
	<b>432</b>	331

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

In April 2008, the Group issued £100m subordinated notes to Abbey National plc. The 6.89% subordinated notes have a maturity date of 31 January 2014. There were £nil redemptions made during the year.

Subordinated liabilities including convertible debt securities in issue are repayable:

	2008 £m	Group 2007 £m
In more than 5 years	432	331
	<b>432</b>	331

## 31. Provisions

	2008 £m	Group 2007 £m
At 1 January 2008	7	11
Used during the year	(5)	(4)
Disposal of subsidiary undertaking	(2)	-
At 31 December 2008	-	7
To be settled:		
Within 12 months	-	5
In more than 12 months	-	2
	-	7

The provision related to heavy maintenance costs on leased rolling stock within the Porterbrook group that was sold in 2008 as described in Note 11.

## 32. Other liabilities

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Trade payables	407	746	83	254
Accrued expenses	-	58	-	-
	<b>407</b>	804	<b>83</b>	254

Trade payables primarily relate to unsettled financial transactions within the Global Banking & Markets business.

## 33. Contingent liabilities and commitments

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

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
Guarantees given on behalf of the Company's UK parent, fellow subsidiaries and subsidiaries	100,780	73,158	128,440	109,000
Guarantees given to third parties	369	3,589	369	3,589
Formal standby facilities, credit lines and other commitments:				
– Original term to maturity of more than one year	2,983	1,913	2,983	1,913

## Notes to the Financial Statements continued

**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 £80m at the balance sheet exchange rate (2007: £61m). At 31 December 2008, additional interest in relation to the demand could amount to £34m at the balance sheet exchange rate (2007: £24m). 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.

**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 £17,139m as at 31 December 2008 (2007: £33,774m) are offset by a contractual right to receive stock under other contractual agreements.

**Operating lease commitments**

	2008 £m	Group 2007 £m	2008 £m	Company 2007 £m
Rental commitments under operating leases expiring:				
No later than 1 year	5	5	4	8
Later than 1 year but no later than 5 years	22	21	18	33
Later than 5 years	45	53	39	9
	<b>72</b>	79	<b>61</b>	50

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

	Group 2008 £m	Company 2008 £m
Year ended 31 December:		
2009	5	4
2010	5	4
2011	6	4
2012	6	5
2013	6	5
Total thereafter	<b>44</b>	<b>39</b>

	Group 2008 £m	Group 2007 £m
Group rental expense comprises:		
In respect of minimum rentals	9	7
Less: sub-lease rentals	-	-
	<b>9</b>	<b>7</b>

Appropriate provisions are maintained to cover the above matters.

## Notes to the Financial Statements continued

## 34. Share capital

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
<b>Ordinary share capital</b>				
Balance at 1 January	2,549	2,549	2,549	2,549
Issued in the year	-	-	-	-
Balance at 31 December	<b>2,549</b>	2,549	<b>2,549</b>	2,549
		Tracker shares of £1 each £m	Ordinary shares of £1 each £m	Total £m
Authorised share capital				
At 31 December 2007		-	5,000	5,000
Increase in the year		-	-	-
<b>At 31 December 2008</b>		-	<b>5,000</b>	<b>5,000</b>
Issued and fully paid share capital				
At 31 December 2007		-	2,549	2,549
Increase in the year		-	-	-
<b>At 31 December 2008</b>		-	<b>2,549</b>	<b>2,549</b>

In 2008, the Company authorised and issued 1,000 Tracker Shares of £1 each at par to its parent company for £1,000.

The 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 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.

## 35. Retained earnings

Movements in retained earnings were as follows:

	Group		Company	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January	528	203	169	63
Profit for the year	330	325	203	107
Dividends	(161)	-	(161)	-
Exchange differences on translation of foreign operations	28	-	17	(1)
At 31 December	<b>725</b>	528	<b>228</b>	169

## 36. Consolidated cash flow statement

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

	Group		Company	
	2008 £m	2007 <sup>(1)</sup> £m	2008 £m	2007 <sup>(1)</sup> £m
<b>Operating profit</b>	<b>330</b>	325	<b>203</b>	107
Depreciation	121	132	5	2
Increase in prepayments and accrued income	(1,243)	(196)	(1,118)	(194)
Increase in accruals and deferred income	1,112	433	1,048	325
Provision for impairment	26	-	26	7
Profit on the sale of subsidiary undertakings	(40)	-	-	-
Other non-cash items	(1,084)	(359)	(1,184)	(399)
Net cash flow from / (used in) trading activities	(778)	335	(1,020)	(152)
<b>Changes in operating assets and liabilities</b>				
Net decrease/ (increase) in financial assets held for trading	8,964	(630)	6,993	13,915
Net decrease/ (increase) in financial assets designated at fair value	441	(3,153)	441	(3,309)
Net decrease/ (increase) in derivatives held for trading	982	(1,129)	1,252	(1,137)
Net (increase) in loans and advances to banks and customers	(90,983)	(9,125)	(82,853)	(9,319)
Net (increase)/decrease in other assets	(724)	1,549	(780)	1,418
Net increase in deposits by banks and customer accounts	71,888	650	72,646	2,038
Net (increase) in financial liabilities held for trading	(14,792)	(2,852)	(10,758)	(4,445)
Net (increase) in financial liabilities designated at fair value	(2,591)	(619)	(2,630)	(610)
Net increase/(decrease) in debt issued	18,033	(301)	22,231	(673)
Net (decrease)/increase in other liabilities	(197)	283	(121)	61
Effects of exchange rate differences	3,606	220	1,260	338
<b>Net cash flow (used in) / from operating activities before tax</b>	<b>(6,151)</b>	(14,772)	<b>6,661</b>	(1,875)
Income tax paid	(4)	(5)	(3)	1
<b>Net cash flow (used in) / from operating activities</b>	<b>(6,155)</b>	(14,777)	<b>6,658</b>	(1,874)

## Notes to the Financial Statements continued

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

	Group		Company	
	2008	2007 <sup>(1)</sup>	2008	2007 <sup>(1)</sup>
	£m	£m	£m	£m
<b>Cash and balances at central banks</b>	<b>8</b>	7	<b>8</b>	7
Debt securities - Trading	<b>5,208</b>	5,819	<b>401</b>	1,290
Loans and advances to banks - Trading	<b>4,946</b>	7,734	<b>4,239</b>	13,708
Loans and advances to customers - Trading	<b>532</b>	17,255	<b>13,238</b>	-
<b>Net trading other cash equivalents</b>	<b>10,686</b>	30,808	<b>17,878</b>	14,998
Loans and advances to banks - Non trading	<b>33,096</b>	14,635	<b>20,134</b>	14,132
<b>Net non-trading other cash equivalents</b>	<b>33,096</b>	14,635	<b>20,134</b>	14,132
<b>Cash and cash equivalents at year end</b>	<b>43,790</b>	45,450	<b>38,020</b>	29,137

(1) A description of the change in accounting policy for cash and cash equivalents can be found in the Accounting policies on page 22.

## c) Sale of subsidiary undertakings

	Group
	2008
	£m
<b>Net assets disposed of:</b>	
Operating lease assets	<b>2,135</b>
Current tax accounts	<b>8</b>
Other assets	<b>58</b>
Deposits by banks	<b>(8)</b>
Other liabilities	<b>(164)</b>
Other provisions	<b>(2)</b>
Current tax liabilities	<b>(19)</b>
Deferred tax liabilities	<b>(444)</b>
Retirement benefit obligation	<b>1</b>
	<b>1,565</b>
Profit on disposal	<b>40</b>
	<b>1,605</b>
<b>Satisfied by:</b>	
Cash and cash equivalents	<b>1,605</b>
Less: Cash and cash equivalents in subsidiary sold	<b>-</b>
Net cash inflow of sale	<b>1,605</b>

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 TSB, for a cash consideration of approximately £1.6bn.

## d) Discontinued operations

The trains and related assets leasing businesses, which constitute 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 £266m (2007: £208m), £(0.7m) (2007: £(0.2m)), and £0.4m (2007: £nil), respectively.

## 37. 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 to counterparties in the normal course of its derivative business. As at 31 December 2008 £1,646m (2007: £683m) 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 provided as collateral. As at 31 December 2008 £844m (2007: £2,035m) of assets had been provided 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 2008 was £30,134m (2007: £37,455m).

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 companies 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 companies are permitted to sell or repledge the collateral held. At 31 December 2008, the fair value of such collateral was £26,987m (2007: £48,015m) of which £26,987m (2007: £48,015m) was sold or repledged. The companies have an obligation to return the collateral that it has sold or pledged with a fair value of £26,987m (2007: £48,015m).

**Notes to the Financial Statements** continued**38. Directors' emoluments and interests**

Further details of Directors' emoluments and interests are included in Note 40. 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 40.

**39. Pensions and other post-retirement benefits**

The Group and the Company also participate in the Abbey group defined benefit pension schemes in operation. There is no contractual agreement of stated policy for charging the net defined benefit cost. The contribution to be paid by the Group and the Company is calculated as the contributions made by Abbey to the schemes in respect of the Group and the Company's employees.

**40. 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 the disclosed below with the Company or parent company's Key Management Personnel. Key Management Personnel are defined as the Directors of the Company, the Board and Executive Committee of Abbey National plc and its ultimate parent company, Banco Santander, S.A..

**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 8.

Key management compensation	2008 £	2007 £
Short-term employee benefits	<b>1,581,660</b>	2,387,559
Post employment benefits	<b>31,876</b>	57,984
Share-based payments	<b>104,824</b>	289,559
Total key management compensation	<b>1,718,360</b>	2,735,102

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 2008, (2007: 3) 4 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 £116,787 (2007: £52,081) based on the closing share price on 20 June 2008 of Euro 11.96 (2007: Euro14.79). 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 21 June 2008 and 31 December 2007, certain Executive Directors, Key Management Personnel (as defined above) and other nominated individuals were granted conditional awards of shares in Banco Santander, S.A. The amount of shares participants will receive throughout a three year period (2007: a three year period) depends on the performance of Banco Santander, S.A during this period. All awards under the Santander Long-Term Incentive Plan will depend on Santander's Total Shareholder Return and Earnings Per Share performance against a competitor benchmark group. Provided the performance conditions are met, 100% of the 2008 conditional award of shares will vest in 2011. 40% of the 2007 conditional award of shares will vest in July 2009 with the remaining 60% vesting in July 2010.

**Parent undertaking and controlling party**

The Company's immediate parent is Abbey National 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 Abbey National plc and Banco Santander S.A. respectively. A copy of the accounts of Abbey National plc may be obtained from Abbey Secretariat, Abbey National House, 2 Triton Square, London, NW1 3AN. A copy of the accounts of Banco Santander, S.A. may be obtained from Grupo Santander Shareholder Department, Grupo Santander (London Branch), Abbey National House, 2 Triton Square, London, NW1 3AN.



## Notes to the Financial Statements continued

## Transactions with related parties

During the year the Group entered into the following transactions with related parties:

	Interest, fees and other income received		Interest, fees and other expense paid		Amounts owed by related parties		Amounts owed to related parties	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Ultimate parent company	(483)	(202)	509	327	9,885	1,222	(2,107)	(7,017)
Immediate parent	(5,561)	(2,904)	4,738	2,023	132,613	57,901	(130,214)	(39,147)
Fellow subsidiaries	(175)	(229)	120	403	44,066	7,135	(15,462)	(8,860)
	(6,219)	(3,335)	5,367	2,753	186,564	66,258	(147,783)	(55,024)

During the year the Company entered into the following transactions with related parties:

	Interest, fees and other income received		Interest, fees and other expense paid		Amounts owed by related parties		Amounts owed to related parties	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Ultimate parent company	(344)	(188)	484	200	5,163	897	(1,815)	(5,145)
Immediate parent	(5,400)	(2,872)	4,734	2,023	126,750	57,563	(130,111)	(39,145)
Subsidiaries	(549)	(879)	565	885	16,752	15,085	(12,076)	(14,180)
Fellow subsidiaries	(175)	(229)	120	402	26,309	7,131	(15,452)	(8,847)
	(6,468)	(4,168)	5,903	3,510	174,974	80,676	(159,454)	(67,317)

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.

## 41. Events after the balance sheet date

No material events have occurred that require disclosure.

## 42. Financial instruments and risks

The Risk Management report 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 an Abbey 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 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 53 to 54.

**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 55 to 60:

- > **Risks in Corporate Banking** – The risks in this segment are described on pages 55 to 56, consisting of:
  - > **Credit risk**, including its management, mitigation, and its disclosure of exposure by rating of counterparty.
  - > **Market risk**, including its management
- > **Risks in Global Banking & Markets** – The risks in this segment are described on pages 56 to 59, including:
  - > **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 and structural market risk.
  - > **Trading risk**, including details of segmental exposures and trading derivatives.
- > **Risks in Asset & Liability Management** – The risks in this segment are described on pages 59 to 60, consisting of:
  - > **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

Notes to the Financial Statements continued

**The Impact of the Current Credit Environment** – Detailed disclosures can be found on pages 60 to 62, including a description of the Group’s exposures to certain classes of financial assets and off-balance sheet entities.

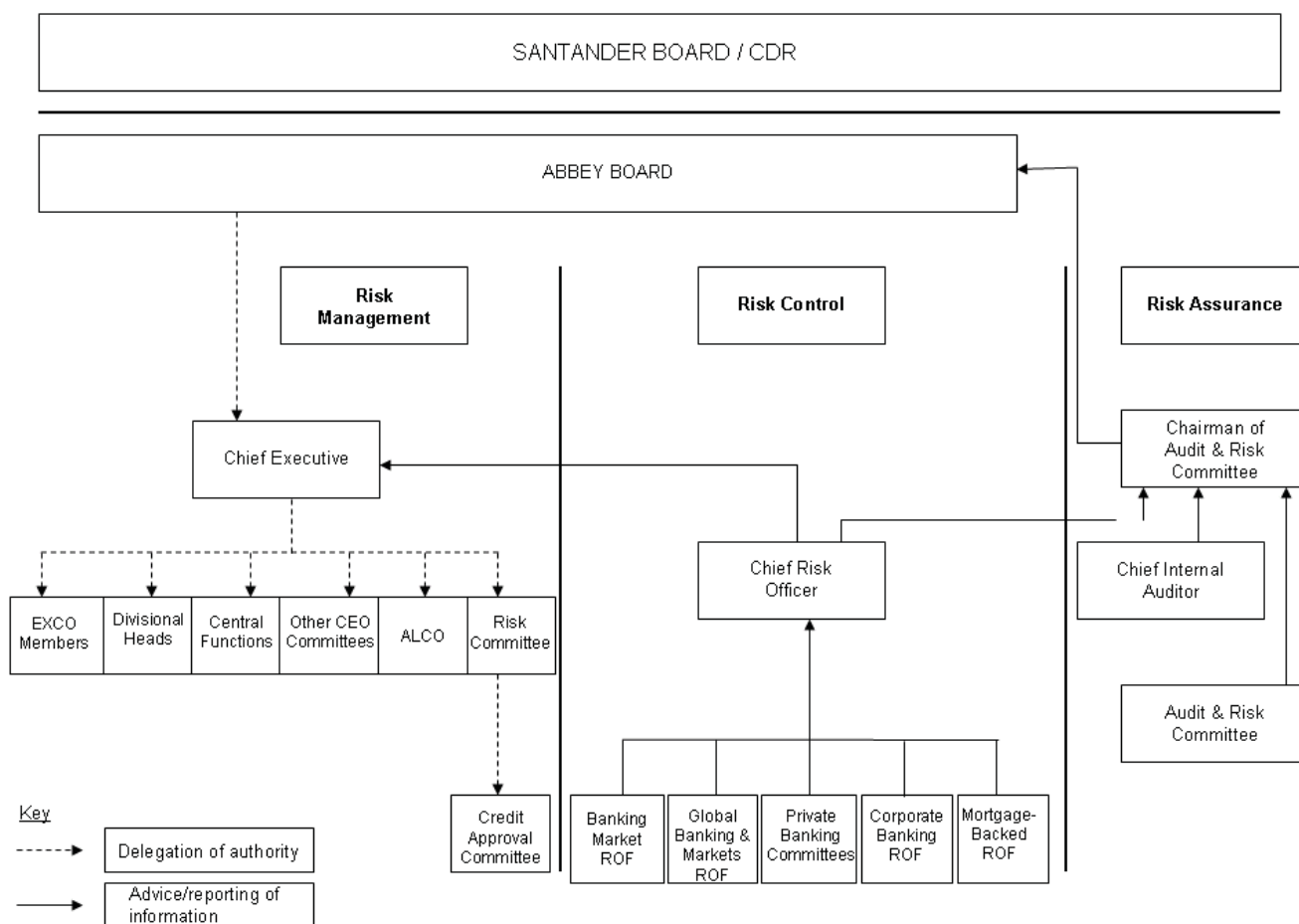
**Liquidity risk** – A description of the liquidity risks the Group faces, along with their management and activity in 2008 and 2007, can be found on page 62 to 63.

**Introduction**

The Group follows the same risk management structure of Abbey. The Group is driven by the core Santander Global Banking and 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 Abbey Board of Directors 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 including Credit Risk, Market Risk, Operational Risk, Concentration Risk, Liquidity Risk, Reputational Risk, Strategic Risk, Group Risk and Regulatory Risk. Risk measurement is used to capture the source of the uncertainty and the magnitude of its potential effect on the profitability and solvency of the Group. Effective risk management and control is therefore of fundamental importance to the long-term success of Abbey and its subsidiaries.

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

Authority for Risk Management flows from the Abbey 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.



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:

## Notes to the Financial Statements continued

### First tier of risk governance in Abbey

Risk management is provided by the Abbey Board. It approves Abbey's risk appetite in consultation with Banco Santander, S.A. as appropriate, approves the strategy for managing risk and is responsible for Abbey's system of internal control. The Abbey 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 Abbey. In addition understanding and identifying the risks generated by Abbey'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 to the Chief Executive, the Executive Committee or other parties as appropriate as well as makes decisions on risk issues within its sphere of responsibility.

### Second tier of risk governance in Abbey

Risk control is provided by the Abbey 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 Global Banking & Markets and Corporate Banking businesses.

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

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

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

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

### Third tier of risk governance in Abbey

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

#### Non-Executive Directors

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

#### Internal Audit

The Internal Audit function supports the Audit and Risk Committee by providing independent and objective opinions on the effectiveness and integrity of Abbey'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.

#### Audit and Risk Committee

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

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

## Notes to the Financial Statements continued

### Financial Risks and Risk Management

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

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

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

#### Financial Instruments

The Group uses financial instruments to manage the structural balance sheet exposure that arise from its and Abbey'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 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.

### Risk Management

#### Operational Risk (unaudited)

The Group's operational risks are managed at an Abbey 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 can also have 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)

Abbey 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 Abbey. The primary purpose of the framework, which is approved by the Risk Committee, is to define and articulate the Abbey-wide policy, processes, roles and responsibilities. The framework incorporates industry practice and regulatory requirements, particularly those emanating from the Basel Committee, European Union Directives and the UK Financial Services Authority. The day-to-day management of operational risk is the responsibility of business managers who identify, assess and monitor the risks, in line with the processes described in the framework. The operational risk function ensures that all key risks are regularly reported to Risk Fora, the Risk Committee and the Abbey Board.

#### Key operational risk activity in 2008 risk (unaudited)

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

Following many high profile customer data security lapses experienced by other organisations in the UK, Abbey has taken proactive steps to minimise similar risks. A corporate information security programme has been established which involves the strengthening of controls for the management of sensitive data and includes the implementation of encryption standards across the Group. A review of trading controls was carried out in response to the incident at Société Générale and the opportunity was taken to further enhance trading controls even though it was confirmed that existing controls were robust in this area. To highlight awareness of such issues, Operational Risk training has been made available to management and staff involved in control functions throughout Abbey. In line with Financial Services Authority guidance and industry practice, Abbey 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.

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

## Notes to the Financial Statements continued

## Credit Risk – Group-wide

## Significant concentrations of credit risk

Although Global Banking & Markets' operations are based mainly in the UK, it has built up exposures to various entities around the world and is therefore exposed to concentrations of risk related to geographic area. At 31 December 2008, 8% of Global Banking & Markets' credit exposures were to counterparties from the United States, and 63% were to counterparties from the UK. 5% 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 Santander centrally and determined according to the classification of the country (whether it is a developed 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. In addition stress tests are designed to assess the impact of specific shocks on niche portfolios.

## 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:

	Year ended 31 December 2008 £m	Year ended 31 December 2007 £m
Trading assets	24,230	32,378
Purchase and resale agreements	10,301	24,049
Derivatives	28,139	9,429
Financial assets designated at fair value	11,005	11,446
Loans and advances to customers	6,893	1,317
Loans and advances to banks	20,252	1,153
Other	2,669	2,602
<b>Third party exposures<sup>(1)(2)</sup></b>	<b>103,489</b>	<b>82,374</b>

(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 33 to the Consolidated Financial Statements

(2) Excludes loan to other members of the Abbey 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)

From 1 January 2008, the Group applied the advanced internal ratings-based (AIRB) approach for the principal wholesale portfolios. For the remaining credit exposures, currently on the Basel II standardised approach, a rolling programme of transition of the appropriate IRB approach is underway. From 1 January 2008, the Standardised Approach was adopted for Operational Risk, and the Group applied Basel II to its Internal Capital Adequacy Assessment Process (ICAAP) and to the risk and capital disclosures.

The Group has applied Santander's approach to risk management in its application of Basel II. Further information on the Group's capital position under Basel II is included on page 65.

## Market Risk

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

## Notes to the Financial Statements continued

## Risk Management in Corporate Banking

## Credit risk in Corporate Banking

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

## Managing credit risk

The Abbey Board has approved a set of risk appetite limits to cover different types of risk, including credit risk, arising in Corporate Banking. Abbey'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 Abbey 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 are provided each month to the Corporate Banking Risk Oversight Forum, with key issues escalated to the Risk Committee as required. Large Exposures (as defined by the UK Financial Services Authority) are reported quarterly to the Risk Committee and the UK Financial Services Authority.

Credit risk on derivative instruments is calculated using the potential future mark-to-market exposure of the instruments at a 97.5% 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, the amount and nature of the collateral 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 in the area of structured lending to the Real Estate, Education and Health sectors. The Group intends to achieve a more modest growth in terms of lending to corporate counterparties in broadly the £500m to £2bn turnover range as well as the initial development of an offering to smaller corporate entities. 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.

## Net exposure by credit rating of the counterparty

	Social Housing £m	Other £m	Total £m
<b>2008</b>			
AAA	-	124	124
AA	1,008	100	1,108
A	5,222	450	5,672
BBB	1,821	3,016	4,837
BB	100	825	925
B	10	41	51
D	-	22	22
<b>Total</b>	<b>8,161</b>	<b>4,578</b>	<b>12,739</b>
	Social Housing £m	Other £m	Total £m
2007			
AAA	-	110	110
AA	1,915	18	1,933
A	5,645	227	5,873
BBB	2,827	703	3,530
BB	383	636	1,019
B	86	2	88
<b>Total</b>	<b>10,856</b>	<b>1,696</b>	<b>12,553</b>

(1) Internal ratings are applied to all exposures.

The reduction in Social Housing exposures of £2,696m in 2008 is due to the termination of a transaction involving the Group writing credit protection on a pool of Social Housing exposures, partially offset by new business. The increase in Other Lending reflects the planned expansion of the Corporate Banking business.

## Notes to the Financial Statements continued

Corporate Banking non-performing loans and advances<sup>(1)</sup>

	2008 £m	2007 £m
Non-performing loans and advances that are impaired	54	-
Non-performing loans and advances that are not impaired	-	-
Total non-performing loans and advances <sup>(2)</sup>	54	-
Non-performing loans and advances as a percentage of loans and advances to customers <sup>(3)</sup>	1.25%	-
Provision as a percentage of total non-performing loans and advances	48.15%	-

(1) Amounts are only presented for 2008 and 2007 as this business only became operational in early 2007.

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

(3) All non-performing loans are UK loans

In 2008, non-performing loans and advances as a percentage of loans and advances to customers increased to 1.25%. 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 £2m. In 2007 there were no impaired loans.

## Credit risk mitigation

## Collateralisation

The Social Housing portfolio is secured on residential real estate owned and let by UK Housing Associations. In the Other category, the real estate portfolio collateral is in the form of commercial real estate assets, the corporate portfolio is largely unsecured but hold cross-guarantee agreements or contractual and financial governance. 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. In 2008 there were no deals made where interest was capitalised to avoid the loan becoming impaired.

## Market risk in Corporate Banking

Market risk is not taken within Corporate Banking. Market risks arising in the Corporate Banking division are transferred 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 ALM on matching terms as regards interest rate repricing and maturity. Similarly, loans are funded through matching borrowings from ALM.

## Risk Management in Global Banking &amp; Markets

## Credit risk in Global Banking &amp; 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 incur losses after realising 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.

## Managing credit risk

The Abbey Board has approved a set of risk appetite limits to cover different types of risk, including credit risk, arising in Global Banking & Markets. Abbey'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 falling within these mandates and policies are accommodated under credit limits approved by the appropriate credit authority. Specific approval is usually required by the Credit 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 either the Santander Global Banking & Markets 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.

## Notes to the Financial Statements continued

**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 Global Banking & Markets 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 £2.8bn. 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.

**Global Banking & Markets net exposure by credit rating of the issuer or counterparty<sup>(1)</sup>**

	2008 £m	2007 £m
AAA	10,625	4,687
AA	10,865	16,552
A	3,007	4,396
BBB	251	445
BB	91	38
B	1	5
<b>Total</b>	<b>24,840</b>	<b>26,123</b>

(1) Internal ratings are applied to all exposures.

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. 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.



## Notes to the Financial Statements continued

For trading activities the standardised risk measure adopted is Value at Risk calculated at a 95% confidence level over a one-day time horizon. 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 Risk in Global Banking & Markets

Trading activities are managed on a continuous basis, and are marked to market on a daily basis. 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 2008, 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.

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, used as a standard across the Group, means that the theoretical loss at a risk factor level is likely to be exceeded in one period in twenty. The Group addresses this risk 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		
	2008 £m	2007 £m	2006 £m
<b>Group trading instruments</b>			
Interest rate risks	5.3	3.0	1.7
Equity risks	1.2	2.2	2.9
Spread risks	1.9	1.9	0.7
Property risks	6.8	3.4	1.2
Other risks <sup>(1)</sup>	0.9	0.3	0.5
Correlation offsets <sup>(2)</sup>	(2.5)	(2.3)	(1.6)
Total correlated one-day Value at Risk	13.6	8.5	5.4

	Exposure for the year ended 31 December									
	2008 £m	Average exposure			Highest exposure			Lowest exposure		
		2007 £m	2006 £m	2008 £m	2007 £m	2006 £m	2008 £m	2007 £m	2006 £m	
<b>Group trading instruments</b>										
Interest rate risks	3.6	1.7	1.8	5.6	3.7	2.7	2.5	0.9	1.2	
Equity risks	2.0	2.4	2.7	3.5	3.7	3.9	1.0	1.6	2.0	
Spread risks	1.3	0.9	1.6	2.8	2.0	2.3	0.5	0.4	0.7	
Property risks	4.7	2.3	1.5	7.4	3.5	2.0	3.2	1.0	1.2	
Other risks <sup>(1)</sup>	0.6	0.3	0.4	1.0	1.2	0.7	0.2	0.1	0.1	
Correlation offsets <sup>(2)</sup>	(2.2)	(1.6)	(1.7)	-	-	-	-	-	-	
Total correlated one-day Value at Risk	10.0	6.0	6.3	14.5	8.8	7.4	8.0	4.1	5.1	

(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.

### 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 the Group's 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.

## Notes to the Financial Statements continued

**Credit Derivatives**

Previously, Global Banking & Markets also operated a credit derivatives business. The business traded in single-name credit derivatives 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 ALM**

The Group is responsible for managing the Abbey Group'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 Abbey Retail Banking's product and structural exposure to interest rates and, in that role, is a link between the Abbey 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 Santander and Abbey Group issued, externally rated, European asset-backed securities and residential mortgage-backed securities, other assets held for liquidity purposes, and lending to fellow subsidiaries of Banco Santander, S.A..

All credit risk meets the criteria approved by the Abbey 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 the Group's Wholesale Risk Team within Abbey.

**ALM net exposure by credit rating of the issuer or counterparty<sup>(1)</sup>**

	2008 £m	2007 £m
AAA	4,409	5,561
AA	134	439
A	3,320	57
BBB+	1,174	43
D	10	5
<b>Total</b>	<b>9,047</b>	<b>6,105</b>

(1) Internal ratings are applied to all exposures.

**Market risk in ALM**

Most market risks arising from Abbey's Retail Banking, Corporate Banking, and Abbey's 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. 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 Abbey'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 is responsible for managing risks in accordance with the Asset and Liability Management Committee's direction.

## Notes to the Financial Statements continued

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 2008 and 2007:

	2008 £m	2007 £m
Net interest margin sensitivity (100 basis points adverse parallel shock)	(64)	(7)
Market value of equity sensitivity (100 basis points adverse parallel shock)	(153)	(197)

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 14 of the Consolidated Financial Statements.

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 <sup>(1)</sup> 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. Investments in structured assets are concentrated in residential mortgage-backed securities issued by Santander entities in Spain and Portugal, with seasoned portfolios that are performing in line with expectations on the basis of strong credit ratings.

## Notes to the Financial Statements continued

The Group had limited exposure to Lehman Brothers Group arising from derivative contracts. The total claim lodged with the Administrators was £9m and was fully provided for at the year end. The Group had no exposure to Washington Mutual and only a £24m exposure to Iceland which is covered by credit default swap protection. At 31 December 2008, the Group also had indirect exposure of euro 3m to Madoff funds through a structured note. This note was closed out with no loss in February 2009.

Details of the Group's investing and lending arrangements with respect to floating rate notes ('FRNs'), asset-backed securities, Collateralised Debt and Loan Obligations ('CDOs' and 'CLOs'), Structured Investment Vehicles ('SIVs'), monoline Insurers, off-balance sheet entities, other holdings for liquidity purposes, and lending activities are set out below.

## Floating Rate Notes

Country	Nominal value		Fair value movement		Provisions and write-offs	Fair value	Value as % of nominal value
	2008	2008	Income statement				
	£m	%	2008	2008			
			2008	2008	2008	2008	2008
			£m	£m	£m	£m	%
UK	2,153	42	(4)	-	-	2,194	102
Italy	215	4	(1)	-	-	215	100
Spain	522	10	(2)	-	-	523	100
Rest of Europe	1,722	34	(15)	-	-	1,676	97
US	108	2	-	-	-	109	101
Rest of World	384	8	(3)	-	-	384	100
	5,104	100	(25)	-	-	5,101	100

Credit rating	Nominal value		Fair value movement		Provisions and write-offs	Fair value	Value as % of nominal value
	2008	2008	Income statement				
	£m	%	2008	2008			
			2008	2008	2008	2008	2008
			£m	£m	£m	£m	%
AA and above	4,085	80	(17)	-	-	4,062	99
A and below	1,019	20	(8)	-	-	1,039	102
Total	5,104	100	(25)	-	-	5,101	100

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

## Asset-Backed Securities

The Group has acquired highly rated, European asset-backed securities ('ABS') and residential mortgage-backed securities with a total value of £4,087m (2007: £5,515m). 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.

Country	Nominal value		Fair value movement		Provisions and write-offs	Fair value	Value as % of nominal value
	2008	2008	Income statement				
	£m	%	2008	2008			
			2008	2008	2008	2008	2008
			£m	£m	£m	£m	%
Europe (excluding UK)							
ABS	363	8	(23)	-	-	336	92
MBS	4,155	92	(305)	-	-	3,751	90
	4,518	100	(328)	-	-	4,087	90

Credit rating	Nominal value		Fair value movement		Provisions and write-offs	Fair value	Value as % of nominal value
	2008	2008	Income statement				
	£m	%	2008	2008			
			2008	2008	2008	2008	2008
			£m	£m	£m	£m	%
AAA							
ABS	352	8	(23)	-	-	325	92
MBS	3,855	85	(266)	-	-	3,496	91
	4,207	93	(289)	-	-	3,821	91
Aa1							
ABS	11	-	(1)	-	-	10	91
MBS	300	7	(38)	-	-	256	85
	311	7	(39)	-	-	266	85
	4,518	100	(328)	-	-	4,087	90

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

## Notes to the Financial Statements continued

### 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 2008 was £186m.

### Structured Investment Vehicles

The Group has insignificant holdings in SIVs, with a nominal value of £17m (2007: £40m) against which provisions of £12m (2007: £10m) are held, giving a book value of £5m (2007: £30m).

### Monoline Insurers

The Group has a £41m exposure to a corporate bond which is wrapped by a monoline insurer. In this instance, principal risk exposure is recorded against the corporate bond, with the monoline wrap being viewed as contingent exposure.

### 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 £3,213m (2007: £2,455m), and the total value of repurchases held by the Group is £254m (2007: £322m).

### 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 £1.1bn where the Group faces external counterparties and the risk has been hedged with Banco Santander, S.A. in Spain.

### Lending Activities

The Group is principally a retail prime lender and has no appetite or product offering for any type of sub-prime business. The Group's credit policy explicitly prohibits such lending and is specifically designed to ensure that any business written is responsible, affordable (both initially and on an on-going basis) and of a good credit quality. The Group's principal lending activities arise in the Retail Banking division. For further information, see Risk Management in Retail Banking and Group Infrastructure.

### 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 significantly higher level of liquid assets than in 2007, in recognition of the current market conditions.

## Liquidity risk

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

The liquidity risks of the Group are managed on a combined basis with Abbey National plc. For further information please refer to the liquidity risk discussion in the Risk Management Report in Abbey National 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. The 'Up to 3 months' grouping largely constitutes wholesale funding of wholesale assets of a similar maturity.

## Notes to the Financial Statements continued

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

At 31 December 2008	Group					Total £m
	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	
Deposits by banks	7,400	59,750	7,124	21,501	36,025	131,800
Customer accounts	117	1,770	70	569	623	3,149
Derivative financial instruments	1,358	1,294	2,640	11,256	33,381	49,929
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
Debt securities in issue	-	10,614	5,396	5,844	24,036	45,890
Subordinated liabilities	-	40	24	130	489	683
	13,940	106,194	17,318	42,799	97,269	277,520

At 31 December 2008	Company					Total £m
	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	
Deposits by banks	7276	59,745	7,124	21,501	36,024	131,670
Customer accounts	117	8,292	265	705	620	9,999
Derivative financial instruments	1,296	648	2,516	11,361	33,347	49,168
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
Debt securities in issue	-	6,995	5,172	5,845	24,036	42,048
	15,189	90,311	16,634	42,911	96,872	261,917

At 31 December 2007	Group					Total £m
	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	
Deposits by banks	2,623	18,590	4,175	21,199	5,507	52,094
Customer accounts	-	1,767	20	15	97	1,899
Derivative financial instruments	3	514	796	5,123	12,650	19,086
Trading liabilities	21,067	28,973	2,931	1,409	1,515	55,895
Financial liabilities designated at fair value	-	1,598	2,111	3,647	1,800	9,156
Debt securities in issue	-	6,107	1,353	2,703	3,079	13,242
Subordinated liabilities	-	40	24	130	522	716
	23,693	57,589	11,410	34,226	25,170	152,088

At 31 December 2007	Company					Total £m
	Demand £m	Up to 3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	
Deposits by banks	2,524	17,152	4,824	25,072	7,282	56,854
Customer accounts	-	9,429	282	15	97	9,823
Derivative financial instruments	-	254	695	4,797	14,219	19,965
Trading liabilities	2,965	26,066	2,931	1,409	1,515	34,886
Financial liabilities designated at fair value	-	1,598	2,111	3,647	1,800	9,156
Debt securities in issue	-	67	1,281	2,703	3,079	7,130
	5,489	54,566	12,124	37,643	27,992	137,814

## Financial instruments

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The accounting policies note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. Each class of financial asset and liability on the balance sheet has a single measurement basis which is described in the accounting policies note.

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

	Group		
	Carrying value 2008 £m	Fair value 2008 £m	Surplus/ (deficit) 2008 £m
<b>Assets</b>			
Cash and balances at central banks	8	8	-
Loans and advances to banks	147,089	148,980	1,891
Loans and advances to customers	24,730	24,733	3
<b>Liabilities</b>			
Deposits by banks	123,496	123,786	(290)
Customer accounts	2,933	2,817	116
Debt securities in issue	33,927	33,788	139
Subordinated liabilities	432	268	164

## Notes to the Financial Statements continued

	Carrying value 2008 £m	Fair value 2008 £m	Company Surplus/ (deficit) 2008 £m
<b>Assets</b>			
Cash and balances at central banks	8	8	-
Loans and advances to banks	128,035	129,926	1,891
Loans and advances to customers	25,027	25,030	3
<b>Liabilities</b>			
Deposits by banks	123,366	123,656	(290)
Customer accounts	9,743	9,627	116
Debt securities in issue	29,692	29,553	139
Subordinated liabilities	-	-	-

	Carrying value 2007 £m	Fair value 2007 £m	Group Surplus/ (deficit) 2007 £m
<b>Assets</b>			
Cash and balances at central banks	7	7	-
Loans and advances to banks	57,711	57,931	220
Loans and advances to customers	4,632	4,632	-
<b>Liabilities</b>			
Deposits by banks	51,788	51,788	-
Customer accounts	1,844	1,844	-
Debt securities in issue	11,929	11,620	308
Subordinated liabilities	331	397	(66)

	Carrying value 2007 £m	Fair value 2007 £m	Company Surplus/ (deficit) 2007 £m
<b>Assets</b>			
Cash and balances at central banks	7	7	-
Loans and advances to banks	57,021	57,241	220
Loans and advances to customers	6,181	6,181	-
<b>Liabilities</b>			
Deposits by banks	49,847	49,847	-
Customer accounts	9,714	9,714	-
Debt securities in issue	5,840	5,532	308

The surplus/(deficit) in the table above represents the surplus/(deficit) of fair value compared to the carrying amount of those financial instruments for which fair values have been estimated.

### Fair value measurement

The fair value of financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. Where quoted market prices are not available fair value is determined using pricing models which use a mathematical methodology based on accepted financial theories, depending on the product type and its components. Pricing models take into account the contract terms of the securities as well as market-based valuation parameters, such as interest rates, volatility, exchange rates and the credit rating of the counterparty. Valuation adjustments are an integral component of the fair value estimation process and are taken on individual positions where either the absolute size of the trade or other specific features of the trade or the particular market (such as counterparty credit risk, concentration or market liquidity) require more than the simple application of pricing models. Further information on fair value measurement can be found in "Critical Accounting Policies" within the Accounting Policies on page 23.

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.

## Notes to the Financial Statements continued

## Liabilities

## Deposits by banks

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

## 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.

## 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.

## Net gains and losses on financial instruments

	2008	2007
	£m	£m
Financial assets and liabilities at fair value through profit or loss on initial recognition	363	(32)
Financial assets and liabilities held for trading	(1,072)	690
Loans and receivables	6,353	2,854
Financial liabilities held at amortised cost	(5,139)	(3,058)
	<b>505</b>	<b>454</b>

## Capital management and resources

## Capital management and capital allocation

The Abbey 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 Abbey group of companies. Authority for capital management flows to the Chief Executive and from him to specific individuals who are members of the Abbey's Asset and Liability Management Committee ('ALCO').

ALCO adopts a centralised capital management approach that is driven by the Abbey's corporate purpose and strategy. This approach takes into account the regulatory and commercial environment in which the Abbey operates, Abbey's risk appetite, the management strategy for each of Abbey's material risks (including whether or not capital provides an appropriate risk mitigant) and the impact of appropriate adverse scenarios and stresses on Abbey's capital requirements. This approach is reviewed annually as part of Abbey's Internal Capital Adequacy Assessment Process ('ICAAP').

On an ongoing basis and in accordance with the latest ICAAP review, Abbey 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 and ICAAP reviews 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.

Abbey manages its equity and debt funding requirements based on the results of the ICAAP, its strategy for managing liquidity and funding risks and by discussion with Santander. Abbey has its own active debt management programme. 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 the Abbey's capital needs.

## Capital adequacy

From 1 January 2008, the Group has managed its capital on a Basel II basis

## Capital table

	Basel II	Basel I
	31 December	31 December
	2008	2007
	£m	£m
Tier 1 capital	3,210	3,077
Deductions from tier 1 capital	(69)	-
<b>Total tier 1 capital</b>	<b>3,141</b>	<b>3,077</b>
Tier 2 capital – subordinated debt	100	-
Deductions from tier 2 capital	(62)	-
<b>Total Tier 2 capital</b>	<b>38</b>	<b>-</b>
<b>Total Capital Resources</b>	<b>3,179</b>	<b>3,077</b>



## Notes to the Financial Statements continued

### Regulatory Capital Base

The Group's Tier 1 capital consists of shareholders' equity and audited profits for the years ended 31 December 2008 and 31 December 2007 after adjustment to comply with FSA rules. The increase in tier 1 capital primarily represents the inclusion of audited profits for the year ended 31 December 2008. 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 increase in tier 2 capital represents subordinated debt issued during the year. The deductions relate to expected losses in excess of credit provisions for portfolios on the IRB approach for measuring credit risk.