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

We have audited the financial statements of Alliance & Leicester plc for the year ended 31 December 2009 which comprise the Consolidated Income Statement, the Consolidated and Company Statements of Comprehensive Income, the Consolidated and Company Balance Sheets, the Consolidated and Company Statements of Changes in Equity, the Consolidated and Company Cash Flow Statements, the Accounting Policies and the related Notes 1 to 44. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006.

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

Respective responsibilities of directors and auditors

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

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and the parent Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion:

> the financial statements give a true and fair view of the state of the Group's and the Company's affairs as at 31 December 2009 and of the Group's profit for the year then ended;

> the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;

> the Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and

> the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

Separate opinion in relation to IFRSs as issued by the IASB

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

Modified opinion

In forming our opinion on the financial statements, which is not qualified, we have considered the adequacy of the disclosure made in Note 1 to the financial statements, which explains that the financial statements have been prepared on a basis other than that of a going concern.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

> adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or

> the financial statements are not in agreement with the accounting records and returns; or

> certain disclosures of directors' remuneration specified by law are not made; or

> we have not received all the information and explanations we require for our audit.

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

Consolidated Income Statement

For the years ended 31 December 2009 and 2008

	Notes	**2009 £m**	2008 £m
Interest and similar income	2	**2,364**	4,032
Interest expense and similar charges	2	**(1,602)**	(3,648)
Net interest income		**762**	384
Fee and commission income	3	**397**	471
Fee and commission expense	3	**(44)**	(79)
Net fee and commission income		**353**	392
Net trading and other income	4	**98**	48
Total operating income		**1,213**	824
Administration expenses	5	**(606)**	(927)
Depreciation and amortisation	6	**(121)**	(114)
Total operating expenses excluding provisions and charges		**(727)**	(1,041)
Impairment losses on loans and advances	8	**(348)**	(1,033)
Provisions for other liabilities and charges	31	**(81)**	(38)
Total operating provisions and charges		**(429)**	(1,071)
Profit/(loss) before tax		**57**	(1,288)
Taxation credit	9	**3**	370
Profit/(loss) for the year		**60**	(918)
Attributable to:			
Equity holders of the parent		**24**	(954)
Innovative Tier 1 holders	34	**17**	17
Preference shareholders	35	**19**	19

The Notes on pages 68 to 107 are an integral part of these Consolidated Financial Statements.

All profits/(losses) during the year were generated from continuing operations.

Consolidated Statement of Comprehensive Income

For the years ended 31 December 2009 and 2008

	Notes	**2009 £m**	2008 £m
Profit/(loss) for the year		**60**	(918)
Other comprehensive income/(loss):			
Actuarial losses on retirement benefit obligations	32	**(192)**	(60)
Gains/(losses) on available-for-sale securities		**180**	(241)
Share-based payments		**-**	(7)
(Losses)/gains on cash flow hedges taken directly to equity		**(15)**	259
Tax on items taken directly to equity		**3**	8
Net loss recognised directly in equity		**(24)**	(41)
Losses on available-for-sale securities transferred to profit or loss on sale		**-**	32
Cash flow hedges transferred to profit or loss		**-**	(11)
Tax on items transferred to profit		**-**	(6)
Net transfers to profit		**-**	15
Total other comprehensive income for the year before tax		**(27)**	(28)
Tax relating to components of other comprehensive income		**3**	2
Total comprehensive income/(loss) for the year		**36**	(944)
Attributable to:			
Equity holders of the parent		**-**	(980)
Innovative Tier 1 holders	34	**17**	17
Preference shareholders	35	**19**	19

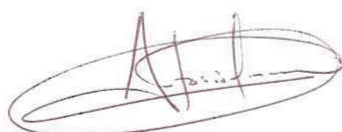
Consolidated Balance Sheet

As at 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Assets			
Cash and balances at central banks	11	**446**	1,553
Derivative financial instruments	12	**1,108**	2,876
Financial assets designated at fair value	13	**50**	63
Loans and advances to banks	14	**49,857**	1,239
Loans and advances to customers	15	**46,796**	51,402
Available-for-sale securities	17	**11**	1,658
Loan and receivable securities	18	**9,828**	14,250
Macro hedge of interest rate risk		**444**	713
Intangible assets	20	**38**	17
Property, plant and equipment	21	**206**	223
Operating lease assets	22	**312**	348
Current tax assets		**81**	17
Deferred tax assets	23	**409**	626
Other assets	24	**352**	259
Total assets		**109,938**	75,244
Liabilities			
Deposits by banks	25	**52,458**	11,516
Deposits by customers	26	**43,436**	39,765
Derivative financial instruments	12	**198**	1,533
Financial liabilities designated at fair value	27	**83**	728
Debt securities in issue	28	**9,981**	17,477
Subordinated liabilities	29	**1,028**	1,436
Other liabilities	30	**503**	631
Provisions	31	**12**	34
Current tax liabilities		**20**	1
Deferred tax liabilities	23	**255**	278
Retirement benefit obligations	32	**150**	17
Total liabilities		**108,124**	73,416
Equity			
Innovative Tier 1	34	**297**	311
Preference shares	35	**294**	294
		591	605
Share capital	35	**928**	328
Share premium account	35	**124**	724
Other reserves		**75**	(39)
Retained earnings		**96**	210
Total ordinary shareholders' equity		**1,814**	1,828
Total liabilities and equity		**109,938**	75,244

The Notes on pages 68 to 107 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 48 to 107 were approved and authorised for issue by the Board on 27 April 2010 and signed on its behalf by:



Antonio Lorenzo
Chief Financial Officer

Company Registered Number 3263713

Consolidated Statement of Changes in Equity

For the years ended 31 December 2009 and 2008

				Other reserves							
	Share Capital £m	Share Premium £m	Other equity £m	Capital redemption reserve £m	Available for sale reserve £m	Cash flow hedging reserve £m	Share based payment reserve £m	Retained earnings £m	Total £m	Non-controlling interest £m	Total £m
1 January 2008	210	125	605	90	(143)	(14)	26	1,421	2,320	4	2,324
Total comprehensive income (gross)	-	-	-	-	(209)	248	(7)	(978)	(946)	-	(946)
Tax relating to components of other comprehensive income	-	-	-	-	59	(70)	(2)	15	2	-	2
Dividends declared	-	-	-	-	-	-	-	(265)	(265)	-	(265)
Issue of share capital	118	599	-	-	-	-	-	-	717	-	717
Transfer from share-based payment reserve	-	-	-	-	-	-	(17)	17	-	-	-
Disposal	-	-	-	-	-	-	-	-	-	(4)	(4)
31 December 2008	328	724	605	90	(293)	164	-	210	1,828	-	1,828
1 January 2009	**328**	**724**	**605**	**90**	**(293)**	**164**	**-**	**210**	**1,828**	**-**	**1,828**
Total comprehensive income (gross)	**-**	**-**	**-**	**-**	**180**	**(15)**	**-**	**(132)**	**33**	**-**	**33**
Tax relating to components of other comprehensive income	**-**	**-**	**-**	**-**	**(55)**	**4**	**-**	**54**	**3**	**-**	**3**
Dividends declared	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**(36)**	**(36)**	**-**	**(36)**
Issue of share capital	**600**	**(600)**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Other movements	**-**	**-**	**(14)**	**-**	**-**	**-**	**-**	**-**	**(14)**	**-**	**(14)**
31 December 2009	**928**	**124**	**591**	**90**	**(168)**	**153**	**-**	**96**	**1,814**	**-**	**1,814**

Consolidated Cash Flow Statement

For the years ended 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Net cash flow from operating activities			
Profit/(loss) for the year		**60**	(918)
Adjustments for:			
Non-cash items included in net profit		**342**	901
Change in operating assets		**(23,587)**	(411)
Change in operating liabilities		**37,789**	4,059
Income taxes (paid)/received		**(3)**	21
Effects of exchange rate differences		**(841)**	-
Net cash flow from operating activities	37	**13,760**	3,652
Net cash flow from investing activities			
Acquisition of subsidiaries, net of cash acquired		**-**	(19)
Purchase of tangible and intangible fixed assets		**(132)**	(241)
Proceeds from sale of tangible and intangible fixed assets		**44**	48
Purchase of non-trading securities		**(3)**	(743)
Proceeds from sale of non-trading securities		**1,650**	2,660
Net cash flow from investing activities		**1,559**	1,705
Net cash flow (used in) financing activities			
Issue of debt securities		**-**	4,066
Repayment of debt securities		**-**	(11,346)
Issue of ordinary shares		**-**	701
Repayment of loan capital		**(2,381)**	-
Preference dividend paid		**(19)**	(19)
Interest paid on innovative Tier 1		**(17)**	(17)
Ordinary dividends paid		**-**	(229)
Net cash flow (used in) financing activities		**(2,417)**	(6,844)
Net increase/(decrease) in cash and cash equivalents		**12,902**	(1,487)
Cash and cash equivalents at beginning of the year		**2,369**	3,856
Cash and cash equivalents at the end of the year		**15,271**	2,369

The Notes on pages 68 to 107 are an integral part of these Consolidated Financial Statements.

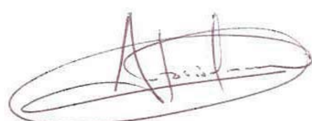
Company Balance Sheet

As at 31 December 2009 and 2008

	Notes	2009 £m	2008 £m
Assets			
Cash and balances at central banks	11	**446**	1,553
Derivative financial instruments	12	**582**	2,190
Financial assets designated at fair value	13	**50**	63
Loans and advances to banks	14	**46,208**	1,236
Loans and advances to customers	15	**52,132**	52,604
Available-for-sale securities	17	**8**	1,654
Loan and receivable securities	18	**9,994**	14,321
Macro hedge of interest rate risk		**306**	557
Investment in subsidiary undertakings	19	**887**	1,091
Intangible assets	20	**38**	16
Property, plant and equipment	21	**133**	148
Current tax assets		**76**	58
Deferred tax assets	23	**286**	358
Other assets	24	**310**	1,431
Total assets		**111,456**	77,280
Liabilities			
Deposits by banks	25	**54,085**	13,585
Deposits by customers	26	**47,691**	41,222
Derivative financial instruments	12	**318**	1,671
Financial liabilities designated at fair value	27	**83**	728
Debt securities in issue	28	**5,879**	12,084
Subordinated liabilities	29	**1,028**	1,436
Other liabilities	30	**540**	4,649
Provisions	31	**11**	-
Deferred tax liabilities	23	**-**	73
Retirement benefit obligations	32	**150**	17
Total liabilities		**109,785**	75,465
Equity			
Innovative Tier 1	34	**297**	311
Preference shares	35	**294**	294
		591	605
Share capital	35	**928**	328
Share premium account	35	**124**	724
Other reserves		**60**	(62)
Retained earnings		**(32)**	220
Total ordinary shareholders' equity		**1,671**	1,815
Total liabilities and equity		**111,456**	77,280

The Notes on pages 68 to 107 are an integral part of these Consolidated Financial Statements.

The Financial Statements on pages 48 to 107 were approved and authorised for issue by the Board on 27 April 2010 and signed on its behalf by:



Antonio Lorenzo
Chief Financial Officer

Company Registered Number 3263713

Company Statement of Comprehensive Income

For the years ended 31 December 2009 and 2008

	Notes	**2009 £m**	2008 £m
Loss for the year		**(78)**	(275)
Other comprehensive income/(loss):			
Actuarial losses on retirement benefit obligations	32	**(192)**	(60)
Gains/(losses) on available-for-sale securities		**180**	(241)
Share-based payments		**-**	(7)
(Losses)/gains on cash flow hedges taken directly to equity		**(4)**	235
Tax on items taken directly to equity		**-**	15
Net loss recognised directly in equity		**(16)**	(58)
Gains on available-for-sale securities transferred to profit or loss on sale		**-**	14
Impairment losses transferred to profit or loss		**-**	18
Cash flow hedges transferred to profit or loss		**-**	(24)
Tax on items transferred to profit		**-**	(2)
Net transfers to profit		**-**	6
Total other comprehensive income/(loss) for the year before tax		**(16)**	(65)
Tax relating to components of other comprehensive income		**-**	13
Total comprehensive income/(loss) for the year		**(94)**	(327)
Attributable to:			
Equity holders of the parent		**(130)**	(363)
Innovative Tier 1 holders	34	**17**	17
Preference shareholders	35	**19**	19

Company Statement of Changes in Equity

For the years ended 31 December 2009 and 2008

	Share Capital £m	Share Premium £m	Other equity £m	Other reserves: Capital redemption reserve £m	Other reserves: Available for sale reserve £m	Other reserves: Cash flow hedging reserve £m	Other reserves: Share based payment reserve £m	Retained earnings £m	Total £m
1 January 2008	210	125	605	90	(143)	(11)	26	788	1,690
Transfer from share-based payment reserve	-	-	-	-	-	-	(17)	17	-
Total comprehensive income (gross)	-	-	-	-	(209)	211	(7)	(335)	(340)
Tax relating to components of other comprehensive income	-	-	-	-	59	(59)	(2)	15	13
Dividends	-	-	-	-	-	-	-	(265)	(265)
Issue of share capital	118	599		-	-	-	-	-	717
31 December 2008	328	724	605	90	(293)	141	-	220	1,815
1 January 2009	**328**	**724**	**605**	**90**	**(293)**	**141**	-	**220**	**1,815**
Total comprehensive income (gross)	**-**	**-**	**-**	**-**	**180**	**(4)**	**-**	**(270)**	**(94)**
Tax relating to components of other comprehensive income	**-**	**-**	**-**	**-**	**(55)**	**1**	**-**	**54**	**-**
Dividends	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**(36)**	**(36)**
Transfer between reserves	**600**	**(600)**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Other movements	**-**	**-**	**(14)**	**-**	**-**	**-**	**-**	**-**	**(14)**
31 December 2009	**928**	**124**	**591**	**90**	**(168)**	**138**	**-**	**(32)**	**1,671**

Company Cash Flow Statement

For the years ended 31 December 2009 and 2008

	Notes	**2009 £m**	2008 £m
Net cash flow from operating activities			
Loss for the year		**(78)**	(275)
Adjustments for:			
Non-cash items included in net loss		**854**	619
Change in operating assets		**(23,858)**	(1,937)
Change in operating liabilities		**36,180**	4,488
Income taxes (paid)/received		**(3)**	32
Effects of exchange rate differences		**(409)**	-
Net cash flow from operating activities	37	**12,686**	2,927
Net cash flow from investing activities			
Increase in investment in subsidiaries		**-**	(5)
Purchase of tangible and intangible fixed assets		**(116)**	(86)
Proceeds from sale of tangible and intangible fixed assets		**64**	1
Purchase of non-trading securities		**(3)**	(822)
Proceeds from sale of non-trading securities		**1,649**	2,463
Net cash flow from investing activities		**1,594**	1,551
Net cash flow used in financing activities			
Issue of debt securities		**-**	3,676
Repayment of debt securities		**-**	(10,058)
Issue of ordinary shares		**-**	701
Repayment of loan capital		**(1,749)**	-
Preference dividend paid		**(19)**	(19)
Interest paid on innovative Tier 1		**(17)**	(17)
Ordinary dividends paid		**-**	(229)
Net cash flow used in financing activities		**(1,785)**	(5,946)
Net increase/(decrease) in cash and cash equivalents		**12,495**	(1,468)
Cash and cash equivalents at beginning of the year		**2,367**	3,835
Cash and cash equivalents at the end of the year		**14,862**	2,367

The Notes on pages 68 to 107 are an integral part of these Consolidated Financial Statements.

Accounting Policies

International Financial Reporting Standards

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

Disclosures required by IFRS 7 'Financial Instruments: Disclosure' relating to the nature and extent of risks arising from financial instruments can be found in the Risk Management section on pages 15 to 37 which forms part of these Consolidated Financial Statements.

Recent developments

In 2009, the Group adopted the following new or revised IFRS:

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

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

c) IFRS 2 'Share based payments - vesting conditions and cancellations' - On 17 January 2008, the IASB issued an amendment to IFRS 2 'Share based payments' which requires share option awards lapsing due to a failure to meet the service condition to be treated as cancellations rather than forfeitures. The adoption of the amendment to IFRS 2 did not have a material impact on the Group's profit or loss or financial position.

d) IFRS 7 'Financial Instruments: Disclosures - Improving Disclosures about Financial Instruments' - On 5 March 2009, the IASB issued an amendment to IFRS 7 'Financial Instruments: Disclosures' which requires enhanced disclosures about fair value measurements and liquidity risk. Among other things, the amendment (1) requires disclosure of any change in the method for determining fair value and the reasons for the change; (2) establishes a three-level hierarchy for making fair value measurement disclosures; (3) requires disclosure for each fair value measurement in the balance sheet of which level in the hierarchy was used, and any transfers between levels, with additional disclosures whenever level 3 of the hierarchy is used including a measure of sensitivity to a change in input data; (4) clarifies that the current maturity analysis for non-derivative financial liabilities should include issued financial guarantee contracts; and (5) amends the required disclosure of a maturity analysis for derivative financial liabilities. The disclosures required by the amendment to IFRS 7 may be found on pages 21 and 104 to 106.

Future developments

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

a) IFRS 3 'Business Combinations' - On 10 January 2008, the IASB issued an amendment to IFRS 3 'Business Combinations' which clarifies and changes certain elements of accounting for a business combination, including measurement of contingent consideration, step 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.

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

Basis of preparation

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

Going concern

The Company's objectives, policies and processes for managing its capital are described in Note 44. Details of the Company's financial risk management objectives, its financial instruments and hedging activities; and its exposures to credit risk, interest rate risk, liquidity risk, operational risk and other risks are set out in the Risk Management Report on pages 15 to 37.

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

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

After making enquiries, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. As set out in Note 42, there is an intention to substantially reduce trading in the next twelve months, subject to UK Financial Services Authority support and Court approval, by the transfer of the Alliance & Leicester business into Santander UK plc under a scheme allowed by Part VII of the Financial Services and Markets Act 2000. IAS 1 requires that financial statements for any Company that has ceased to trade, or substantially reduced trading, or where there is an intention for the Company to cease to trade, or substantially reduce trading in the next twelve months, are prepared on an "other than going concern" basis. Accordingly the financial statements have been prepared on an "other than going concern" basis as there is the intention to substantially reduce trading in the next twelve months. In accordance with Santander UK's accounting policy of accounting for internal reorganisations, the assets and liabilities of the Alliance & Leicester business will be transferred to Santander UK at their book values in Alliance & Leicester. Preparation of the financial statements on an "other than going concern" basis has therefore had no impact on the amounts reported.

Consolidation

a) Subsidiaries

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

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

b) Jointly controlled entities

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

Foreign currency translation

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

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

Accounting Policies continued

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

The amount of exchange rate differences recognised in profit or loss on items not at fair value through profit and loss was £832m charge (2008: £nil). 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 available-for-sale, and interest expense on financial liabilities other than those at fair value through profit and loss are determined using the effective interest method. The effective interest rate is the rate that discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the future cash flows are estimated after considering all the contractual terms of the instrument excluding future credit losses. The calculation includes all amounts paid or received by the Group that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of the financial instrument and all other premiums or discounts. Interest income on assets classified as loans and receivables or available-for-sale, interest expense on liabilities classified at amortised cost and interest income and expense on hedging derivatives are recognised in interest and similar income and interest expense and similar charges in the income statement.

(b) Fee and commissions income
Fees and commissions that are not an integral part of the effective interest rate are recognised when the service has been provided. For retail products, fee and commission income consists principally of collection services fees, commission on foreign currencies, and fees for non-banking financial products. Revenue from these income streams is recognised as earned when the service is provided.

For insurance products, fee and commission income consists principally of commissions earned on the sale of building and contents insurance, life protection insurance and payment cover insurance.

Asset management fee and commission income comprises portfolio and other management advisory and service fees, investment fund management fees, and fees for private banking, financial planning and custody services. Portfolio and other management advisory and service fees are recognised based on the applicable service contracts. Asset management fees related to investment funds are recognised rateably over the period the service is provided. The same principle is applied for private banking, financial planning and custody services that are continuously provided over an extended period of time.

(c) Net trading and other income
Net trading and other income comprises all gains and losses from changes in the fair value of financial assets and liabilities held at fair value through profit or loss (including financial assets and financial liabilities held for trading and designated as fair value through profit or loss), together with related interest income, expense and dividends. It also includes income from operating lease assets, and profits/(losses) on the sales of fixed assets and subsidiary undertakings.

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

Pensions and other post retirement benefits

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

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

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

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

Share-based payments

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

Non-market vesting conditions are taken into account by adjusting the number of shares or share options included in the measurement of the cost of employee service so that ultimately, the amount recognised in the income statement reflects the number of vested shares or share options. Further details on the Schemes can be found in Notes 39 and 41.

Goodwill and other intangible assets

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

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

Property, plant and equipment

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

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

Owner-occupied properties	Not exceeding 50 years
Office fixtures and equipment	3 to 15 years
Computer software	3 to 7 years

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

Accounting Policies continued

Financial assets

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

(a) Financial assets at fair value through profit or loss
Financial assets are classified 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 as fair value through profit or loss where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring assets or recognising the gains or losses on them on a different basis, where the assets are managed and their performance evaluated on a fair value basis, or where a financial asset contains one or more embedded derivatives which are not closely related to the host contract.

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

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

(c) Available-for-sale financial assets
Available-for-sale financial assets are non-derivative financial assets that are designated as available-for-sale and are not categorised into any of the other categories described. They are initially recognised at fair value including direct and incremental transaction costs. They are subsequently held at fair value. Gains and losses arising from changes in fair value are included as a separate component of equity until sale when the cumulative gain or loss is transferred to the income statement. Interest is determined using the effective interest method.

Gains and losses arising on securities prior to reclassification in the available-for-sale reserve is being recognised on a straight-line basis over the period to maturity of the assets, which is considered to be immaterially different to using the effective interest rate basis.

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

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

Valuation of financial instruments

In 2008, the Group adopted the amendment to IAS 39 published on 13 October 2008 and, where permitted, reclassified financial assets held-for-trading and available-for-sale assets to loans and receivables with effect from 1 July 2008 (see Note 18).
Financial instruments that are classified at fair value through profit or loss (including those held for trading purposes) or available-for-sale, and all derivatives, are stated at fair value. The fair value of such financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing, knowledgeable parties, other than in a forced or liquidation sale.

Initial measurement

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

Subsequent measurement

Fair value hierarchy

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

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

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

Level 3: Inputs to the pricing or valuation techniques that are significant to the overall fair value measurement of the asset or liability are unobservable. Level 3 positions consist solely of debt securities containing embedded derivatives.

The Group assesses active markets for equity instruments based on the average daily trading volume both in absolute terms and relative to the market capitalisation for the instrument. The Group assesses active markets for debt instruments based on both the average daily trading volume and the number of days with trading activity. The Group assesses active markets for exchange traded derivatives based on the average daily trading volume both in absolute terms and relative to the market capitalisation for the instrument. Market activity and liquidity is discussed in the relevant monthly Risk Forum as well as being part of the daily update given by each business at the start of the trading day. This information, together with the observation of active trading and the magnitude of the bid-offer spreads allow consideration of the liquidity of a financial instrument.

All underlying assets and liabilities are reviewed to consider the appropriate adjustment to mark the mid price reported in the trading systems to a realisable value. This process takes into account the liquidity of the position in the size of the adjustment required. These liquidity adjustments are presented and discussed at the monthly Risk Forum.

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

Financial instruments valued using observable market prices

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

Financial instruments valued using a valuation technique

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

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

The timing of recognition of deferred day one profit and loss is determined individually. It is deferred until either the instrument’s fair value can be determined using market observable inputs or is realised through settlement. The financial instrument is subsequently measured at fair value, adjusted for the deferred day one profit and loss. Subsequent changes in fair value are recognised immediately in the consolidated income statement without immediate reversal of deferred day one profits and losses.

Accounting Policies continued

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 'Loan and receivable securities' and the counterparty liabilities are included in 'Deposits by customers'.

Derivative financial instruments

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

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

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

Hedge accounting

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

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

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

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

For fair value hedges, changes in the fair value of the hedged risk and hedged item are recognised in net trading and other income. 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.

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

Securitisation transactions

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

Impairment of financial assets

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

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

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

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

In making collective assessment for impairment, financial assets are assessed for each portfolio segmented by similar risk characteristics. For each risk segment, future cash flows from these portfolios are estimated through the use of historical loss experience. The historical loss experience is adjusted for current observable data, including estimated current property prices, to reflect the effects of current conditions not affecting the period of historical experience. The loss is discounted at the effective interest rate, except where portfolios meet the criteria for short-term receivables. The unwind of the discount over time is reported through interest receivable within the income statement, with the provision on the balance sheet increasing.

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

Generally, the length of time before an asset is placed on default status for provisioning is when one payment is missed. Repayment default periods vary depending on the nature of the collateral that secures the advances. On advances secured by residential property, the default period is three months.

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

A provision for inherent losses is made for loan losses that have been incurred but have not been separately identified at the balance sheet date because the loan is not yet past due. An example of this situation is where a borrower has not yet missed a payment but is experiencing financial difficulties at the reporting date, e.g. due to loss of employment or divorce. In these circumstances, an inherent loss had been incurred at the reporting date. The provision for inherent losses is determined on a portfolio basis based on management's best estimate of the current position based on past experience adjusted by current trends. These statistical techniques involve the following (i) estimation of a period of time called the emergence period, which is discussed below, (ii) assessment of the number of accounts that go into arrears over the emergence period, and (iii) application of the provision methodology outlined for observed provisions to these accounts identified as impaired as a result of this exercise. Accounts that suffered credit deterioration after the reporting date are accordingly excluded from the statistical analysis.

The emergence period
This is the period which the Group's statistical analysis shows to be the period in which losses that had been incurred but have not been separately identified at the balance sheet date, become evident as the loans turn into past due. Based on the Group's statistical analysis at 31 December 2009, the emergence period was two to three months for unsecured lending and 12 months for secured lending. The longer emergence period for secured lending reflects the fact that a customer is more likely to default on unsecured debt before defaulting on secured lending. The factors considered in determining the length of the emergence period for unsecured lending are recent changes in customers' debit/credit payment profiles and credit scores. The factors considered for secured lending are the frequency and duration of exceptions from adherence to the contractual payment schedule.

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

Accounting Policies continued

Impairment losses are recognised in the income statement and the carrying amount of the financial asset or group of financial assets is reduced by establishing an allowance for impairment losses. If in a subsequent period the amount of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance. For secured loans, a write-off is only made when all collection procedures have been exhausted and the security has been sold. For unsecured loans, a write-off is only made when all internal avenues of collecting the debt have been exhausted and the debt is passed over to external collection agencies. Write-offs are charged against previously established provisions for impairment.

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

Corporate assets

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

In such situations, the file is transferred to the Corporate Banking Workouts team within Credit Risk As part of their assessment, 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.

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

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

Loans and receivables securities

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

(b) Available-for-sale financial assets

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In assessing whether assets are impaired, a significant or prolonged decline in the fair value of the security below its cost is considered evidence. The cumulative loss is measured as the difference between the acquisition cost and the current fair value, less any impairment loss previously reported in the income statement and is removed from equity and recognised in the income statement.

If in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase is due to an event occurring after the impairment loss was recognised in the income statement (with objective evidence to support this), the impairment loss is reversed through the income statement.

Impairment of non-financial assets

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

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

Leases

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

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

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

Income taxes, including deferred taxes

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

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

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

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries except where the Group is able to control reversal of the temporary difference and it is probable that it will not reverse in the foreseeable future.

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

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

Cash and cash equivalents

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

Accounting Policies continued

Financial liabilities

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

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

Derivative financial instruments and Financial liabilities designated at fair value are classified as fair value through profit or loss, unless in a hedge relationship.

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

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

Borrowings

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

Share capital

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

Provisions

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

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

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

Financial guarantee contracts

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

Dividends

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

Critical accounting policies and areas of significant management judgement

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

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

(a) Provisions for loans and advances

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

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

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

The Consolidated Financial Statements for the year ended 31 December 2009 include a provision charge for loans and advances in connection with retail lending for an amount equal to £139m and corporate lending for an amount equal to £91m. The provision for retail lending increased reflecting higher default rates in the unsecured portfolios and increased reserving due to a further general deterioration in economic conditions. The provision for corporate lending reflected the current economic down turn and the impact this is having on the corporate sector. In calculating the retail and corporate lending provisions, within the Retail Banking and Corporate Banking segments, a range of outcomes was calculated based principally on management's conclusions regarding the current economic outlook relative to historic experience. Had management used different assumptions regarding the current economic outlook, a larger or smaller provision for loans and advances would have resulted that could have had a material impact on the Group's reported loss before tax in 2009.

Specifically, if management's conclusions as to the current economic outlook were different, but within the range of what management deemed to be reasonably possible economic outlooks, the provision charge for loans and advances in the Retail Banking segment could have decreased in 2009 from an actual provision charge of £139m (2008: £274m) by up to £52m (2008: £22m), with a potential corresponding increase (2008: reduction) in the Group's profit (2008: loss) before tax in 2009 of up to 91% (2008: 2%), or increased by up to £6m (2008: £29m), with a potential corresponding decrease (2008: increase) in the Group's profit (2008: loss) before tax in 2009 of up to 11% (2008: 2%). The provision charge for loans and advances in the Corporate Banking segment could have decreased in 2009 from an actual provision charge of £91m (2008: £275m) by up to £4m (2008: £51m), with a potential corresponding increase (2008: decrease) in the Group's profit (2008: loss) before tax in 2009 of up to 7% (2008: 4%), or increased by up to £3m (2008: £29m), with a potential corresponding decrease (2008: increase) in the Group's profit (2008: loss) before tax in 2009 of up to 5% (2008: 2%).

The actual provision charge for retail lending of £139m (2008: £274m) and corporate lending of £91m (2008: £275m) in 2009 was based on what management estimated to be the most probable economic outlook within the range of reasonably possible assumptions.

The provision charge for the Treasury asset portfolio (securities, loans and advances to banks and the Conduit shown in loans and advances to customers) of £118m (2008: £485m) was based on management's assessment of impairment of each individual asset based on data available at 31 December 2009. A detailed analysis of the Treasury asset portfolio by type of instrument, credit structure, credit rating and geography can be found in the Risk Management Report on pages 29 to 37.

(b) Valuation of financial instruments

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

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

Accounting Policies continued

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 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.

(c) Provisions for misselling

The Group estimates provisions for misselling with the objective of maintaining reserve levels believed by management to be sufficient to absorb current estimated probable losses in connection with compensation from customers who claim reimbursement of payment protection insurance ('PPI'). The calculation of provisions for misselling is based on the estimated number of claims that may be received, of those, the number that will be upheld, and the estimated average settlement per case. These assessments are based on management's estimate for each of these three factors. In certain instances, the extent to which the Group is required to uphold claims is driven by binding legal decisions or precedents, as described in Note 33.

The Group considers accounting estimates related to misselling provisions 'critical accounting estimates' because: (i) they are highly susceptible to change from period to period per the three factors above, and (ii) any significant difference between the Group's estimated losses as reflected in the provisions and actual losses will require the Group to take provisions which, if significantly different, could have a material impact on its future income statement and its balance sheet. The Group's assumptions about estimated losses are based on past claims uphold rates, past customer behaviour, and past average settlements, which are not necessarily an indication of future losses.

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

The Consolidated Financial Statements for the year ended 31 December 2009 include a provision charge for misselling in the Retail Banking segment for an amount equal to £70m (2008: £38m). The balance sheet provision decreased from £34m in 2008 to £nil in 2009, reflecting settlement of claims principally relating to Payment Protection Insurance. In calculating the misselling provision within the Retail Banking segment, management's best estimate of the provision was calculated based on conclusions regarding the number of claims that may be received, of those, the number that will be upheld, and the estimated average settlement per case. Had management used different assumptions regarding these factors, a larger or smaller provision for misselling would have resulted in the Retail Banking segment that could have had a material impact on the Group's reported profit before tax in 2009.

Specifically, if management's conclusions as to the number of claims that will be received, of those, the number that will be upheld, and the estimated average settlement per case were different, but within the range of what management deemed to be reasonably possible, the provision charge for misselling in the Retail Banking segment could have decreased in 2009 by up to £4m (2008: £25m), with a potential corresponding increase (2008: decrease) in the Group's profit (2008: loss) before tax in 2009 of up to 8% (2008: 2%), or increased by up to £5m (2008: £16m), with a potential corresponding decrease (2008: increase) in the Group's profit (2008: loss) before tax in 2009 of up to 9% (2008: 1%). The actual charge in 2009 was based on what management estimated to be the most probable number of claims that will be received, of those, the number that will be upheld, and the estimated average settlement per case within the range of reasonably possible outcomes.

(d) Pensions

The Group operates a funded and an unfunded defined benefit pension scheme as described in Note 32 to the Consolidated Financial Statements. The assets of the funded scheme are measured at their fair values at the balance sheet date. The liabilities of the schemes are estimated by projecting forward the growth in current accrued pension benefits to reflect inflation and salary growth to the date of pension payment, discounted to present value using the interest rate applicable to high quality AA rated corporate bonds of the same currency and term as the scheme liabilities. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme. In determining the value of scheme liabilities, assumptions are made by management as to mortality, price inflation, discount rates, pension increases, and earnings growth. Financial assumptions are based on market conditions at the balance sheet date and can generally be derived objectively. Demographic assumptions require a greater degree of estimation and judgement to be applied to externally derived data.

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

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

The Consolidated Financial Statements for the year ended 31 December 2009 include current year defined benefit service cost of £8m and a pension scheme deficit of £139m. The current year service cost of £8m (2008: £19m) was reduced, reflecting reductions in scheme membership, salary reviews, changes in pension increases, changes in mortality assumptions, changes in price inflation assumptions and changes in discount rates. The current year pension scheme deficit of £139m (2008: £7m) was increased, reflecting changes in price inflation assumptions, changes in discount rates, reductions in scheme membership, salary reviews, changes in pension increases and changes in mortality assumptions. In calculating the current year service cost and deficit, a range of outcomes was calculated based principally on management's estimates regarding mortality, price inflation, discount rates, pension increases, and earnings growth. Had management used different assumptions principally regarding mortality, but also price inflation, discount rate, pensions increases and earnings growth, a larger or smaller charge for pension costs would have resulted that could have had a material impact on the Group's reported profit before tax in 2009.

Specifically, if management's conclusions as to mortality, price inflation, discount rates, pensions increases and earnings growth were different, but within the range of what management deemed to be reasonably possible conclusions, the charge for pension costs could have decreased in 2009 from an actual pension charge of £8m (2008: £19m) by up to £2m (2008: £10m), with a potential corresponding increase (2008: decrease) in the Group's profit (2008: loss) before tax in 2009 of up to 4% (2008: 1% decrease in loss), or increased by up to £2m (2008: £5m), with a potential corresponding decrease (2008: increase) in the Group's profit (2008: loss) before tax in 2009 of up to 4% (2008: 0%). The actual current year service pension charge of £8m (2008: £19m) in 2009 was based on what management estimated to be the most probable mortality, price inflation, discount rates, pensions increases and earnings growth within the range of reasonably possible values. In addition, if management's conclusions as to mortality, price inflation, discount rates, pensions increases and earnings growth were different, but within the range of what management deemed to be reasonably possible conclusions, the value of the deficit at the year end could have moved in 2009 from an actual deficit of £139m (2008: £7m deficit) to a deficit of up to £9m (2008: surplus of up to £117m), or increased to a deficit of up to £243m (2008: deficit of up to £90m).

(e) Deferred tax

The Group recognises deferred tax assets with respect to tax losses carried forward to the extent that it is probable that future taxable profits will be available against which the unused tax losses and unused tax credits can be utilised. At 31 December 2009 and 2008 the Group has recognised such deferred tax assets in full. As at 31 December 2009 this amounted to £297m (2008: £368m). The value of the deferred tax asset is based on management's best estimate of the amount that will be recoverable in the foreseeable future. This estimate is based on management's assessment of future taxable profits that are expected to arise over this period.

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

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

The Consolidated Financial Statements for the year ended 31 December 2009 do not include a charge for changes in the value of deferred tax assets arising in connection with the non recoverability of taxable losses. If management estimates of future tax profits were not met, it is possible that the deferred tax asset would still be recovered, but over a longer period, therefore it is not possible to quantify reliably a meaningful sensitivity or range of possible outcomes. Under current UK tax legislation, the tax losses in respect of which deferred tax assets have been recognised do not expire.

It is management's view that the recoverable value of the deferred tax asset will be unaffected by the scheme allowed by Part VII of the Financial Services and Markets Act 2000 under which the Company intends to transfer Alliance & Leicester plc's business into Santander UK plc later this year, as described in Note 42.

Notes to the Financial Statements

1. Segments

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

- Retail Banking;
- Corporate Banking;
- Private Banking; and
- Group Infrastructure.

In 2009, the off-shore deposit-taking company was managed and reported separately from the rest of the Retail Banking businesses and renamed Private Banking. The segmental analysis of the Group's results for 2008 has been amended to reflect this change. In addition, in 2009, the Group's transfer pricing arrangements were updated to reflect the greater benefit of retail deposits in a period of higher funding costs. 2008 has been adjusted for consistency.

The Group's segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. The Group has four segments. Retail Banking offers a range of personal banking, savings and mortgage products and services. Corporate Banking offers banking services principally to small and mid-sized UK companies. It also contains operations in run down. Private Banking offers specialist banking services. Group Infrastructure consists of Asset and Liability Management activities and the Treasury asset portfolio.

The segment information below is presented on the basis used by the Company's Board to evaluate performance, in accordance with IFRS 8. The Company's Board reviews discrete financial information for each of its segments, including measures of operating results and assets. The segments are managed primarily on the basis of their results, which are measured on a 'trading' basis. The trading basis differs from the statutory basis (described in the Accounting Policies section on pages 54 to 67) 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. Management reviews the Group's performance on a basis consistent with its presentation at the Santander UK group level. Therefore those items that either eliminate, or are treated as non-trading, at a Santander UK group level are treated as non-trading by the Group.

The adjustments are:

- **Reorganisation and other items –** These comprise implementation costs in relation to the integration of Alliance & Leicester into Santander UK plc, as well as certain remediation administration expenses, credit provisions and other one-off items. Management needs to understand the underlying drivers of the cost base that will remain after these exercises are complete, and does not want this view to be clouded by these costs, which are managed independently.
- **Depreciation of operating lease assets –** The operating lease businesses are managed as financing businesses and, therefore, management needs to see the margin earned on the businesses. Residual value risk is separately managed. As a result, the depreciation is netted against the related income.
- **Hedging and other variances –** The Balance Sheet and Income Statement are subject to mark-to-market volatility including that arising from the accounting for elements of derivatives deemed under IFRS to be ineffective as hedges. Where appropriate, such volatility is separately identified to enable management to view the underlying performance of the business.
- **Treasury asset portfolio –** This portfolio is managed separately as a run-down portfolio.
- **Capital and other charges** – These principally comprise internal nominal charges for capital invested in the Group's businesses. Management implemented this charge with effect from 2009 to assess the effectiveness of capital investments.

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

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

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

Notes to the Financial Statements continued

2009	Retail Banking £m	Corporate Banking £m	Private Banking £m	Group Infra-structure £m	Total £m	Adjustments £m	Group Total £m
Net interest income	835	162	8	(177)	828	(66)	762
Non-interest income	179	110	1	(30)	260	191	451
Total trading income	1,014	272	9	(207)	1,088	125	1,213
Administration expenses	(301)	(128)	(4)	(19)	(452)	(154)	(606)
Depreciation and amortisation	(30)	(13)	(1)	(4)	(48)	(73)	(121)
Total trading expenses	(331)	(141)	(5)	(23)	(500)	(227)	(727)
Impairment losses on loans and advances	(143)	(4)	-	(57)	(204)	(144)	(348)
Provisions for other liabilities and charges	-	-	-	-	-	(81)	(81)
Trading profit/(loss) before tax	540	127	4	(287)	384	(327)	57
Adjust for:							
Reorganisation and other items	(66)	(85)	-	(14)	(165)		
Hedging and other variances	-	-	-	57	57		
Treasury asset portfolio	-	-	-	(219)	(219)		
Capital and other charges	(75)	(70)	-	145	-		
Profit/(loss) before tax	399	(28)	4	(318)	57		
Average number of staff	5,375	404	31	91	5,901		
Total assets	56,643	19,595	4	33,696	109,938		

Adjustments comprise:	Net interest income £m	Non interest income £m	Administration expenses £m	Depreciation and amortisation £m	Impairment losses on loans and advances £m	Provisions for other liabilities and charges £m	Profit/(loss) before tax £m
Reorganisation and other items	50	104	(154)	-	(84)	(81)	(165)
Depreciation on operating lease assets	-	73	-	(73)	-	-	-
Hedging and other variances	43	14	-	-	-	-	57
Treasury asset portfolio	(159)	-	-	-	(60)	-	(219)
	(66)	191	(154)	(73)	(144)	(81)	(327)

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

2008	Retail Banking £m	Corporate Banking £m	Private Banking £m	Group Infrastructure £m	Total £m	Adjustments £m	Group Total £m
Net interest income	592	147	10	(132)	617	(233)	384
Non-interest income	211	131	2	(14)	330	110	440
Total trading income	803	278	12	(146)	947	(123)	824
Administration expenses	(344)	(174)	(4)	(30)	(552)	(375)	(927)
Depreciation and amortisation	(26)	(20)	-	(2)	(48)	(66)	(114)
Total trading expenses	(370)	(194)	(4)	(32)	(600)	(441)	(1,041)
Impairment losses	(133)	(50)	-	-	(183)	(850)	(1,033)
Provisions for other liabilities and charges	-	-	-	-	-	(38)	(38)
Trading profit/(loss) before tax	300	34	8	(178)	164	(1,452)	(1,288)
Adjust for:							
Reorganisation and other items	(366)	(202)	-	(321)	(889)		
Hedging and other variances	-	-	-	(78)	(78)		
Treasury asset portfolio	-	-	-	(485)	(485)		
Profit/(loss) before tax	(66)	(168)	8	(1,062)	(1,288)		
Average number of staff	5,370	404	31	91	5,896		
Total assets	40,891	9,954	3	24,396	75,244		

Notes to the Financial Statements continued

Adjustments comprise:	Net interest income £m	Non interest income £m	Administration expenses £m	Depreciation and amortisation £m	Impairment losses on loans and advances £m	Provisions for other liabilities and charges £m	Profit/(loss) before tax £m
Reorganisation and other items	(269)	158	(375)	-	(365)	(38)	(889)
Depreciation on operating lease assets	-	66	-	(66)	-	-	-
Hedging and other variances	36	(114)	-	-	-	-	(78)
Treasury asset portfolio	-	-	-	-	(485)	-	(485)
	(233)	110	(375)	(66)	(850)	(38)	(1,452)

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

2. Net interest income

	Group 2009 £m	2008 £m
Interest and similar income:		
On loans and advances to Group undertakings	**203**	-
Loans and advances to banks	**1**	242
Loans and advances to customers	**1,938**	2,987
Other interest-earning financial assets	**222**	803
Total interest and similar income	**2,364**	4,032
Interest expense and similar charges:		
On deposits by Group undertakings	**428**	-
Deposits by banks	**166**	1,017
Deposits by customers	**505**	1,262
Debt securities in issue	**341**	1,219
Other interest-bearing financial liabilities	**162**	150
Total interest expense and similar charges	**1,602**	3,648
Net interest income	**762**	384

3. Net fee and commission income

	Group 2009 £m	2008 £m
Fee and commission income:		
Retail products	**332**	418
Insurance products	**47**	53
Asset management	**18**	-
Total fee and commission income	**397**	471
Fee and commission expense:		
Other fees paid	**44**	79
Total fee and commission expense	**44**	79
Net fee and commission income	**353**	392

4. Net trading and other income

	Group 2009 £m	2008 £m
Net trading and funding of other items by the trading book	**-**	(7)
Income from operating lease assets	**95**	88
Losses on assets designated at fair value through profit or loss	**(2)**	(11)
Funding on liabilities designated at fair value through profit or loss	**-**	(1)
Gains on derivatives managed with assets / liabilities held at fair value through profit or loss	**-**	-
Excess on sale of credit cards to MBNA	**-**	16
Profit on sale of fixed assets	**1**	-
Mark-to-market losses on credit default swaps	**17**	(115)
Hedge ineffectiveness and other	**(13)**	78
	98	48

5. Administration expenses

	Group	
	2009	2008
	£m	£m
Staff costs:		
Wages and salaries	**184**	221
Social security costs	**19**	20
Pensions costs: – defined contribution plans	**11**	10
– defined benefit plans	**7**	15
Other personnel costs	**21**	74
	242	340
Property, plant and equipment expenses	**68**	39
Information technology expenses	**43**	42
Intangible and tangible assets write offs	**-**	163
Other administrative expenses	**253**	343
	606	927

Other personnel costs include restructuring costs.

6. Depreciation and amortisation

	Group	
	2009	2008
	£m	£m
Depreciation of property, plant and equipment excluding operating lease assets	**36**	32
Depreciation of operating lease assets	**74**	66
Amortisation of intangible assets	**11**	16
	121	114

7. Audit services

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

	Group	
	2009	2008
	£m	£m
Fees payable to the Company's auditors for the audit of the Group's annual accounts	**0.3**	0.8
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**0.6**	0.6
Total audit fees	**0.9**	1.4

8. Impairment losses on loans and advances

	Group	
	2009	2008
	£m	£m
Impairment losses on loans and advances	**363**	1,045
Recoveries of loans and advances	**(15)**	(12)
	348	1,033

Notes to the Financial Statements continued

9. Taxation credit

	Group	
	2009 £m	2008 £m
Current tax:		
UK corporation tax on profit of the year	**(161)**	–
Adjustments and reclassifications in respect of prior periods	**(36)**	(45)
Overseas taxation	**1**	1
Total current tax credit	**(196)**	(44)
Deferred tax charge/(credit):		
Current year	**151**	(340)
Adjustments and reclassifications in respect of prior periods	**42**	14
Total deferred tax charge/(credit)	**193**	(326)
Tax credit for the year	**(3)**	(370)

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

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

	Group	
	2009 £m	2008 £m
Profit/(loss) before tax	**57**	(1,288)
Tax calculated at a tax rate of 28% (2008: 28.5%)	**16**	(367)
Effect of non-allowable provisions and other non-equalised items	**(23)**	24
Tax relief in respect of Innovative Tier 1	**-**	(5)
Impact of loss of capital allowances	**-**	4
Effect of non-UK profits and losses	**(2)**	(2)
Effect of change in tax rate on deferred tax provision	**-**	7
Adjustment to prior year provisions	**6**	(31)
Income tax credit	**(3)**	(370)

In addition to the income tax expense charged to profit or loss, a deferred tax asset of £1m (2008:£3m) has been recognised in equity in the year. Further information about deferred income tax is presented in Note 23.

10. Loss on ordinary activities after tax

The loss after tax of the Company attributable to the shareholders is £78m (2008: £275m). As permitted by Section 408 of the UK Companies Act 2006, the Company's profit and loss account has not been presented in these Consolidated Financial Statements.

11. Cash and balances at central banks

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Cash in hand	**400**	457	**400**	457
Balances with central banks	**46**	1,096	**46**	1,096
	446	1,553	**446**	1,553

For regulatory purposes, certain minimum cash balances are required to be maintained with the Bank of England. At 31 December 2009, these amounted to £46m (2008: £48m).

12. Derivative financial instruments

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

Derivatives held for trading purposes

The Group does not hold derivative products for trading purposes. Derivatives held for economic hedging purposes that do not qualify for hedge accounting under IAS 39 are required to be classified as "held for trading purposes". Responsibility for implementing derivative hedging with the external market is transferred to Santander UK.

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

Derivatives held for risk management purposes

The main derivatives are interest rate and cross-currency swaps, which are used to hedge the Group's exposure to interest rates and exchange rates. These risks are inherent in non-trading assets, liabilities and positions, including fixed-rate lending and structured savings products within the relevant operations throughout the Group, including medium-term note issues, capital issues and fixed-rate asset purchases. Such risks may also be managed using natural offsets within other on-balance sheet instruments as part of an integrated approach to risk management.

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

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 hedging below:

			Group
2009 **Derivatives held for trading**	**Contract/notional Amount £m**	**Fair value Assets £m**	**Fair value Liabilities £m**
Exchange rate contracts:			
– Cross-currency swaps	**4,053**	**758**	**20**
– Foreign exchange swaps and forwards	**428**	**3**	**22**
	4,481	**761**	**42**
Interest rate contracts:			
– Interest rate swaps	**2,493**	**89**	**134**
– Caps, floors and swaptions	**1,044**	**21**	**20**
	3,537	**110**	**154**
Credit contracts:			
– Credit default swaps	**15**	**-**	**2**
Total derivative assets and liabilities held for trading	**8,033**	**871**	**198**

			Group
2009 **Derivatives held for fair value hedging**	**Contract/notional Amount £m**	**Fair value Assets £m**	**Fair value Liabilities £m**
Interest rate contracts:			
– Interest rate swaps	**2,562**	**237**	**-**
Total derivative assets and liabilities held for fair value hedging	**2,562**	**237**	**-**
Total recognised derivative assets and liabilities	**10,595**	**1,108**	**198**

Notes to the Financial Statements continued

2009 Derivatives held for trading	Contract/notional Amount £m	Fair value Assets £m	Company Fair value Liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	**1,450**	**176**	**45**
– Foreign exchange swaps and forwards	**428**	**3**	**22**
	1,878	**179**	**67**
Interest rate contracts:			
– Interest rate swaps	**8,284**	**142**	**223**
– Caps, floors and swaptions	**1,044**	**21**	**20**
	9,328	**163**	**243**
Credit contracts:			
– Credit default swaps	**162**	**2**	**8**
Total derivative assets and liabilities held for trading	**11,368**	**344**	**318**

2009 Derivatives held for fair value hedging	Contract/notional Amount £m	Fair value Assets £m	Company Fair value Liabilities £m
Interest rate contracts:			
– Interest rate swaps	**2,562**	**238**	**-**
Total derivative assets and liabilities held for fair value hedging	**2,562**	**238**	**-**
Total recognised derivative assets and liabilities	**13,930**	**582**	**318**

2008 Derivatives held for trading	Contract/notional Amount £m	Fair value Assets £m	Group Fair value Liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	6,044	1,738	21
– Foreign exchange swaps and forwards	2,461	–	336
	8,505	1,738	357
Interest rate contracts:			
– Interest rate swaps	20,629	386	286
– Caps, floors and swaptions	496	7	1
	21,125	393	287
Credit contracts:			
– Credit default swaps	25	1	12
Total derivative assets and liabilities held for trading	29,655	2,132	656

2008 Derivatives held for hedging	Contract/notional Amount £m	Fair value Assets £m	Group Fair value Liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	170	80	–
Interest rate contracts:			
– Interest rate swaps	39,291	664	877
Total derivative assets and liabilities held for hedging	39,461	744	877
Total recognised derivative assets and liabilities	69,116	2,876	1,533

2008 Derivatives held for trading	Contract/notional Amount £m	Fair value Assets £m	Company Fair value Liabilities £m
Exchange rate contracts:			
– Cross-currency swaps	2,790	714	83
– Foreign exchange swaps and forwards	2,486	–	334
	5,276	714	417
Interest rate contracts:			
– Interest rate swaps	32,953	562	431
– Caps, floors and swaptions	496	6	1
	33,449	568	432
Credit contracts:			
– Credit default swaps	185	(11)	66
Total derivative assets and liabilities held for trading	38,910	1,271	915

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

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Net gains/(losses):				
– on hedging instruments	**436**	(521)	**436**	(297)
– on hedged items attributable to hedged risks	**(394)**	509	**(394)**	343
Transferred from the cash flow reserve	**(48)**	11	**(48)**	24
Other	**-**	21	**-**	156
	(6)	20	**(6)**	226

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

The Company previously applied cash flow hedge accounting to cash flow hedges of interest rate risk on a portfolio of variable rate assets. Due to the administrative burden associated with the detailed hedge accounting provisions of IAS 39 the Company opted to cease claiming hedge accounting during 2009.

13. Financial assets designated at fair value

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Debt securities	**50**	63	**50**	63

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 a contract contains one or more embedded derivatives.

Debt securities representing holdings of collateralised synthetic obligations of £50m (2008: £nil) and asset-backed securities of £nil (2008: £63m) have been designated at fair value through profit or loss:

> The collateralised synthetic obligations contain embedded derivatives which would otherwise require bifurcation and separate recognition as derivatives. The collateralised synthetic obligations were initially recognised in 2009 upon the consolidation of the assets of the Group's Conduit vehicles as described in 'Exposure to Off-Balance Sheet Entities sponsored by the Group - Secured Loan to Conduit' in the Risk Management Report.

> The asset-backed securities 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.

The maximum exposure to credit risk on the financial assets held at fair value through profit or loss at the balance sheet date was £94m (2008: £97m) for the Group and £94m (2008: £97m) for the Company.

Debt securities can be analysed by listing status as follows:

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Listed outside UK	**50**	38	**50**	38
Unlisted	**-**	25	**-**	25
	50	63	**50**	63

Notes to the Financial Statements continued

14. Loans and advances to banks

	Group 2009 £m	Group 2008 £m	Company 2009 £m	Company 2008 £m
Placements with other banks	**325**	1,239	**297**	1,236
Amounts due from fellow subsidiaries	**49,532**	–	**45,911**	–
	49,857	1,239	**46,208**	1,236

Repayable:	Group 2009 £m	Group 2008 £m	Company 2009 £m	Company 2008 £m
On demand	**2,621**	816	**2,222**	814
In not more than 3 months	**12,204**	77	**12,193**	77
In more than 3 months but not more than 1 year	**14,529**	346	**13,256**	345
In more than 1 year but not more than 5 years,	**15,343**	-	**15,343**	-
Due in more than 5 years	**5,160**	-	**3,194**	-
	49,857	1,239	**46,208**	1,236

15. Loans and advances to customers

	Group 2009 £m	Group 2008 £m	Company 2009 £m	Company 2008 £m
Loans secured on residential properties	**37,729**	37,665	**37,728**	37,665
Corporate loans	**7,598**	9,058	**4,408**	5,419
Finance leases	**1,602**	1,791	-	-
Other secured advances	**37**	57	**29**	10
Other unsecured advances	**215**	3,477	**215**	188
Amounts due from subsidiaries	**-**	-	**10,255**	9,661
Amounts due from fellow subsidiaries	**38**	-	**38**	-
Loans and advances to customers	**47,219**	52,048	**52,673**	52,943
Less: loan loss allowances	**(423)**	(646)	**(541)**	(339)
Loans and advances to customers, net of loan loss allowances	**46,796**	51,402	**52,132**	52,604

Repayable:	Group 2009 £m	Group 2008 £m	Company 2009 £m	Company 2008 £m
On demand	**275**	108	**681**	3,374
In no more than 3 months	**1,827**	831	**4,722**	5,211
In more than 3 months but not more than 1 year	**1,488**	3,262	**2,508**	2,721
In more than 1 year but not more than 5 years	**8,894**	10,282	**10,156**	7,118
In more than 5 years	**34,735**	37,565	**34,606**	34,519
Loans and advances to customers	**47,219**	52,048	**52,673**	52,943
Less: loan loss allowances	**(423)**	(646)	**(541)**	(339)
Loans and advances to customers, net of loan loss allowances	**46,796**	51,402	**52,132**	52,604

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

Gross investment in finance leases and hire purchase contracts receivable	2009 £m	2008 £m
Within 1 year	**240**	333
Between 1-5 years	**543**	699
In more than 5 years	**1,570**	1,556
	2,353	2,588
Unearned future finance income on finance leases and hire purchase contracts	**(751)**	(797)
Net investment in finance leases and hire purchase contracts	**1,602**	1,791

The net investment in finance leases and hire purchase contracts is analysed as follows:	2009 £m	2008 £m
Within 1 year	**246**	230
Between 1-5 years	**435**	484
In more than 5 years	**921**	1,077
Net investment in finance leases and hire purchase contracts	**1,602**	1,791

Included in the carrying value of Net investment in finance leases and hire purchase contracts is £13m (2008: £48m) residual value at the end of the current lease terms, which will be recovered through re-letting or sale.

Included within loans and advances to customers are £nil (2008: £3,222m) of mortgage advances assigned to a bankruptcy remote special purpose entity, Alliance & Leicester Covered Bonds LLP. These loans provide security to issues of covered bonds made by the Company.

Loans and advances to customers have the following interest rate structures:

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Fixed rate	**15,084**	24,788	**14,984**	19,765
Variable rate	**32,135**	27,260	**37,689**	33,178
Less: loan loss allowances	**(423)**	(646)	**(541)**	(339)
	46,796	51,402	**52,132**	52,604

Movement in loan loss allowances:

2009	**Loans secured on residential property £m**	**Corporate loans £m**	**Finance leases £m**	**Other secured advances £m**	**Other unsecured advances £m**	Group **Total £m**
As at 1 January 2009:						
- Individually assessed	**45**	**138**	**4**	**1**	**289**	**477**
- Collectively assessed	**14**	**132**	**1**	**-**	**22**	**169**
	59	**270**	**5**	**1**	**311**	**646**
Disposal of portfolio:						
- Individually assessed	**-**	**-**	**-**	**-**	**(73)**	**(73)**
- Collectively assessed	**-**	**-**	**-**	**-**	**(11)**	**(11)**
	-	**-**	**-**	**-**	**(84)**	**(84)**
Charge/(release) to the income statement:						
- Individually assessed	**34**	**122**	**5**	**(1)**	**113**	**273**
- Collectively assessed	**41**	**(34)**	**-**	**-**	**(9)**	**(2)**
	75	**88**	**5**	**(1)**	**104**	**271**
Write offs	**(16)**	**(96)**	**(8)**	**-**	**(290)**	**(410)**
At 31 December 2009:						
- Individually assessed	**63**	**164**	**1**	**-**	**39**	**267**
- Collectively assessed	**55**	**98**	**1**	**-**	**2**	**156**
	118	**262**	**2**	**-**	**41**	**423**

During the year, Alliance & Leicester Personal Finance Limited sold its unsecured loan portfolio to Santander UK plc. There was no profit or loss on the sale.

2008	Loans secured on residential property £m	Corporate loans £m	Finance leases £m	Other secured advances £m	Other unsecured advances £m	Group Total £m
As at 1 January 2008:						
- Individually assessed	8	-	4	1	115	128
- Collectively assessed	4	18	7	-	6	35
	12	18	11	1	121	163
Charge/(release) to the income statement:						
- Individually assessed	46	155	-	-	272	473
- Collectively assessed	10	114	(6)	-	16	134
	56	269	(6)	-	288	607
Write offs	(9)	(17)	-	-	(98)	(124)
At 31 December 2008:						
- Individually assessed	45	138	4	1	289	477
- Collectively assessed	14	132	1	-	22	169
	59	270	5	1	311	646

2009	**Loans secured on residential property £m**	**Amounts due from subsidiaries £m**	**Corporate loans £m**	**Finance leases £m**	**Other secured advances £m**	**Other unsecured advances £m**	Company **Total £m**
As at 1 January 2009	**59**	**39**	**160**	**–**	**1**	**105**	**364**
Charge/(release) to the income statement	**75**	**222**	**27**	**–**	**(1)**	**47**	**370**
Write-offs	**(17)**	**–**	**(66)**	**–**	**–**	**(110)**	**(193)**
At 31 December 2008	**117**	**261**	**121**	**–**	**–**	**42**	**541**

Notes to the Financial Statements continued

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

Recoveries:

	Loans secured on residential property £m	**Corporate loans £m**	**Finance leases £m**	**Other secured advances £m**	**Other unsecured advances £m**	Group **Total £m**
2009	**-**	**2**	**-**	**-**	**13**	**15**
2008	1	1	-	-	10	12

16. Securitisation of assets

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

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

Master Trust Structures

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

The Company established the Fosse Master Trust securitisation structure in 2006. Notes were issued by Fosse Master Issuer plc to third party investors and the proceeds loaned to Fosse Funding (No. 1) Limited, which in turn used the funds to purchase beneficial interests in mortgages held by Fosse Trustee Limited. The Company raised £2,502m in 2007, £396m in 2008 and £nil in 2009 from securitisations involving the Fosse Master Trust. Mortgage backed notes totalling £0.6bn equivalent were redeemed during the year.

In March 2010 the Group issued through the Fosse Master Trust the first publicly-placed mortgage-backed securitisation transaction from a UK bank since 2007; other recent transactions from UK banks had included an investor put. The transaction was denominated in both pounds sterling and euro and raised approximately £1.4bn.

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

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

The Company and its subsidiaries receive payments from the securitisation companies in respect of fees for administering the loans, and payment of deferred consideration for the sale of the loans. The Company and its subsidiaries have no right or obligation to repurchase the benefit of any securitised loan, except if certain representations and warranties given by the Company or its subsidiaries at the time of transfer are breached.

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

Outstanding balances of assets securitised and non-recourse finance at 31 December 2009 were as follows:

Securitisation company	Closing date of securitisation	Gross assets Securitised £m	Non-recourse Finance £m	Issued to A&L as collateral £m
Fosse Master Issuer plc	28 Nov 2006	**1,859**	**1,924**	**-**
Fosse Master Issuer plc	1 Aug 2007	**2,050**	**2,080**	**-**
Fosse Master Issuer plc	21 Aug 2008	**287**	**314**	**-**
Bracken Securities plc	11 Oct 2007	**6,736**	**-**	**6,909**
Langton Securities (2008-1) plc	25 Jan 2008	**1,227**	**-**	**1,228**
Langton Securities (2008-2) plc	5 Mar 2008	**2,210**	**-**	**2,211**
Langton Securities (2008-3) plc	17 Jun 2008	**3,521**	**-**	**3,522**
Beneficial interest in mortgages held by Fosse Master Trust Ltd		**2,251**	**-**	**-**
Beneficial interest in mortgages held by Langton Master Trust Ltd		**1,572**	**-**	**-**
		21,713	**4,318**	**13,870**

The securitisation companies have cash deposits totalling £115m, which have been accumulated to finance the redemption of a number of Securities issued by the Securitisation Companies. The securitisation companies' contractual interest in advances secured on residential property is therefore reduced by this amount. The Company does not own directly, or indirectly, any of the share capital of any of the above Securitisation Companies or their parents.

Issues under the Group's covered bond programmes are not included in the tables above. For more information, see Note 28.

17. Available-for-sale securities

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Debt securities	**3**	1,648	–	1,644
Equity securities	**8**	10	**8**	10
	11	1,658	**8**	1,654

Maturities of debt securities:

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Due in less than 3 months	**-**	1,644	**-**	1,644
Due in more than 3 months but less than 1 year	**3**	-	**-**	-
Due in more than 1 year but not more than 5 years	**-**	4	**-**	-
	3	1,648	**-**	1,644

Debt securities do not include any Treasury Bills (2008: £1,644m) in either the Group or Company. Equity securities do not bear interest and are all unlisted.

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

	Group £m	Company £m
At 1 January 2009	**1,658**	**1,654**
Additions	**3**	**3**
Redemptions and maturities	**(1,650)**	**(1,649)**
At 31 December 2009	**11**	**8**

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

Notes to the Financial Statements continued

18. Loan and receivable securities

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Loan and receivable securities	**9,828**	14,250	**9,994**	14,321

In 2008, the Group applied the amendment to IAS 39 regarding the reclassification of financial assets out of 'fair value through profit & loss' and 'available-for-sale' categories into 'loans & receivables'. If these assets had remained as 'available-for-sale', the pre-tax impact on the 'available-for-sale' reserve would have been a credit of £577m (2008: charge of £1,018m) based on exit prices for these debt securities rather than their recoverable values. The credit for the year is a result of the significant improvement in the mark-to-market deficit and effective disposal programme. The net income recognised in the income statement on these assets in 2009 was £128m. The pre-tax charge to the 'available-for-sale' reserve on these assets in 2008 prior to the reclassification was £264m.

The amount reclassified out of 'held-for-trading' and into 'loans & receivables' in 2008 was £732m. If these assets had remained as 'held-for-trading' a £25m fair value gain (2008: £54m fair value loss) would have been recognised in the income statement. The net income recognised in the income statement on these assets in 2009 was £27m. The loss recognised in income in 2008 on these assets prior to the reclassification was £6m. There has been no change in the way net interest income is recognised in the income statement on these assets reclassified. The reclassifications were made as there was no active trading market in the assets. The reduction in the carrying value of the reclassified assets prior to their reclassification is expected to be recovered over the period to maturity of the assets. This is being recognised on a straight-line basis over the period to maturity, which is considered to be immaterially different to using an Effective Interest Rate basis.

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

In 2009, the Group recognised additional securities as a result of the requirement to consolidate the assets of the Group's Conduit vehicles, rather than recognising the Group's loans to the Conduit vehicles and treating the assets of the Conduit vehicles as off-balance sheet, as described in "Exposure to Off-Balance Sheet Entities sponsored by the Group - Secured Loan to Conduit" in the Risk Management Report on page 36. Upon initial recognition by the Group, these securities were classified as 'loans and receivables' as the Group identified that a rare circumstance of extreme market illiquidity existed at that time.

Detailed analysis of these securities is contained in the Risk Management Report.

19. Investment in subsidiary undertakings

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

			Company
	Cost	**Impairment**	**Net book value**
	£m	**£m**	**£m**
At 1 January 2009	**1,097**	**(6)**	**1,091**
Disposals within the Group	**(158)**	**-**	**(158)**
Impairments	**-**	**(46)**	**(46)**
At 31 December 2009	**939**	**(52)**	**887**

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

The principal subsidiaries of Alliance & Leicester plc at 31 December 2009 are shown below. The Directors consider that to give full particulars of all subsidiary undertakings would lead to a statement of excessive length. In accordance with Section 410(2) of the Companies Act 2006, the following information relates to those subsidiary undertakings whose results or financial position, in the opinion of the Directors, principally affect the results of the Group. Full particulars of all subsidiary undertakings will be annexed to the Company's next annual return in accordance with Section 410(3)(b) of the Companies Act 2006.

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

* Held indirectly through subsidiary companies.

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

20. Intangible assets

a) Goodwill

	Group	
	2009 £m	2008 £m
Cost		
At 1 January	**22**	11
Acquisitions	**-**	11
At 31 December	**22**	22
Accumulated impairment		
At 1 January	**22**	2
Impairment losses	**-**	20
At 31 December	**22**	22
Net book value	**-**	-

Impairment of goodwill

A review of the economic value of goodwill was carried out at 31 December 2008. The goodwill on the Group's balance sheet was considered fully impaired.

b) Other intangibles

	Group		
	Software development cost £m	**Intangible assets under development £m**	**Total £m**
Cost			
At 1 January 2009	**46**	**-**	**46**
Additions	**32**	**-**	**32**
At 31 December 2009	**78**	**-**	**78**
Accumulated amortisation/impairment			
At 1 January 2009	**29**	**-**	**29**
Charge for the year	**11**	**-**	**11**
At 31 December 2009	**40**	**-**	**40**
Net book value	**38**	**-**	**38**

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

	Company		
	Software development cost £m	**Intangible assets under development £m**	**Total £m**
Cost			
At 1 January 2009	**44**	**-**	**44**
Additions	**33**	**-**	**33**
At 31 December 2009	**77**	**-**	**77**
Accumulated amortisation/impairment			
At 1 January 2009	**28**	**-**	**28**
Charge for the year	**11**	**-**	**11**
At 31 December 2009	**39**	**-**	**39**
Net book value	**38**	**-**	**38**

Notes to the Financial Statements continued

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

Disposals in 2008 include the costs capitalised in relation to the development of a new banking engine which were written off following the acquisition of the Company by Banco Santander, S.A. as it intends to implement its banking system, Partenon.

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

			Group
	Owner-occupied properties £m	**Office fixtures and equipment £m**	**Total £m**
Cost:			
At 1 January 2009	**363**	**242**	**605**
Additions	**-**	**19**	**19**
Disposals	**-**	**(46)**	**(46)**
At 31 December 2009	**363**	**215**	**578**
Accumulated depreciation:			
At 1 January 2009	**190**	**192**	**382**
Charge for the year	**10**	**26**	**36**
Disposals	**-**	**(46)**	**(46)**
At 31 December 2009	**200**	**172**	**372**
Net book value	**163**	**43**	**206**

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

			Company
	Owner-occupied properties £m	**Office fixtures and equipment £m**	**Total £m**
Cost:			
At 1 January 2009	**256**	**226**	**482**
Additions	**-**	**83**	**83**
Disposals	**-**	**(110)**	**(110)**
At 31 December 2009	**256**	**199**	**455**
Accumulated depreciation:			
At 1 January 2009	**157**	**177**	**334**
Charge for the year	**9**	**25**	**34**
Disposals	**-**	**(46)**	**(46)**
At 31 December 2009	**166**	**156**	**322**
Net book value	**90**	**43**	**133**

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

At 31 December 2009 capital expenditure contracted, but not provided for was £nil (2008: £nil) in respect of property, plant and equipment. Of the carrying value as at 31 December 2009, £nil (2008: £nil) related to assets under construction. The cost of office fixtures and equipment held under finance leases was £26m (2008: £26m).

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

	Group		Company	
Leases which expire	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Within 1 year	**1**	–	**1**	–
Between 1-5 years	**2**	3	**1**	2
In more than 5 years	**3**	5	**3**	5
	6	8	**5**	7

22. Operating lease assets

	Group	
	2009 £m	2008 £m
Cost		
At 1 January	**475**	355
Additions	**81**	152
Disposals	**(101)**	(32)
At 31 December	**455**	475
Depreciation and impairment		
At 1 January	**127**	71
Charge for the year	**74**	66
Disposals	**(58)**	(10)
At 31 December	**143**	127
Net book value	**312**	348

The operating lease assets of the Group consist of commercial vehicles. Future minimum lease receipts under non-cancellable operating leases are due over the following periods:

	Group	
	2009 £m	2008 £m
In no more than 1 year	**71**	81
In more than 1 year but no more than 5 years	**96**	133
In more than 5 years	**26**	17
Total	**193**	231

The Company has no operating lease assets.

Notes to the Financial Statements continued

23. Deferred tax

Deferred taxes are calculated on temporary differences under the liability method using the tax rates expected to apply when the liability is settled or the asset is realised. The movement on the deferred tax account was as follows:

	Group		Company	
	2009 **£m**	2008 £m	**2009** **£m**	2008 £m
At 1 January	**348**	5	**285**	(8)
Income statement (charge)/credit	**(193)**	326	**3**	279
Credited/(charged) to equity	**1**	3	**(2)**	14
Deferred tax on acquisitions and disposals	**(2)**	14	**-**	-
At 31 December	**154**	348	**286**	285

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

	Group		Company	
	2009 **£m**	2008 £m	**2009** **£m**	2008 £m
Deferred tax liabilities				
Provision for loan impairment and other provisions	**-**	-	**-**	(1)
Accelerated tax depreciation	**(236)**	(193)	**-**	(2)
Cash flow hedging	**(6)**	(64)	**-**	(47)
Other temporary differences	**(13)**	(21)	**-**	(23)
	(255)	(278)	**-**	(73)

	Group		Company	
	2009 **£m**	2008 £m	**2009** **£m**	2008 £m
Deferred tax assets				
Pensions and other post-retirement benefits	**41**	20	**41**	20
Accelerated book depreciation	**120**	202	**3**	-
Cash flow hedging	**(53)**	-	**(53)**	-
Provision for loan impairment and other provisions	**6**	22	**3**	-
Other temporary differences	**(2)**	14	**(5)**	-
Tax losses carried forward	**297**	368	**297**	338
	409	626	**286**	358

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

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

	Group	
	2009 **£m**	2008 £m
Accelerated tax depreciation	**123**	(16)
Pensions and other post-retirement benefits	**27**	-
Provision for loan impairment and other provisions	**(7)**	(8)
Tax losses carried forward	**31**	(309)
Other temporary differences	**19**	7
	193	(326)

24. Other assets

	Group		Company	
	2009 **£m**	2008 £m	**2009** **£m**	2008 £m
Trade and other receivables	**297**	171	**282**	1,337
Prepayments	**26**	74	**22**	82
Accrued income	**29**	14	**6**	12
	352	259	**310**	1,431

25. Deposits by banks

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Amounts due to subsidiaries	**-**	-	**2,112**	2,090
Amounts due to fellow subsidiaries	**51,317**	-	**51,215**	-
Items in the course of transmission	**57**	178	**46**	160
Sale and repurchase agreements	**-**	8,816	**-**	8,816
Other deposits	**1,084**	2,522	**712**	2,519
	52,458	11,516	**54,085**	13,585

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Repayable:				
On demand	**16,155**	1,279	**16,163**	1,907
In not more than 3 months	**12,020**	6,897	**12,462**	8,333
In more than 3 months but not more than 1 year	**3,100**	517	**4,216**	521
In more than 1 year but not more than 5 years	**12,228**	2,823	**12,254**	2,824
In more than 5 years	**8,955**	-	**8,990**	-
	52,458	11,516	**54,085**	13,585

26. Deposits by customers

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Retail deposits	**26,477**	24,978	**24,490**	23,050
Amounts due to subsidiaries	-	-	**6,242**	3,385
Amounts due to fellow subsidiary	**10,460**	8,741	**10,460**	8,741
Wholesale deposits by customers	**6,499**	6,046	**6,499**	6,046
	43,436	39,765	**47,691**	41,222
Repayable:				
On demand	**27,547**	28,435	**28,586**	30,556
In no more than 3 months	**12,497**	8,025	**15,917**	7,592
In more than 3 months but no more than 1 year	**2,678**	3,119	**2,494**	2,902
In more than 1 year but not more than 5 years	**713**	95	**694**	81
In more than 5 years	**1**	91	-	91
	43,436	39,765	**47,691**	41,222

Retail deposits and wholesale deposits by customers are interest-bearing.

27. Financial liabilities designated at fair value

	Group		Company	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Deposits by banks	**44**	153	**44**	153
Deposits by customers	**12**	252	**12**	252
Debt securities in issue	**27**	323	**27**	323
	83	728	**83**	728

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 deposits by banks, deposits by customers and debt securities in issue would otherwise be measured at amortised cost, and the associated derivatives used to economically hedge the risk are held at fair value.

No material amount of the movements in the fair value of the above debt securities in issue reflects any element of the Group's own credit risk. This was calculated by applying current spreads at the next call date or maturity date to the nominal value of the security to determine the extra cost of the debt security for the remaining period of the debt security were it to have been issued at current spreads.

The amount that would be required to be contractually paid at maturity of the deposits by banks, deposits by customers, and debt securities in issue above is £5m lower (2008: £14m higher) than the carrying value.

Notes to the Financial Statements continued

28. Debt securities in issue

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Bonds and medium-term notes:				
- Euro 10bn Global Covered Bond Programme	**-**	2,800	**-**	2,800
- US$40bn Euro Medium Term Note Programme	**5,879**	9,683	**5,879**	9,284
	5,879	12,483	**5,879**	12,084
Securitisation programmes:				
- Fosse	**4,102**	4,331	**-**	-
Other debt securities in issue	**-**	663	**-**	-
	9,981	17,477	**5,879**	12,084

Euro 10bn Global Covered Bond Programme

Alliance & Leicester plc previously issued certain Covered Bonds under the euro 10bn Global Covered Bond Programme. On 17 November 2009, the outstanding Covered Bonds issued under the Programme were redeemed and the Programme was discontinued.

The Programme provided that Covered Bonds may be listed or admitted to trading, on the official list of the UK Listing Authority and on the London Stock Exchange's Regulated Market or any other stock exchanges or regulated or unregulated markets. The Programme also provided for the issue of unlisted Covered Bonds and/or Covered Bonds not admitted to trading on any regulated or unregulated market.

Alliance & Leicester Covered Bonds LLP ("LLP") guaranteed payments of interest and principal under the Covered Bonds pursuant to a guarantee which was secured over its portfolio of mortgages and its other assets. Recourse against LLP under its guarantee was limited to its portfolio of mortgages and such assets.

US$40bn Euro Medium Term Note Programme

In January 2009, it was decided that no further issuance would be made under the US$40bn Euro Medium Term Note Programme. Outstanding notes will remain in issue until maturity.

Alliance & Leicester plc issued both senior notes and subordinated notes and from time to time issued notes denominated in any currency as agreed with the relevant dealer under the US$40bn Euro Medium Term Notes Programme. The notes are direct, unsecured and unconditional obligations of Alliance & Leicester plc. The Programme provided for issuance of Fixed Rate Notes, Floating Rate Notes, Index Linked Notes, Dual Currency Notes and Zero-Coupon Notes. The notes are listed on the London Stock Exchange or may be listed on any other or further stock exchange(s) or may be unlisted, as agreed.

The notes were issued in bearer form. The maximum aggregate nominal amount of all notes from time to time outstanding under the Programme did not exceed US$40bn (or its equivalent in other currencies), subject to any modifications in accordance with the terms of the Programme agreement.

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

			Group		Company	
	Interest Rate	Maturity	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Euro	0.00% – 3.99%	Up to 2010	**934**	1,897	**934**	1,897
		2011 – 2019	**2,041**	1,939	**2,041**	1,939
		2040 – 2059	**1,836**	-	**-**	-
	4.00% – 4.99%	Up to 2010	**-**	443	**-**	443
		2011 – 2019	**-**	193	**-**	193
	5.00% – 7.99%	Up to 2010	**276**	406	**276**	406
		2011 – 2019	**-**	148	**-**	148
		2030 – 2039	**-**	139	**-**	-
		2040 – 2059	**-**	2,105	**-**	-
US Dollar	0.00% – 3.99%	Up to 2010	**309**	753	**309**	753
		2011 – 2019	**618**	95	**618**	-
		2040 – 2059	**917**	-	**-**	-
	4.00% – 6.87%	Up to 2010	**20**	390	**20**	390
		2011 – 2019	**49**	743	**49**	743
		2040 – 2059	**-**	1,650	**-**	-
Pounds sterling	0.00% – 3.99%	Up to 2010	**121**	3,048	**121**	3,047
		2011 – 2019	**207**	427	**207**	427
		2040 – 2059	**1,349**	-	**-**	-
	4.00% – 6.99%	Up to 2010	**626**	693	**626**	693
		2011 – 2019	**302**	113	**302**	113
		2040 – 2059	**-**	1,388	**-**	-
Other currencies	0.00% – 5.99%	Up to 2010	**337**	852	**337**	852
		2011 – 2019	**39**	40	**39**	40
	6.00% – 8.99%	2011 – 2039	**-**	15	**-**	-
			9,981	17,477	**5,879**	12,084

29. Subordinated liabilities

	Group and Company	
	2009 £m	2008 £m
Dated subordinated liabilities:		
5.875% Subordinated notes 2031	**168**	191
5.25% Subordinated notes 2023	**162**	171
Subordinated floating rate EURIBOR notes 2017	**133**	145
Subordinated floating rate US$ LIBOR notes 2015	**93**	102
Subordinated floating rate EURIBOR notes 2017	**89**	97
9.625% Subordinated notes 2023	**383**	399
	1,028	1,105
Undated subordinated liabilities:		
Subordinated floating rate US$ LIBOR notes (US$ 100m)	**-**	69
Subordinated floating rate US$ LIBOR notes (US$ 220m)	**-**	151
Subordinated floating rate EURIBOR notes (euro 115m)	**-**	111
	-	331
Total subordinated liabilities	**1,028**	1,436

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

In 2009, the subordinated floating rate US$ LIBOR notes (US$ 100m), subordinated floating rate US$ LIBOR notes (US$ 220m) and subordinated floating rate EURIBOR notes (euro 115m) were redeemed in full.

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

Subordinated liabilities in issue are repayable:

	Group and Company	
	2009 £m	2008 £m
In more than 5 years	**1,028**	1,105
Undated	**-**	331
	1,028	1,436

30. Other liabilities

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Trade and other payables	**443**	600	**539**	4,545
Deferred income	**60**	31	**1**	104
	503	631	**540**	4,649

Trade and other payables include £37m (2008: £40m) of finance lease obligations mainly relating to a lease and leaseback of Group property. The maturity of net obligations under finance leases are as follows:

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Within 1 year	**5**	4	**-**	-
Between 1-5 years	**20**	21	**-**	1
In more than 5 years	**12**	15	**-**	-
	37	40	**-**	1

Future minimum lease payments are:

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Within 1 year	**7**	6	**-**	-
Between 1-5 years	**25**	27	**-**	1
In more than 5 years	**13**	17	**-**	-
	45	50	**-**	1

Notes to the Financial Statements continued

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

	Group		Company	
Leases which expire	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Within 1 year	**-**	1	**-**	-
Between 1-5 years	**-**	2	**-**	-
	-	3	**-**	-

During the year, £3m (2008: £3m) was incurred as a finance lease interest charge.

31. Provisions

			Group
	Misselling £m	**Other £m**	**Total £m**
At 1 January 2009	**34**	**-**	**34**
Additional provisions	**70**	**11**	**81**
Disposal of subsidiary undertakings	**(16)**	**(14)**	**(30)**
Used during the year	**(88)**	**(3)**	**(91)**
Reclassifications	**-**	**18**	**18**
At 31 December 2009	**-**	**12**	**12**
To be settled:			
Within 12 months	**-**	**12**	**12**

			Company
	Misselling £m	**Other £m**	**Total £m**
At 1 January 2009	**-**	**-**	**-**
Additional provisions	**-**	**11**	**11**
At 31 December 2009	**-**	**11**	**11**
To be settled:			
Within 12 months	**-**	**11**	**11**

			Group
	Misselling £m	Other £m	Total £m
At 1 January 2008	-	-	-
Additional provisions	38	-	38
Used during the year	(4)	-	(4)
At 31 December 2008	34	-	34
To be settled:			
Within 12 months	34	-	34

There were no provisions in the Company in 2008.

The misselling provision comprises various claims with respect to product misselling. In calculating the misselling provision, management's best estimate of the provision was calculated based on conclusions regarding the number of claims that will be received, of those, the number that will be upheld, and the estimated average settlement per case. Further information on misselling provisions can be found in 'Critical Accounting Policies' within the Accounting Policies on page 66.

32. Retirement benefit obligations

The amounts recognised in the balance sheet were as follows:

	Group and Company	
	2009 £m	2008 £m
Assets/(liabilities)		
Funded defined benefit pension scheme	**-**	4
Funded defined benefit pension scheme	**(126)**	-
Unfunded defined benefit pension scheme	**(13)**	(11)
Net defined benefit obligation	**(139)**	(7)
Post-retirement medical benefits (unfunded)	**(11)**	(10)
Total net liabilities	**(150)**	(17)

The total net deficit on the Group's defined benefit schemes, and other post-retirement benefit schemes, increased significantly from £17m at 31 December 2008 to £150m at 31 December 2009. The key reason for the increase was a reduction of 100 basis points in the net discount rate (i.e. the discount rate less the inflation rate) used to value the defined benefit scheme liabilities. The increase in assumed inflation also impacted the expected rate of pension increase, in turn leading to a further increase in scheme liabilities. These changes have increased the scheme liabilities, partly offset by contributions made and increase in asset values.

Defined Contribution Pension schemes

The Group operates one defined contribution scheme, which is part of the Alliance & Leicester Pension Scheme. Employees of the Group were eligible to join the scheme from 1 April 1998. The assets of the schemes are held and administered separately from those of the Company in a separate trustee-administered fund.

An expense of £11m (2008: £10m) was recognised for defined contribution plans in the year, and is included in staff costs classified within administration expenses in the income statement. None of this amount was recognised in respect of key management personnel for the years ended 31 December 2009 and 2008.

Defined Benefit Pension schemes

The Group operates one defined benefit pension scheme, the Alliance & Leicester Pension Scheme, covering 30% (2008: 31%) of the Group's employees. The defined benefit section of this scheme closed to new entrants on 31 March 1998 and has a defined contribution section for employees who joined the Company after this date. As the defined benefit section of the scheme is closed to new entrants, under the projected unit method, the current service cost when expressed as a percentage of pensionable salaries, will gradually increase over time.

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

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

	Group	
	2009 £m	2008 £m
Current service cost	**8**	19
Past service cost	**14**	-
Expected return on pension scheme assets	**(75)**	(84)
Interest cost	**77**	75
	24	10

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

	Group and Company				
	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Present value of funded defined benefit obligation	**(1,477)**	(1,209)	(1,324)	(1,327)	(1,305)
Fair value of plan assets	**1,351**	1,213	1,377	1,311	1,230
	(126)	4	53	(16)	(75)
Unfunded benefit obligation	**(13)**	(11)	(11)	(10)	(9)
	(139)	(7)	42	(26)	(84)

Notes to the Financial Statements continued

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

	Group and Company	
	2009	2008
	£m	£m
Balance at 1 January	**(1,220)**	(1,335)
Current service cost	**(8)**	(19)
Interest cost	**(77)**	(75)
Employee contributions	**(4)**	(2)
Past service cost	**(14)**	–
Actuarial (loss)/gain	**(222)**	170
Actual benefit payments	**55**	41
Balance at 31 December	**(1,490)**	(1,220)

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

	Group and Company	
	2009	2008
	£m	£m
Balance at 1 January	**1,213**	1,377
Expected return on scheme assets	**75**	84
Actuarial gain/(loss) on scheme assets	**30**	(230)
Company contributions paid	**83**	20
Employee contributions	**5**	2
Actual benefit payments	**(55)**	(40)
Balance at 31 December	**1,351**	1,213

The amounts recognised in the Consolidated Statement of Comprehensive Income for each of the five years indicated were as follows:

	Group and Company				
	2009	2008	2007	2006	2005
	£m	£m	£m	£m	£m
Actuarial (gain)/loss on scheme assets	**(30)**	230	3	(13)	(108)
Actuarial loss/(gain) on scheme liabilities	**222**	(170)	(57)	(34)	130
Total net actuarial loss/(gain)	**192**	60	(54)	(47)	22

The actual return on scheme assets was a gain of £105m (2008: £146m loss). Cumulative net actuarial loss of £179m (2008: £13m gain) has been recognised in the Consolidated Statement of Comprehensive Income. The Group's pension schemes did not directly hold any equity securities of the Company or any of its related parties at 31 December 2009. In addition, the Group does not hold insurance policies over the schemes, and has not entered into any significant transactions with the schemes.

The assets of the funded plans are held independently of the Group's assets in separate trustee administered funds. The principal duty of the trustees is to act in the best interests of the members of the scheme. Ultimate responsibility for investment strategy rests with the trustees of the scheme who are required under the Pensions Act 2004 to prepare a statement of investment principles.

The trustees of the Group's scheme have developed the following investment objectives:

> To maintain a portfolio of suitable assets of appropriate quality, suitability and liquidity which will generate income and capital growth to meet, together with new contributions from members and the employers, the cost of current and future benefits which the pension scheme provides, as set out in the trust deed and rules.

> To limit the risk of the assets failing to meet the liabilities, over the long-term and on a shorter-term basis as required by prevailing legislation.

> To minimise the long-term costs of the pension scheme by maximising the return on the assets whilst having regard to the objectives shown above.

Asset allocation strategies were reviewed in 2008 and 2009, and automatic rebalancing to the central benchmark positions was suspended as a result of the unprecedented volatility in asset markets during this period. Future allocation strategies will be set to allow for a more dynamic approach. Implementation of these strategies began in 2009 and will continue during 2010 whilst taking into account market conditions.

The statement of investment principles for the scheme adopted in 2009 has set the long-term target allocation of plan assets at 25% Equities, 25% alternative return-seeking assets (including Property), 25% Bonds and 25% Gilts. Movement towards this long term target commenced during the year and progress will be dependent on market conditions.

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

	2009 £m	2009 %	2008 £m	2008 %
UK equities	**283**	**21**	283	23
Overseas equities	**269**	**20**	218	18
Corporate bonds	**333**	**25**	228	19
Government Fixed Interest	**247**	**18**	252	21
Government Index Linked	**128**	**10**	117	10
Property funds	**58**	**4**	64	5
Cash	**3**	**-**	5	-
Other	**30**	**2**	46	4
	1,351	**100**	1,213	100

Other assets consist of annuities and derivatives that are used to protect against inflation and interest rate movements.

The expected rates of return by asset class used to calculate the expected return for the year were:

	Group and Company	
	2009 %	2008 %
Equities	**8.1**	7.8
Corporate bonds	**6.2**	5.0
Government bonds	**3.9**	5.0
Property	**6.3**	6.4

The expected return on plan assets is determined by considering the expected returns available on the assets underlying the current investment policy, as follows:

>	Equities	Long-term median real rate of return experienced after considering projected movements in asset indices
>	Corporate bonds	Gross redemption yields as at the balance sheet date, less a margin for default risk
>	Government bonds	Gross redemption yields as at the balance sheet date
>	Property funds	Average of returns for UK equities and government bonds
>	Cash	Expected long term bank rate, after considering projected inflation rate

Actuarial assumptions

The principal actuarial assumptions used were as follows:

	2009 %	2008 %
To determine benefit obligations:		
- Discount rate for scheme liabilities	**5.8**	6.4
- General price inflation	**3.4**	3.0
- General salary increase	**3.4**	3.5
- Expected rate of pension increase	**3.3**	3.0
To determine net periodic benefit cost:		
- Discount rate	**6.4**	5.7
- Expected rate of pension increase	**3.0**	3.3
- Expected rate of return on plan assets	**6.4**	6.5
Medical cost trend rates:		
- Initial rate	**5.5**	6.0
- Ultimate rate	**4.5**	4.5
- Year of ultimate rate	**2013**	2013

	Years	Years
Longevity at 60 for current pensioners, on the valuation date:		
- Males	**27.6**	27.5
- Females	**30.0**	29.9
Longevity at 60 for future pensioners currently aged 40, on the valuation date:		
- Males	**29.7**	29.6
- Females	**31.3**	31.2

The rate used to discount the retirement benefit obligation is determined to reflect duration of the liabilities based on the annual yield at 31 December of the sterling 15+ year AA Corporate Bond iBoxx Index, representing the market yield of high quality corporate bonds on that date, adjusted to match the terms of the scheme liabilities. The inflation assumption is set based on the Bank of England projected inflation rates over the duration of scheme liabilities weighted by projected scheme cash flows.

Notes to the Financial Statements continued

The mortality assumption used in preparation of the valuation was the Continuous Mortality Investigation Table PXA 92MCC 2009 with a future improvement underpin of 1% for males and 0.5% for females. The table above shows that a member retiring at age 60 as at 31 December 2009 is assumed to live for, on average, 27.6 years for a male and 30.0 years for a female. In practice, there will be variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 40 now, when they retire in 20 years time at age 60.

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

The Group currently expects to contribute £19m to its defined benefit pension schemes in 2010. The benefits expected to be paid in each of the next five years, and in the aggregate for the five years thereafter are:

Year ending 31 December:	**£m**
2010	**55**
2011	**57**
2012	**59**
2013	**61**
2014	**63**
Five years ended 2019	**347**

Post Retirement Medical Benefit Plans

The Group also operates unfunded post retirement medical benefit plans for a number of its former employees. The post retirement medical benefit plans in operation are accounted for in the same manner as defined benefit pension plans.

Formal actuarial valuations of the liabilities of the schemes are carried out on a triennial basis by an independent professionally qualified actuary and updated for accounting purposes at each balance sheet date. The latest formal actuarial valuation was made as at 31 December 2006 and updated to 31 December 2009 by a qualified independent actuary.

Actuarial assumptions used for the Group's post retirement medical benefit plan are the same as those used for the Group's defined benefit pension schemes. There was an actuarial loss during the year of £1m (2008: £nil) on the Group's post-retirement medical benefits liability. A one percentage point movement in medical cost trends would increase or decrease the post-retirement medical benefit liability and interest cost by £1m (2008: £1m).

33. Contingent liabilities and commitments

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Guarantees given to subsidiaries	-	-	**208,232**	-
Guarantees given to third parties	**137**	202	**137**	200
Formal standby facilities, credit lines and other commitments with original term to maturity of:				
– 1 year or less	**2,014**	380	**1,620**	323
– More than 1 year	**137**	1,595	**137**	725
	2,288	2,177	**210,126**	1,248

Unauthorised overdraft fees

A number of financial institutions have been involved in legal proceedings with the Office of Fair Trading ("OFT"), regarding the legal status and enforceability of unarranged overdraft fees (the "OFT Proceedings"). The Company was not a party to the OFT Proceedings but its parent company, Santander UK plc, was. The OFT Proceedings were concerned with whether certain of the financial institutions' terms and conditions are subject to the fairness test in the Unfair Terms in Consumer Contract Regulations 1999 (the "Regulations") and whether they are capable of being 'penalties' at common law.

In April 2008 the High Court confirmed that the then current terms and conditions of Santander UK plc were not capable of being penalties at common law. This finding was not appealed by the OFT. The High Court also found that the relevant terms were assessable for fairness under the Regulations. On 26 February 2009, the Court of Appeal dismissed the appeal against the High Court's judgment made by the relevant financial institutions and held that unarranged overdraft fees were assessable for fairness under the Regulations.

The House of Lords gave the relevant financial institutions permission to appeal this judgment. The hearing before the House of Lords took place on 23 to 25 June 2009. The Supreme Court (previously The House of Lords) gave its judgment on 25 November 2009 and ruled that the level of the unauthorised overdraft fees of the relevant financial institutions could not be assessed for fairness under the Regulations (to the extent that the terms pursuant to which the fees are levied are in plain and intelligible language), although they may be assessed for fairness on some other basis.

On 22 December 2009, the OFT announced that it would not be continuing with its investigation into the fairness of unarranged overdraft fees.

The Company has rejected the vast majority of complaints which remained in respect of unarranged overdraft fees after the Supreme Court decision, and it is understood that the Financial Ombudsman Service has also rejected the vast majority of complaints that it had had on hold since the commencement of the OFT Proceedings. The Company has started to invite County Courts to dismiss those claims against them which have been stayed since the commencement of the OFT Proceedings and which relate to the issues covered in the OFT Proceedings. It is presently anticipated that the Company will continue with this approach.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS), the UK's statutory fund of last resort for customers of authorised financial services firms, pays compensation if a firm is unable to meet its obligations as they fall due. As a result of the failure of a number of deposit-taking institutions during the second half of 2008, the FSCS now stands as a creditor of Bradford & Bingley plc and the administrations of Heritable Bank, Kaupthing Singer & Friedlander and Landsbanki "Icesave". The FSCS has borrowed from HM Treasury to fund the compensation costs associated with those failures. These borrowings are currently on an interest-only basis until 31 March 2012.

The FSCS fulfils its obligations by raising management expenses levies and compensation levies on the industry. In relation to compensation relating to protected deposits, each deposit-taking institution contributes towards these levies in proportion to their share of total protected deposits, subject to a threshold set by the UK Financial Services Authority establishing the maximum that the FSCS can levy for compensation in any one year. The limit on the FSCS management expenses for the three years from September 2008 in relation to the above-mentioned failures has been capped at £1bn per annum. The FSCS has the power to raise levies on firms who have ceased to participate in the scheme and are in the process of ceasing to be authorised (so called 'exit levies') for the amount that the firm would otherwise have been asked to pay during the relevant levy year. The Group has an accrual for its share of management expenses levies for the 2009/10 and 2010/11 levy years as at 31 December 2009 of £25m (2008: £21m).

The FSCS will receive funds from asset sales, surplus cash flow, or other recoveries from each of the above-named banks. These recoveries will be used to reduce the principal amount outstanding on the FSCS's borrowings. Only after the interest-only period which is expected to end on 31 March 2012 will a schedule for repayment of any remaining principal outstanding (after recoveries) on the borrowings be agreed between the FSCS and HM Treasury. It is expected that, from that point, the FSCS will begin to raise compensation levies (principal repayments) relating to the above-named banks. No provision for compensation levies, which could be significant, has been made in these Consolidated Financial Statements.

Regulatory

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

Obligations under stock borrowing and lending agreements

Obligations under stock borrowing and lending agreements represent contractual commitments to return stock borrowed. These obligations totalling £13,619m at 31 December 2009 (2008: £2,795m) are offset by a contractual right to receive stock under other contractual agreements.

Other off-balance sheet commitments

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

Operating lease commitments

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Rental commitments under operating leases expiring:				
– No later than 1 year	**14**	1	**13**	1
– Later than 1 year but no later than 5 years	**38**	7	**38**	7
– Later than 5 years	**32**	64	**32**	124
	84	72	**83**	132

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

Leases expiring year ended 31 December:	Group **£m**	Company **£m**
2010	**14**	**13**
2011	**11**	**11**
2012	**10**	**10**
2013	**9**	**9**
2014	**8**	**8**
Total thereafter	**32**	**32**

Notes to the Financial Statements continued

Group rental expense comprises:

	Group 2009 £m	2008 £m
In respect of minimum rentals	**37**	12
Less: sub-lease rentals	–	(1)
	37	11

34. Innovative Tier 1

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

The coupon is 5.827% per annum until 22 March 2016. Thereafter the coupon steps up to a rate, reset every five years, of 2.13% per annum above the gross redemption yield on a UK Government Treasury Security. The Tier 1 securities are redeemable at the option of the Company on 22 March 2016 or on each payment date thereafter. No such redemption may be made without the consent of the UK Financial Services Authority. In both 2009 and 2008 the coupon of £17.5m was paid.

35. Share capital and preference shares

	Ordinary shares of 50 pence each £m
Share capital	
Issued and fully paid share capital	
At 1 January 2009	**328**
Shares issued	**600**
At 31 December 2009	**928**
At 1 January 2008	210
Shares issued	118
At 31 December 2008	328

The Company has one class of ordinary shares which carry no right to fixed income. On 10 June 2009 the Company issued 116,583 ordinary shares of £0.50 each to Alliance & Leicester Share Ownership Trust Limited as nominee and on behalf of participants in the Alliance & Leicester Deferred Bonus Scheme. These shares were subsequently transferred to Santander UK plc in accordance with the Scheme of Arrangement, in exchange for 38,817 shares in Banco Santander, S.A.

On 30 June 2009 the Company issued 1,200,000,000 ordinary shares of £0.50 each in capital of the Company to Santander UK plc, utilising £600,000,000 of the Company's share premium account to issue new bonus shares at par.

	Ordinary shares of 50 pence each £m
Share premium account	
At 1 January 2009	**724**
Shares issued	**(600)**
At 31 December 2009	**124**
At 1 January 2008	125
Shares issued	599
At 31 December 2008	724

Preference shares

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

On 26 February 2010 it was announced that as the Company's preference shares will not transfer to Santander UK plc under the proposed Part VII Transfer, the Company and Santander UK plc have agreed that the holders of the Company's preference shares should be given the opportunity to exchange their Alliance & Leicester plc preference shares for new preference shares to be issued by Santander UK plc. It is intended that the exchange will be carried out by a scheme of arrangement under Part 26 of the Companies Act 2006, which, if approved by the Court as well as holders of the Company's preference shares and Santander UK plc (as holder of the ordinary shares of Alliance & Leicester plc), the Company's preference shares would be substituted with new preference shares to be issued by Santander UK plc on substantially similar terms.

36. Dividends

Analysis of dividends paid is as follows:

	Group and Company	
	2009 Pence per Share	2008 Pence per Share
Ordinary shares (equity):		
2007 interim	-	18.8
2007 final	-	36.5
2008 interim	-	18.0
	-	73.3

37. Cash flow statement

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Profit/(loss) for the year	**60**	(918)	**(78)**	(275)
Non-cash items included in net profit				
Increase in prepayments and accrued income	**(128)**	(4)	**(142)**	(7)
(Decrease)/increase in accruals and deferred income	**(358)**	(36)	**130**	(29)
Depreciation and amortisation	**121**	114	**45**	44
Provisions for liabilities and charges	**81**	15	**11**	(19)
Provision for impairment	**363**	1,033	**532**	783
Other non-cash items	**263**	(221)	**278**	(153)
	402	(17)	**776**	344
Changes in operating assets and liabilities				
Net decrease in trading assets	**-**	1,439	**-**	1,439
Net decrease/(increase) in derivative assets	**1,768**	(1,905)	**1,608**	(1,286)
Net decrease/(increase) in financial assets designated at fair value	**13**	828	**13**	(27)
Net (increase)/decrease in loans and advances to banks and customers	**(25,553)**	5,114	**(26,703)**	4,750
Net decrease/(increase) in other assets	**185**	(5,887)	**1,224**	(6,813)
Net increase/(decrease) in deposits by banks and deposits by customers	**44,991**	2,794	**46,870**	4,583
Net (decrease)/increase in derivative liabilities	**(1,335)**	990	**(1,353)**	1,013
Net decrease in financial liabilities designated at fair value	**(650)**	(3,299)	**(650)**	(3,299)
Net (decrease)/increase in debt issued	**(4,760)**	3,603	**(4,513)**	2,582
Net decrease in other liabilities	**(457)**	(29)	**(4,174)**	(391)
Effects of exchange rate differences	**(841)**	-	**(409)**	-
Net cash flow from operating activities before tax	**13,763**	3,631	**12,689**	2,895
Income tax (paid)/received	**(3)**	21	**(3)**	32
Net cash flow from operating activities	**13,760**	3,652	**12,686**	2,927

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

	Group		Company	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Cash and balances with central banks	**446**	1,553	**446**	1,553
Loans and advances to banks	**14,825**	816	**14,416**	814
Cash and cash equivalents	**15,271**	2,369	**14,862**	2,367

Notes to the Financial Statements continued

38. Collateral pledged and received

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

The Company enters into securitisation transactions whereby portfolios of residential mortgage loans are purchased by or assigned to special purpose securitisation companies, and have been funded through the issue of mortgage-backed securities. Holders of the securities are only entitled to obtain payments of principal and interest to the extent that the resources of the securitisation companies are sufficient to support such payments and the holders of the securities have agreed in writing not to seek recourse in any other form. At 31 December 2009, £21,713m (2008: £22,582m) of residential mortgage loans were so assigned.

In 2008, the Company also established a covered bond programme, whereby securities are secured by a pool of ring-fenced residential mortgages. At 31 December 2009, £nil (2008: £3,222m) of residential mortgage loans had been so secured.

Collateral is also provided in the normal course of derivative business to counterparties. As at 31 December 2009, £21m (2008: £196m) of such collateral in the form of cash had been pledged.

The Company enters into sale and repurchase agreements and similar transactions, which are accounted for as secured borrowings. Upon entering into such transactions, the Company provides collateral equal to 100%-131% of the borrowed amount. The fair value of assets that were so pledged at 31 December 2009 was £19,395m (2008: £21,133m).

The Company also enters into purchase and resale agreements and similar transactions whereby the Company receives collateral. The Company is permitted to sell or re-pledge the collateral held. The carrying amount of assets that were so provided at 31 December 2009 was £4,643m (2008: £2,795m) of which £4,643m (2008: £2,763m) was sold or re-pledged.

39. Share-based compensation

During the year ended 31 December 2009, the Group had four share-based payment arrangements, including Share Incentive Plan (SIP) partnership shares. Three other share-based payment arrangements ceased to operate in 2008 following the acquisition by Banco Santander, S.A.. The Executive Directors of the Company also participate in schemes as disclosed in the Annual Report & Accounts of Santander UK plc.

Options held under the ShareSave plan, share option plan and senior manager deferred bonus scheme became exercisable on 7 October 2008 and lapsed, if they had not been exercised, on 7 April 2009. Shares acquired upon exercise of the option in that period were automatically exchanged for Banco Santander, S.A. shares in the same three for one ratio as was applicable to all shareholders upon acquisition by Banco Santander, S.A. Outstanding executive deferred bonus scheme options were all exercised on 7 October 2008 and Long-Term Incentive Plan (LTIP) shares all lapsed on 7 October 2008. Restricted share plan shares vested and were converted to Banco Santander, S.A. shares on acquisition in the same three for one ratio, in accordance with the scheme rules.

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

2009	**ShareSave No. of shares**	**Share option plan No. of shares**	**Senior manager deferred bonus[1] No. of shares**
Outstanding at 1 January	**564,675**	**2,232,426**	**64,726**
Lapsed	**(564,675)**	**(2,232,426)**	**-**
Exercised	**-**	**-**	**(64,726)**
Outstanding at 31 December 2009[3]	**-**	**-**	**-**
Weighted average exercise price in 2009	**-**	**-**	**285.5p**

2008	ShareSave No. of shares	Share option plan No. of shares	Executive deferred bonus No. of shares	Restricted share plan No. of shares	Long term incentive plan (LTIP) No. of shares	Senior manager deferred bonus[1] No. of shares
Outstanding at 1 January	3,388,840	3,830,524	58,721	306,932	1,083,669	243,597
Granted[4]	-	376,255	-	627,598	676,876	291,901
Lapsed	(2,768,842)	(1,974,353)	(32,514)	(627,361)	(1,736,241)	(137,725)
Exercised	(55,323)	-	(26,207)	(307,169)	(24,304)	(333,047)
Outstanding at 31 December 2008	564,675	2,232,426	-	-	-	64,726
Exercisable at 31 December 2008	564,675	2,232,426	-	-	-	64,726
Weighted average exercise price in 2008	630.2p	n/a	525.5p	274.2p	525.5p	285.5p
Range of exercise prices for options	632p - 815p	544p - 1,093p	n/a	n/a	n/a	n/a
Weighted average remaining contractual	n/a	n/a	n/a	n/a	n/a	n/a
Weighted average fair value options	n/a	84p	n/a	390p	428p	1,553p[2]

(1) The figures in the table relate to the level of bonus deferred, i.e. excluding the matching element.
(2) The option value includes the deferred share and the fair value of the matched element less the cash bonus foregone.
(3) Upon exercise, Alliance & Leicester plc shares were automatically converted to Banco Santander S.A. shares in the ratio three to one.
(4) No shares have been granted under any of the schemes since acquisition by Banco Santander, S.A. on 7 October 2008.

The Share Incentive Plan (SIP) was available to all employees. Prior to the Company's acquisition by Banco Santander, S.A., participants could elect to invest up to £125 per month from pre-tax salary to purchase shares at the prevailing market price. Shares can be released from Trust after five years free of income tax and national insurance contributions.

On the acquisition of the Company by Banco Santander, S.A., Alliance & Leicester plc shares held in the SIP were converted to Banco Santander, S.A. shares on the same three for one basis as was applicable to all other shareholders upon acquisition by Banco Santander, S.A.. These will remain in the SIP Trust under the terms of the SIP rules. 195,454 SIP partnership shares were issued during 2008 prior to acquisition, at the then prevailing market rate of Alliance & Leicester plc shares, at a weighted average price of 428p per share. All were converted to Banco Santander, S.A. shares on acquisition. No Banco Santander SIP shares have been issued since acquisition.

For these schemes, the estimated fair value is calculated as the value of the share price option plus the present value of any deferred dividends.

The assumptions used in the model are as follows:

Input	Assumption
Share price	Price at date of grant
Exercise price	Per scheme rules
Expected volatility	Estimated by calculating the annualised, exponential weighted monthly volatility of share price over prior two years
Option life	Per scheme rules
Risk free rate	Generated from LIBOR swap curve

40. Directors' emoluments and interests

Any loans, quasi loans and credit transactions entered into or agreed by the Company or its subsidiaries with persons who are or were Directors, Other Key Management Personnel and each of their connected persons during the year are set out in the Annual Report & Accounts of Santander UK plc for 2009, and for 2008 are set out below:

Other Key Management Personnel Loans*	**Number of persons**	**Aggregate amount Outstanding £000**
2008	2	217

* Other Key Management Personnel are defined as the Executive Committee of the Company and the Board and Executive Committee of Alliance & Leicester's parent company, Santander UK plc who served during the year.

Secured and unsecured loans are made to Directors, Other Key Management Personnel and their connected persons, in the ordinary course of business, with terms prevailing for comparable transactions and on the same terms and conditions as applicable to other employees or customers within the Group. Such loans do not involve more than the normal risk of collectability or present any unfavourable features.

41. Related party disclosures

Transactions with Directors, Other Key Management Personnel and each of their connected persons

Any transactions undertaken by Directors, Other Key Management Personnel and their connected persons with the Group in the course of normal banking are set out in the Annual Report & Accounts of Santander UK plc, and for 2008 are set out below.

2008	Number of Directors and Other Key Management Personnel(2)	Amounts in respect of Directors, Other Key Management Personnel(1) and their connected persons £000
Secured loans, unsecured loans and overdrafts		
Loans outstanding at 1 January	4	541
Net movements in the year	(2)	(324)
Loans outstanding at 31 December	2	217
Deposit, bank and instant access accounts and investments		
Deposits, bank instant access accounts and investments at 1 January	10	850
Net movements in the year	(6)	(580)
Deposit, bank and instant access accounts and investments at 31 December	4	270
Life assurance policies		
Life assurance policies at 1 January and 31 December	–	–

(1) In 2008, other Key Management Personnel are defined as the Executive Committee of the Company and the Board and Executive Committee of Alliance & Leicester's parent company, Santander UK plc who served during the year.
(2) In 2007, only the Board of Directors of the Company were Key Management Personnel.

Secured and unsecured loans are made to Directors, Other Key Management Personnel and their connected persons, in the ordinary course of business, with terms prevailing for comparable transactions and on the same terms and conditions as applicable to other employees and customers within the Group. Such loans do not involve more than the normal risk of collectability or present any unfavourable features. Amounts deposited by Directors, Other Key Management Personnel and their connected persons earn interest at the same rates as those offered to the market or on the same terms and conditions applicable to other employees within the Group.

Notes to the Financial Statements continued

No life assurance policies and investments were entered into by Directors, Other Key Management Personnel and their connected persons with the Company or its subsidiaries during the year.

Remuneration of Key Management Personnel

The remuneration of the Directors, and Other Key Management Personnel of Alliance & Leicester plc, in aggregate for each of the categories specified in IAS 24 Related Party Disclosures for 2009 is set out in the Annual Report & Accounts of Santander UK plc, and for 2008 is set out below. Further information about the aggregate remuneration of the Directors in 2009 is provided in the 'Directors' Remuneration' table in the Annual Report & Accounts of Santander UK plc.

Key management compensation	2008 £m
Short-term employee benefits	3.7
Post-employment benefits	0.4
Termination benefits	2.2
Share-based payments	2.3
	8.6

Company Share Option Plan

In 2008, Executive Directors and Other Key Management Personnel were granted options over shares in the Company under the Alliance & Leicester Company Share Option Plan. These options lapsed on 7 April 2009.

In 2005, three Executive Directors and five Other Key Management Personnel were granted options over shares in the Company. The amount of shares participants would receive at the end of the three-year period depended on the Earnings per Share performance of the Company in this period. The performance condition was not met and the options lapsed on 7 April 2008.

Deferred Bonus Scheme

In 2005 and 2004, three Executive Directors and five Other Key Management Personnel were granted deferred and matching options over shares in the Company under the Alliance & Leicester Deferred Bonus Scheme. The amount of matching shares Executive Directors would receive at the end of the three-year period depended on the Company's Total Shareholder Return against a competitor benchmark group. The conditions attached to the matching shares were not met at the end of the three-year period and the matching options awarded to Executive Directors lapsed. During 2009, all remaining deferred and matching options were exercised. During 2008, three Executive Directors exercised deferred options and four Key Management Personnel exercised deferred and matching options on 7 October 2008.

Long-Term Incentive Plan

In 2008, three Executive Directors and six Other Key Management Personnel were granted conditional awards of shares in the Company under the Alliance & Leicester plc Long-Term Incentive Plan for a total fair value of £518,893, (based on the fair value of £4.28 per share). The value attributable to 2008 of these conditional awards is included in the charge for share-based payments in 2008 in Note 39. Under the Alliance & Leicester plc Long-Term Incentive Plan granted on 27 March 2008, certain Executive Directors, Other Key Management Personnel (as defined in Note 40 above) and other nominated individuals were granted a conditional award of shares in the Company. The amount of shares participants would receive throughout a three-year period depended on the performance of the Company during this period. All awards under the Alliance & Leicester plc Long-Term Incentive Plan depended on the Company's Total Shareholder Return against a competitor benchmark group, Return on Equity and Earnings per Share performance. These conditions were not met at 9 October 2008, when the Scheme of Arrangement for the acquisition of the Company by Banco Santander, S.A. was completed, and the awards lapsed.

Parent undertaking and controlling party

At 31 December 2009, the Company's ultimate parent undertaking and controlling party was Banco Santander, S.A., a company incorporated in Spain. Banco Santander, S.A. is the parent undertaking of the largest Group of undertakings for which Group accounts are drawn up and of which the Company is a member. See Note 42 below for changes in Company ownership since 31 December 2009.

Copies of all sets of Group accounts, which include the results of the Company, are available from Secretariat, 2 Triton Square, Regent's Place, London NW1 3AN.

Transactions with related parties

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

								Group
	Interest, fees and other income received		Interest, fees and other expenses paid		Amounts owed by related parties		Amounts owed to related parties	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Ultimate parent company	–	–	**10**	–	**–**	–	**(276)**	–
Parent company	**(1)**	–	**20**	–	**1,096**	–	**(436)**	–
Fellow subsidiaries	**(289)**	3	**416**	38	**48,808**	149	**(61,798)**	9,465
	(290)	3	**446**	38	**49,904**	149	**(62,510)**	9,465

	Interest, fees and other income received		Interest, fees and other expenses paid		Amounts owed by related parties		Amounts owed to related parties (Company)	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Ultimate parent company	**–**	–	**10**	–	**–**	–	**(276)**	–
Parent company	**–**	–	**20**	–	**5**	–	**(340)**	–
Subsidiaries	**(400)**	1,376	**271**	636	**10,523**	11,272	**(8,478)**	9,717
Fellow subsidiaries	**(275)**	3	**416**	38	**46,277**	149	**(61,799)**	9,465
	(675)	1,379	**717**	674	**56,805**	11,421	**(70,893)**	19,182

The balances above include debt securities in issue held by related parties. In addition, transactions with pension schemes operated by the Group are described in Note 32. Transactions with fellow subsidiaries mainly relate to funding received from Santander UK plc.

42. Events after the balance sheet date

On 25 February 2010 it was announced that the Company intends to transfer its business into Santander UK plc later this year under a scheme allowed by Part VII of the Financial Services and Markets Act 2000. This transfer is subject to UK Financial Services Authority support and Court approval. The transfer will provide benefits for the Company's customers and for Santander UK plc. For Alliance & Leicester plc customers this includes access to Santander UK's full product range plus use of over 1,300 branches, four times as many branches currently available for Alliance & Leicester plc customers. By rationalising systems and improving the sales and risk management processes through having a single view of customers' dealings, Santander UK plc will also benefit from the significant synergies that were announced to the market at the time of the acquisition of Alliance & Leicester plc by Banco Santander, S.A. in 2008.

On 26 February 2010 it was announced that as the Company's preference shares will not transfer to Santander UK plc under the proposed Part VII Transfer, the Company and Santander UK plc have agreed that the holders of the Company's preference shares should be given the opportunity to exchange their Alliance & Leicester plc preference shares for new preference shares to be issued by Santander UK plc. It is intended that the exchange will be carried out by a scheme of arrangement under Part 26 of the Companies Act 2006, which, if approved by the Court as well as holders of the Company's preference shares and Santander UK plc (as holder of the ordinary shares of Alliance & Leicester plc), the Company's preference shares would be substituted with new preference shares to be issued by Santander UK plc on substantially similar terms.

In March 2010 the Group issued through the Fosse Master Trust the first publicly-placed mortgage-backed securitisation transaction from a UK bank since 2007; other recent transactions from UK banks had included an investor put. The transaction was denominated in both pounds sterling and euro and raised approximately £1.4bn.

Notes to the Financial Statements continued

43. Financial instruments

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The Accounting Policies Note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the Group's financial instruments into those measured at fair value and those measured at amortised cost in the balance sheet:

Group

31 December 2009	Held at fair value				Held at amortised cost		Non-financial assets / liabilities	Total
	Trading	Derivatives held for hedging	Designated at fair value through P&L	Available-for-sale	Loans and receivables	Financial liabilities at amortised cost		
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash & balances at central banks	-	-	-	-	446	-	-	446
Derivative financial instruments	871	237	-	-	-	-	-	1,108
Financial assets designated at FV	-	-	50	-	-	-	-	50
Loans and advances to banks	-	-	-	-	49,857	-	-	49,857
Loans and advances to customers	-	-	-	-	46,796	-	-	46,796
Available-for-sale securities	-	-	-	11	-	-	-	11
Loans and receivables securities	-	-	-	-	9,828	-	-	9,828
Macro hedge of interest rate risk	-	-	-	-	444	-	-	444
Intangible assets	-	-	-	-	-	-	38	38
Property, plant and equipment	-	-	-	-	-	-	206	206
Operating lease assets	-	-	-	-	-	-	312	312
Current tax assets	-	-	-	-	-	-	81	81
Deferred tax assets	-	-	-	-	-	-	409	409
Other assets	-	-	-	-	326	-	26	352
	871	237	50	11	107,697	-	1,072	109,938
Liabilities								
Deposits by banks	-	-	-	-	-	52,458	-	52,458
Deposits by customers	-	-	-	-	-	43,436	-	43,436
Derivative financial liabilities	198	-	-	-	-	-	-	198
Financial liabilities at FVTPL	-	-	83	-	-	-	-	83
Debt securities in issue	-	-	-	-	-	9,981	-	9,981
Subordinated liabilities	-	-	-	-	-	1,028	-	1,028
Other liabilities	-	-	-	-	-	443	60	503
Provisions	-	-	-	-	-	-	12	12
Current tax liabilities	-	-	-	-	-	-	20	20
Deferred tax liabilities	-	-	-	-	-	-	255	255
Retirement benefit obligations	-	-	-	-	-	-	150	150
	198	-	83	-	-	107,346	497	108,124

Company

31 December 2009	Held at fair value				Held at amortised cost		Non-financial assets / liabilities	Total
	Trading	Derivatives held for hedging	Designated at fair value through P&L	Available-for-sale	Loans and receivables	Financial liabilities at amortised cost		
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash & balances at central banks	-	-	-	-	446	-	-	446
Derivative financial instruments	344	238	-	-	-	-	-	582
Financial assets designated at FV	-	-	50	-	-	-	-	50
Loans and advances to banks	-	-	-	-	46,208	-	-	46,208
Loans and advances to customers	-	-	-	-	52,132	-	-	52,132
Available-for-sale securities	-	-	-	8	-	-	-	8
Loan and receivables securities	-	-	-	-	9,994	-	-	9,994
Marco hedge of interest rate risk	-	-	-	-	306	-	-	306
Investment in sub undertakings	-	-	-	-	-	-	887	887
Intangible assets	-	-	-	-	-	-	38	38
Property, plant and equipment	-	-	-	-	-	-	133	133
Current tax assets	-	-	-	-	-	-	76	76
Deferred tax assets	-	-	-	-	-	-	286	286
Other assets	-	-	-	-	288	-	22	310
	344	238	50	8	109,374	-	1,442	111,456

	Held at fair value				Held at amortised cost		Company	
	Trading	Derivatives held for hedging	Designated at fair value through P&L	Available-for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Liabilities								
Deposits by banks	-	-	-	-	-	54,085	-	54,085
Deposits by customers	-	-	-	-	-	47,691	-	47,691
Derivative financial liabilities	318	-	-	-	-	-	-	318
Financial liabilities at FVTPL	-	-	83	-	-	-	-	83
Debt securities in issue	-	-	-	-	-	5,879	-	5,879
Subordinated liabilities	-	-	-	-	-	1,028	-	1,028
Other liabilities	-	-	-	-	-	539	1	540
Provisions	-	-	-	-	-	-	11	11
Retirement benefit obligations	-	-	-	-	-	-	150	150
	318	-	83	-	-	109,222	162	109,785

At 31 December 2008

	Held at fair value				Held at amortised cost		Group	
	Trading	Derivatives held for hedging	Designated at fair value through P&L	Available-for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash & balances at central banks	-	-	-	-	1,553	-	-	1,553
Derivative financial instruments	2,132	744	-	-	-	-	-	2,876
Financial assets designated at FV	-	-	63	-	-	-	-	63
Loans and advances to banks	-	-	-	-	1,239	-	-	1,239
Loans and advances to customers	-	-	-	-	51,402	-	-	51,402
Available-for-sale securities	-	-	-	1,658	-	-	-	1,658
Loans and receivables securities	-	-	-	-	14,250	-	-	14,250
Macro hedge of interest rate risk	-	-	-	-	713	-	-	713
Intangible assets	-	-	-	-	-	-	17	17
Property, plant and equipment	-	-	-	-	-	-	223	223
Operating lease assets	-	-	-	-	-	-	348	348
Current tax assets	-	-	-	-	-	-	17	17
Deferred tax assets	-	-	-	-	-	-	626	626
Other assets	-	-	-	-	185	-	74	259
	2,132	744	63	1,658	69,342	-	1,305	75,244
Liabilities								
Deposits by banks	-	-	-	-	-	11,516	-	11,516
Deposits by customers	-	-	-	-	-	39,765	-	39,765
Derivative financial liabilities	656	877	-	-	-	-	-	1,533
Financial liabilities at FVTPL	-	-	728	-	-	-	-	728
Debt securities in issue	-	-	-	-	-	17,477	-	17,477
Subordinated liabilities	-	-	-	-	-	1,436	-	1,436
Other liabilities	-	-	-	-	-	600	31	631
Provisions	-	-	-	-	-	-	34	34
Current tax liabilities	-	-	-	-	-	-	1	1
Deferred tax liabilities	-	-	-	-	-	-	278	278
Retirement benefit obligations	-	-	-	-	-	-	17	17
	656	877	728	-	-	70,794	361	73,416

At 31 December 2008

	Held at fair value				Held at amortised cost		Company	
	Trading	Derivatives held for hedging	Designated at fair value through P&L	Available-for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Cash & balances at central banks	-	-	-	-	1,553	-	-	1,553
Derivative financial instruments	1,461	729	-	-	-	-	-	2,190
Financial assets designated at FV	-	-	63	-	-	-	-	63
Loans and advances to banks	-	-	-	-	1,236	-	-	1,236
Loans and advances to customers	-	-	-	-	52,604	-	-	52,604
Available-for-sale securities	-	-	-	1,654	-	-	-	1,654
Loans and receivables securities	-	-	-	-	14,321	-	-	14,321
Marco hedge of interest rate risk	-	-	-	-	557	-	-	557
Investment in sub undertakings	-	-	-	-	-	-	1,091	1,091
Intangible assets	-	-	-	-	-	-	16	16
Property, plant and equipment	-	-	-	-	-	-	148	148
Current tax assets	-	-	-	-	-	-	58	58
Deferred tax assets	-	-	-	-	-	-	358	358
Other assets	-	-	-	-	1,349	-	82	1,431
	1,461	729	63	1,654	71,620	-	1,753	77,280

Notes to the Financial Statements continued

	Held at fair value				Held at amortised cost		Company	
	Trading	Derivatives held for hedging	Designated at fair value through P&L	Available-for-sale	Loans and Receivables	Financial liabilities at amortised cost	Non-financial assets / liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Liabilities								
Deposits by banks	-	-	-	-	-	13,585	-	13,585
Deposits by customers	-	-	-	-	-	41,222	-	41,222
Derivative financial liabilities	976	695	-	-	-	-	-	1,671
Financial liabilities at FVTPL	-	-	728	-	-	-	-	728
Debt securities in issue	-	-	-	-	-	12,084	-	12,084
Subordinated liabilities	-	-	-	-	-	1,436	-	1,436
Other liabilities	-	-	-	-	-	4,545	104	4,649
Deferred tax liabilities	-	-	-	-	-	-	73	73
Retirement benefit obligations	-	-	-	-	-	-	17	17
	976	695	728	-	-	72,872	194	75,465

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

			Group
2009	**Carrying Value £m**	**Fair value £m**	**Surplus/ (deficit) £m**
Assets			
Cash and balances at central banks	**446**	**446**	**-**
Loans and advances to banks	**49,857**	**50,296**	**439**
Loans and advances to customers	**46,796**	**47,418**	**622**
Loans & receivables securities	**9,828**	**9,377**	**(451)**
Liabilities			
Deposits by banks	**52,458**	**53,231**	**(773)**
Deposits by customers	**43,436**	**43,414**	**22**
Debt securities in issue	**9,981**	**9,846**	**135**
Subordinated liabilities	**1,028**	**1,226**	**(198)**

			Company
2009	**Carrying Value £m**	**Fair value £m**	**Surplus/ (deficit) £m**
Assets			
Cash and balances at central banks	**446**	**446**	**-**
Loans and advances to banks	**46,208**	**46,584**	**376**
Loans and advances to customers	**52,132**	**52,718**	**586**
Loans & receivables securities	**9,994**	**9,543**	**(451)**
Liabilities			
Deposits by banks	**54,085**	**54,858**	**(773)**
Deposits by customers	**47,691**	**47,674**	**17**
Subordinated liabilities	**1,028**	**1,226**	**(198)**

			Group
2008	Carrying Value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	1,553	1,553	–
Loans and advances to banks	1,239	1,240	1
Loans and advances to customers	51,402	52,377	975
Loans & receivables securities	14,250	13,153	(1,097)
Liabilities			
Deposits by banks	11,516	11,501	15
Deposits by customers	39,765	39,826	(61)
Debt securities in issue	17,477	16,605	872
Subordinated liabilities	1,436	1,411	25

2008	Company Carrying Value £m	Fair value £m	Surplus/ (deficit) £m
Assets			
Cash and balances at central banks	1,553	1,553	–
Loans and advances to banks	1,236	1,237	1
Loans and advances to customers	52,604	53,275	671
Loans & receivables securities	14,321	13,224	(1,097)
Liabilities			
Deposits by banks	13,585	13,570	15
Deposits by customers	41,222	41,283	(61)
Debt securities in issue	12,084	11,790	294
Subordinated liabilities	1,436	1,411	25

The surplus/(deficit) in the table above represents the surplus/(deficit) of fair value compared to the carrying amount of those financial instruments for which fair values have been estimated. The carrying value above of any financial assets and liabilities that are designated as hedged items in a portfolio (or macro) fair value hedge relationship excludes gains and losses attributable to the hedged risk, as this is presented as a single separate line item on the balance sheet.

Fair value measurement
The fair value of financial instruments is the estimated amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. Where quoted market prices are not available, fair value is determined using pricing models which use a mathematical methodology based on accepted financial theories, depending on the product type and its components. Further information on fair value measurement can be found in the Group's Accounting Policies from pages 58 to 59 and the Valuation techniques section below on page 105 to the Consolidated Financial Statements.

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

Assets:
Cash and balances at central banks/Loans and advances to banks
The carrying amount is deemed a reasonable approximation of the fair value, because they are short term in nature.

Loans and advances to customers
Loans and advances to personal customers are made both at variable and at fixed rates. As there is no active secondary market in the UK for such loans and advances, there is no reliable market value available for such a significant portfolio.
a) Variable rate
The Directors believe that the carrying value of the variable rate loans may be assumed to be their fair value.
b) Fixed rate
Certain of the loans secured on residential properties are at a fixed rate for a limited period, typically two to five years from their commencement. At the end of this period these loans revert to the relevant variable rate. The excess of fair value over carrying value of each of these loans has been estimated by reference to the market rates available at the balance sheet date for similar loans of maturity equal to the remaining fixed period.

Loan and receivable securities
These debt securities are valued with the assistance of valuations prepared by an independent, specialist valuation firm.

Liabilities:
Deposits by banks
The carrying amount is deemed a reasonable approximation of the fair value, because it is short-term in nature.

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

The fair value of such deposits liabilities has been estimated using the same valuation technique for financial instruments accounted for at fair value as described in the Valuation techniques section below on page 105 to the Consolidated Financial Statements.

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Debt securities in issue and subordinated liabilities

Where reliable prices are available, the fair value of debt securities in issue and subordinated liabilities has been calculated using quoted market prices. Other market values have been determined using the same valuation technique for financial instruments accounted for at fair value as described in the Valuation techniques section below on page 105 to the Consolidated Financial Statements.

Fair value valuation bases

The following tables summarise the fair values at 31 December 2009 and 2008 of the asset and liability classes accounted for at fair value, by the valuation methodology used by the Group to determine their fair value. The tables also disclose the percentages that the recorded fair values of financial assets and liabilities represent of the total assets and liabilities, respectively, that are recorded at fair value in the balance sheet:

At 31 December 2009

		Quoted prices in active markets		Internal models based on: Market observable data		Internal models based on: Significant unobservable data		Total		Valuation technique
Balance sheet category		**£m**	**%**	**£m**	**%**	**£m**	**%**	**£m**	**%**	
Assets										
Derivative assets	Exchange rate contracts	**-**	**-**	**761**	**65**	**-**	**-**	**761**	**65**	**A**
	Interest rate contracts	**-**	**-**	**347**	**30**	**-**	**-**	**347**	**30**	**A & C**
Financial assets at FVTPL	Debt securities	**-**	**-**	**-**	**-**	**50**	**4**	**50**	**4**	**A**
	Equity securities	**1**	**-**	**-**	**-**	**-**	**-**	**1**	**-**	**-**
Available-for-sale financial assets	Debt securities	**3**	**-**	**-**	**-**	**-**	**-**	**3**	**-**	**-**
	Equity securities	**8**	**1**	**-**	**-**	**-**	**-**	**8**	**1**	**B**
Total assets at fair value		**12**	**1**	**1,108**	**95**	**50**	**4**	**1,170**	**100**	
Liabilities										
Derivative liabilities	Exchange rate contracts	**-**	**-**	**42**	**15**	**-**	**-**	**42**	**15**	**A**
	Interest rate contracts	**-**	**-**	**154**	**55**	**-**	**-**	**154**	**55**	**A & C**
	Equity & credit contracts	**-**	**-**	**2**	**1**	**-**	**-**	**2**	**1**	**B**
Financial liabilities at FVTPL	Deposits by banks	**-**	**-**	**45**	**16**	**-**	**-**	**45**	**16**	**A**
	Deposits by customers	**-**	**-**	**12**	**3**	**-**	**-**	**12**	**3**	**A**
	Debt securities in issue	**-**	**-**	**27**	**10**	**-**	**-**	**27**	**10**	**A**
Total liabilities at fair value		**-**	**-**	**282**	**100**	**-**	**-**	**282**	**100**	

At 31 December 2008

		Quoted prices in active markets		Internal models based on market observable data		Total		Valuation technique
Balance sheet category		£m	%	£m	%	£m	%	
Assets								
Trading assets	Debt securities	-	-	1,818	40	1,818	40	A
Derivative assets	Exchange rate contracts	-	-	1,058	23	1,058	23	A
Financial assets at FVTPL	Debt securities	-	-	63	1	63	1	A
Available-for-sale financial assets	Debt securities	1,648	36	-	-	1,648	36	-
	Equity securities	-	-	10	-	10	-	B
Total assets at fair value		1,648	36	2,949	64	4,597	100	
Liabilities								
Derivative liabilities	Exchange rate contracts	-	-	357	16	357	16	A
	Interest rate contracts	-	-	1,164	51	1,164	51	A&C
	Equity & credit contracts	-	-	12	1	12	1	B
Financial liabilities at FVTPL	Deposits by banks	-	-	153	7	153	7	A
	Deposits by customers	-	-	252	11	252	11	A
	Debt securities in issue	-	-	323	14	323	14	A
Total liabilities at fair value		-	-	2,261	100	2,261	100	

Valuation techniques

The main valuation techniques employed in the Group's internal models to measure the fair value of the financial instruments disclosed above at 31 December 2009 and 2008 are set out below. In substantially all cases, the principal inputs into these models are derived from observable market data. The Group did not make any material changes to the valuation techniques or internal models it used during the years ended 31 December 2009 and 2008. The Group developed a discounted cash flow model during 2008 for credit default swaps, the effect of which was immaterial.

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

C In the valuation of financial instruments exposed to interest rate risk that require either static or dynamic hedging (such as interest rate futures, caps and floors, and options), the present value method (futures), Black's model (caps/floors) and the Hull/White and Markov functional models (Bermudan options) are used. These types of models are widely accepted in the financial services industry. The significant inputs used in these models are observable market data, including appropriate interest rate curves, volatilities, correlations and exchange rates.

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

The credit risk adjustment is measured as a lifetime expected loss for each counterparty based on the probability of default, the loss given default and the expected exposure of the OTC derivative position with the counterparty.

The probability of default is calculated at the counterparty level through the use of internal rating models. The loss given default ("LGD") is calculated at the facility level and takes into account the counterparty characteristics as well as the instrument traded. Credit ratings and LGD are updated by the credit team as new relevant information becomes available and at periodic reviews performed at least annually.

The expected exposure is calculated on a portfolio level and is based on the underlying risks of the portfolio. The main drivers of the expected exposure are the size of the risk position with the counterparty along with the prevailing market environment.

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 such as in OTC derivatives contracts. The Group has not realised any profit or loss on revaluing fair values of derivatives to reflect its own creditworthiness. If the Group had reflected such adjustments it would not have had a material impact on the valuations.

The fair values of the financial instruments arising from the Group's internal models take into account, among other things, contract terms and observable market data, which include such factors as bid-offer spread, interest rates, credit risk, exchange rates, the quoted market price of raw materials and equity securities, volatility and prepayments.

The 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 to determine the fair value of certain financial instruments could result in different estimates of fair value at the reporting date and the amount of gain or loss recorded for a particular instrument. Most of the valuation models are not significantly subjective, because they can be tested and, if necessary, recalibrated by the internal calculation of and subsequent comparison to market prices of actively traded securities, where available.

Internal models based on observable market data

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

Internal models based on information other than market data

The collateralised synthetic obligations (CSOs) securities are valued using internal models based on information other than market data. These debt securities were initially recognised at transaction price and subsequently measured using valuation prepared by an independent, third party specialist professional valuation firm. At 31 December 2009, the value of these securities was £50m (2008: £nil).

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Internal valuation review
In all instances, risk control teams review positions to assess a realistic realisable value for the position and develop a methodology for any adjustment to fair value which marks the position to that value using information relevant to that asset. Consideration is given to the quality of the information available that provides the current mark-to-model valuation and estimates of how different these valuations could be on an actual trade, taking into consideration how active the market is. For spot assets that cannot be sold due to illiquidity, forward estimates are discounted to provide an estimate of a realisable value over time. All adjustments for illiquid positions are regularly reviewed to reflect changing market conditions.

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy
The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	Fair value through profit or loss £m
At 1 January 2009	-
Total gains or losses recognised in profit/loss	-
Transfers in	50
At 31 December 2009	50
Total gains or losses recognised in profit/loss relating to those assets and liabilities held at the end of the year	-

Financial instrument assets and liabilities at 31 December 2009
Financial instrument assets valued using internal models based on information other than market data were 4% (2008: nil%) of total assets measured at fair value and 0.05% (2008: nil%) of total assets at 31 December 2009.

Assets designated at fair value through profit or loss valued using internal models based on information other than market data increased in 2009 due to the recognition of collateralised synthetic obligations ('CSOs') upon the consolidation of the assets of the Group's Conduit vehicles as described in 'Exposure to Off-Balance Sheet Entities sponsored by the Group - Secured Loan to Conduit' in the Risk Management Report.

Effect of changes in significant unobservable assumptions to reasonably possible alternatives
No sensitivities are presented for the FVTPL – debt securities as they have been valued by an independent, specialist valuation firm.

44. Capital Management and Resources

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

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

Santander UK manages its capital requirements, debt funding and liquidity on the basis of policies and plans reviewed regularly at ALCO and as part of the ICAAP process. To support its capital and senior debt issuance programmes, Santander UK is rated on a stand-alone basis.

On an ongoing basis, and in accordance with the latest ICAAP review, Santander UK forecasts its regulatory and internal capital requirements based on the approved capital volumes allocated to business units as part of the corporate planning process and the need to have access to a capital buffer. Capital allocation decisions are made as part of planning based on the relative returns on capital using both economic and regulatory capital measures. Capital allocations are reviewed in response to changes in risk appetite and risk management strategy, changes to the commercial environment, changes in key economic indicators or when additional capital requests are received.

This combination of regulatory and economic capital ratios and limits, internal buffers and restrictions, together with the relevant costs of differing capital instruments and a consideration of the various other capital management techniques are used to shape the most cost-effective structure to fulfil Santander UK's capital needs.

Capital adequacy
From 1 January 2007, the Group has managed its capital on a Basel II basis. Throughout 2009, the Group held capital over and above its regulatory requirements, and managed internal capital allocations and targets in accordance with its capital and risk management policies.

Group Capital

	31 December 2009 £m	31 December 2008 £m
Core Tier 1 capital	**1,303**	1,352
Deductions from Core Tier 1 capital	**(139)**	(78)
Total Core Tier 1 capital after deductions	**1,164**	1,274
Other Tier 1 capital	**569**	605
Total Tier 1 capital after deductions	**1,733**	1,879
Tier 2 capital	**939**	1,306
Deductions from Tier 2 capital	**(101)**	(61)
Total Tier 2 capital after deductions	**838**	1,245
Deductions from total Tier 1 and Tier 2 capital	**-**	-
Tier 3 capital	**-**	147
Total capital resources	**2,571**	3,271

The Group's Tier 1 capital consists of shareholders' equity and audited profits for the years ended 31 December 2009 and 31 December 2008 after adjustment to comply with UK Financial Services Authority rules. Tier 1 deductions 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. In addition, the Group has elected to deduct certain securitisation positions from capital rather than treat these exposures as a risk weighted asset.

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