

Bank of Scotland plc

Report and Accounts
2010

Member of Lloyds Banking Group

Contents

Directors' report	2
Directors	6
Principal risks and uncertainties	7
Independent auditors' report	10
Consolidated income statement	12
Statements of comprehensive income	13
Balance sheets	14
Statements of changes in equity	16
Cash flow statements	20
Notes to the accounts	21

Results

The consolidated income statement on page 12 shows a loss attributable to equity shareholders for the year ended 31 December 2010 of £3,813 million.

Principal activities

Bank of Scotland plc (the Bank) and its subsidiaries (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

The Group's revenue is earned through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and capital market products to commercial, corporate and asset finance customers; and private banking.

Business review

The loss before tax reduced from £15,996 million to £3,871 million, a reduction of £12,125 million, or 76 per cent, arising principally from an improved credit performance. This resulted in a £10,066 million, or 48 per cent, reduction in the impairment charge from £20,992 million for the year ended 31 December 2009 to £10,926 million for the year ended 31 December 2010.

The trading surplus increased by £1,434 million, or 25 per cent, from £5,709 million to £7,143 million comprising a £2,444 million increase in net interest income, a £1,429 million decrease in other income and a £419 million reduction in operating expenses.

Net interest income increased by £2,444 million, or 38 per cent, from £6,381 million to £8,825 million, as margins improved as a result of more mortgage customers moving on to, and remaining on, standard variable-rate terms and from the decrease in interest expense as the Bank of Scotland funding held outside of the Lloyds Banking Group continues to mature.

Other income, excluding the £3,000 million of subvention income received in 2009, increased by £1,571 million, or 82 per cent, from £1,909 million to £3,480 million. The increase was primarily due to net gains on financial instruments held for trading increasing by £1,328 million from a loss of £726 million in 2009 to a profit of £602 million in 2010. Net fee and commission income decreased by £52 million, or 5 per cent, from £1,096 million to £1,044 million.

Operating expenses decreased by £419 million, or 8 per cent, from £5,581 million to £5,162 million, principally as a result of a £310 million reduction in operating lease depreciation charges following the transfer of operating lease assets to another member of Lloyds Banking Group, the non-recurrence of a goodwill impairment charge of £385 million incurred in 2009 and reduced staff costs, partially offset by a £500 million customer goodwill payments provision.

Impairment losses reduced by £10,066 million, or 48 per cent, from £20,992 million to £10,926 million. This reflects the continuing slow recovery of the economy, improved quality of new business, effective portfolio management and the benefit of action taken in 2009, offset by significant impairments incurred in the Group's business in Ireland. On 31 December 2010, Bank of Scotland (Ireland) Limited (BOSI) was merged into the Bank by virtue of a merger by absorption of a wholly-owned subsidiary pursuant to the Companies (Cross-Border Mergers) Regulations 2007. As a consequence of the merger, all of the assets and liabilities of BOSI were transferred to the Bank and BOSI was dissolved without going into liquidation; there is no impact on the Group's consolidated results.

The share of losses from joint ventures and associates reduced from £713 million to £88 million, as the Group's investments in many of these joint ventures were written down in prior years.

Loans and advances to customers reduced by £34,013 million, or 8 per cent, from £439,538 million to £405,525 million reflecting the Group's strategy to reduce assets associated with non-relationship lending. Customer deposits decreased by £24,454 million, or 9 per cent, from £265,971 million to £241,517 million, resulting in a small increase in the ratio of customer loans and advances to customer deposits from 165 per cent at 31 December 2009 to 168 per cent at 31 December 2010.

Loans and advances to banks decreased from £91,259 million to £61,349 million and deposits from banks decreased from £174,338 million to £143,056 million as the Group aligned its funding arrangements with other parts of the Lloyds Banking Group.

Debt securities in issue decreased by £18,436 million, or 15 per cent, from £119,157 million to £100,721 million as funding requirements continued to decrease as asset balances reduced.

Shareholders' equity has decreased by £2,305 million from £22,147 million to £19,842 million as a result of the £3,813 million loss attributable to equity shareholders for the year offset by favourable movements in other reserves.

At the end of December 2010, the Group's capital ratios increased with a total capital ratio on a Basel II basis of 13.9 per cent (compared to 11.5 per cent at 31 December 2009) and a tier 1 ratio of 8.6 per cent (compared to 7.4 per cent at 31 December 2009). During 2010, risk-weighted assets decreased by £72,268 million to £250,598 million. This reflects lower lending volumes across all banking divisions, a revised assessment of Retail secured lending risk-weighted assets following improvements in the economic outlook and changes introduced as a result of continuing the process of integrating regulatory capital approaches which have impacted particularly on non-retail balances.

Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 45. A discussion of the principal risks and uncertainties faced by the Group is set out on pages 7 to 9.

Group structure

Following a reorganisation of the Lloyds Banking Group on 1 January 2010, Lloyds Banking Group plc's holding of 100 per cent of the issued ordinary share capital of HBOS plc, the Bank's immediate parent company, was transferred to Lloyds TSB Bank plc.

Directors

The names of the directors of the Bank are shown on page 6. Changes to the composition of the board since 1 January 2010 are shown below:

Dr W C G Berndt retired from the board on 6 May 2010.

Three directors joined the board during the year as follows: Mr G R Moreno (1 March 2010), Mr D L Roberts (1 March 2010) and Ms A M Frew (1 December 2010).

Mr A Horta-Osório joined the board on 17 January 2011. Mr J E Daniels will retire from the board on 28 February 2011 and will be succeeded as group chief executive by Mr A Horta-Osório on 1 March 2011.

Directors' interests

The directors are also directors of Lloyds Banking Group plc and their interests in shares in Lloyds Banking Group plc are shown in the report and accounts of that company.

Directors' conflicts of interest

The board, as permitted by the Bank's articles of association, has authorised all potential conflicts of interest declared by individual directors. Decisions regarding these conflicts of interest could only be taken by directors who had no interest in the matter. In taking the decision, the directors acted in a way they considered, in good faith, would be most likely to promote the Bank's success. The directors had the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given will be reviewed at least every 15 months. No director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest. The board confirms that it did not authorise any material conflicts during the year.

Directors' indemnities

The directors, including the former director who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. These deeds were in force during the whole of the financial year or from the date of appointment in respect of the directors who joined the board in 2010 and 2011. The indemnities remain in force for the duration of a director's period of office. Deeds for existing directors are available for inspection at the Bank's registered office.

Share capital

Information about share capital is shown in note 37 on page 50.

Statement of directors' responsibilities

The directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the group and parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Bank and of the profit or loss of the Group and the Bank for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent; and
- state whether applicable IFRSs as adopted by the European Union have been followed.

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

A copy of the financial statements is placed on the website www.lloydsbankinggroup.com. The directors are responsible for the maintenance and integrity in relation to the Bank on that website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current directors, whose names are shown on page 6 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Bank and Group and the profit or loss of the Group;
- the business review includes a fair review of the development and performance of the business and the position of the Bank and Group; and
- the principal risks and uncertainties faced by the Bank and the Group are set out on pages 7 to 9.

Going concern

The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies as discussed in note 1 and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Employees

The Bank, as part of Lloyds Banking Group, is committed to providing employment practices and policies which recognise the diversity of our workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief.

In the UK, Lloyds Banking Group belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers' Forum on Disability, Employers' Forum on Age, Stonewall and the Race for Opportunity. Our involvement with these organisations enables us to identify and implement best practice for our staff.

Employees are kept closely involved in major changes affecting them through measures such as: team meetings, briefings, internal communications and opinion surveys. There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions.

Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in Lloyds Banking Group plc.

Directors' report

Lloyds Banking Group is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. We have established a full suite of communication channels, including an extensive face-to-face briefing programme which allows us to update our employees on our performance and any financial issues throughout the year.

Policy and practice on payment of creditors

The Bank has signed up to the 'Prompt Payment Code' published by the Department for Business Innovation and Skills ('BIS'), regarding the making of payments to suppliers. Information about the 'Prompt Payment Code' may be obtained by visiting www.promptpaymentcode.org.uk.

The Bank's policy is to agree terms of payment with suppliers and these normally provide for settlement within 30 days after the date of the invoice, except where other arrangements have been negotiated. It is the policy of the Bank to abide by the agreed terms of payment, provided the supplier performs according to the terms of the contract.

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 2006, is 14. This bears the same proportion to the number of days in the year as the aggregate of the amounts owed to trade creditors at 31 December 2010 bears to the aggregate of the amounts invoiced by suppliers during the year.

Auditors and audit information

Each person who is a director at the date of approval of this report confirms that, so far as the director is aware, there is no relevant audit information of which the Bank's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director to make himself or herself aware of any relevant audit information and to establish that the Bank's auditors are aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

A resolution will be proposed at the 2011 annual general meeting to reappoint PricewaterhouseCoopers LLP as auditors. The Bank's audit committee is satisfied that the external auditors remain independent and effective.

On behalf of the board

Harry F Baines

Company Secretary

24 February 2011

Company Number 327000

Directors

Sir Winfried Bischoff *Chairman*

J E Daniels *Group Chief Executive* (to 28 February 2011)

A Horta-Osório *Group Chief Executive* (from 1 March 2011)

T J W Tookey *Group Finance Director*

A M Frew

Sir Julian Horn-Smith

A G Kane

Lord Leitch

G R Moreno

D L Roberts

T T Ryan, Jr

M A Scicluna

G T Tate

A Watson CBE

H A Weir CBE

Principal risks and uncertainties

At present the most significant risks faced by the Group are:

Credit

Definition: The risk of reductions in earnings and/or value, through financial loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Features: Arising in the retail, wholesale and wealth and international operations, reflecting the risks inherent in the Group's lending. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group's assets and materially increase the Group's write-downs and allowances for impairment losses. Credit risk can be affected by a range of factors, including, inter alia, increased unemployment, reduced asset values, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates or higher tenant defaults. Over the last three years, the global banking crisis and economic downturn has driven cyclically high bad debt charges. These have arisen from the Group's lending to:

- Wholesale customers (including those in wealth and international operations): where companies continue to face difficult business conditions, resulting in elevated corporate default levels, illiquid commercial property markets and heightened impairment charges. The Group has high levels of exposure in both the UK and internationally, including Ireland, USA and Australia. There are particular concentrations to financial institutions and commercial real estate including secondary and tertiary locations.
- Retail customers: this portfolio will remain strongly linked to the economic environment, with inter alia house prices falls, unemployment increases, consumer over-indebtedness and rising interest rates all likely to impact both secured and unsecured retail exposures.

The Group follows a through the economic cycle, relationship based, business model with risk management processes, appetites and experienced staff in place.

Legal and regulatory

Definition: Legal and regulatory risk is the risk of reductions in earnings and/ or value, through financial or reputational loss, from failing to comply with the laws, regulations or codes applicable.

Features: Legal and regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector.

At the time of the acquisition of HBOS plc by Lloyds Banking Group the Office of Fair Trading (OFT) identified some competition concerns in the UK personal current accounts and mortgages markets and for SME banking in Scotland. The OFT reiterated that it would keep these under review and consider whether to refer any banking markets to the Competition Commission if it identifies any prevention, restriction or distortion of competition.

The UK Government appointed an Independent Commission on Banking to review possible structural measures to reform the banking system and promote stability and competition. That commission will publish its final report by the end of September 2011. The Treasury Select Committee is conducting an examination of competition in retail banking. It is too early to quantify the potential impact of these developments on the Group.

From April 2011, lead regulation and supervision of the Group's activities will begin transitioning from the FSA to the new Financial Conduct Authority for conduct of business supervision and the Prudential Regulatory Authority (PRA) for capital and liquidity supervision. In addition, from 2011, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory approaches across the EU. These could lead to changes in how the Group is regulated and supervised on a day-to-day basis.

Evolving capital and liquidity requirements continue to be a priority for the Group. In September 2010 and further clarified in December 2010, the Basel Committee on Banking Supervision put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of 'capital', introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2012 and 2018.

Principal risks and uncertainties

Lloyds Banking Group is currently assessing the impacts of these regulatory developments and will participate in the consultation and calibration processes to be undertaken by the various regulatory bodies during 2011. Lloyds Banking Group continues to work closely with the regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes and mitigate against risks to the Group and its stakeholders.

There is a risk that certain aspects of the Group's business may be determined by the authorities or the courts as not being conducted in accordance with applicable laws or regulations, or with what is fair and reasonable in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

Liquidity and funding

Definition: Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

Features: Arising in the banking business of the Group through its retail, wholesale and wealth and international operations reflecting the risk that the Group is unable to attract and retain either retail, wholesale or corporate deposits or issue debt securities. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and provide liquidity when necessary, the Group's ability to fund its financial obligations could be impacted.

The key dependencies for successfully funding the Group's balance sheet include the continued functioning of the money and capital markets; successful right sizing of the Lloyds Banking Group balance sheet; the continuation of HM Treasury and Bank of England facilities to Lloyds Banking Group in accordance with the terms agreed; limited further deterioration in the UK's, Lloyds Banking Group's and the Group's credit rating and no significant or sudden withdrawal of deposits resulting in increased reliance on wholesale funding markets. A return to the extreme market conditions of 2008 would place a strain on the Group's ability to meet its financial commitments.

Additionally, the Lloyds Banking Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

Liquidity and funding risks are managed within a board approved framework using a range of metrics to monitor the Group's profile against its stated appetite and potential market conditions.

Market Risk

Definition: The risk of reductions in earnings and/or value, through financial or reputational loss, from unfavourable market moves; including changes in, and increased volatility of, interest rates, market-implied inflation rates, credit spreads, foreign exchange rates, equity, property and commodity prices.

Features: Market risk is managed within a Board approved framework using a range of metrics to monitor the Group's profile against its stated appetite and potential market conditions.

The principal market risks are as follows:

There is a risk to the Group's banking income arising from the level of interest rates and the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Continuing concerns about the scale of deficits in Ireland and southern European countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the Euro and widened spreads between central bank and interbank rates.

The Group's trading activity is small relative to its peers and is not considered to be a principal risk.

Principal risks and uncertainties

Customer treatment

Definition: The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment.

Features: Customer treatment and how the Group manages its customer relationships affects all aspects of the Group's operations and is closely aligned with achievement of the Group's strategic aim – to create deep long lasting relationships with its customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies.

The FSA continues to drive focus on conduct of business activities and has established a new approach to supervision of Conduct Risk, replacing the previous 'Treating Customers Fairly' initiative for retail customers. Under this new regime the FSA has indicated that it will seek to place greater emphasis on product governance and contract terms in general, and will seek to intervene much earlier in the product lifecycle to prevent customer detriment. The FSA also continues to carry out thematic reviews on a variety of issues across the industry as a whole, for example complaints handling. Lloyds Banking Group actively engages with the regulatory authorities and other stakeholders on these key customer treatment challenges, which includes for example, PPI (see note 43 of financial statements).

The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers. Since the acquisition of HBOS, the Group has made significant progress in aligning its approach to Treating Customers Fairly across both heritages. In addition the Group has aligned its Treating Customers Fairly governance and management information arrangements, with customer impact being a key factor in assessing every integration proposition. The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place.

People

Definition: The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate colleague actions and behaviour, industrial action, legal action in relation to people, or health and safety issues. Loss can also be incurred through failure to recruit, retain, train, reward and incentivise appropriately skilled staff to achieve business objectives and through failure to take appropriate action as a result of staff underperformance.

Features: The Group aims to attract, retain, and develop high calibre talent. Failure to do so presents a significant risk to delivering the Group's overall strategy and is affected by a range of factors including:

- Ongoing regulatory and public interest in remuneration practices
- Delivery of Lloyds Banking Group's integration commitments, and
- Uncertainty about European Union state aid requirements and the Independent Commission on Banking's proposals for banking reform.

The Group's remuneration arrangements encourage compliant and appropriate behaviour from colleagues, in line with group policies, values and short and long term people risk priorities. The Group has continued to work closely with regulators to seek to ensure compliance with our obligations. However, there is recognition that international consensus must be achieved to avoid UK institutions being significantly disadvantaged in attracting and retaining the highest calibre talent.

The Group continues to manage union relationships actively and the majority of colleagues are now on harmonised Terms and Conditions. There is strong ongoing commitment to support and retain colleagues throughout a period of significant integration and organisational change. Active monitoring of the Colleague Engagement Survey allows the Group to understand engagement levels. These continue to increase and are now exceeding industry benchmarking for high performing organisations.

Lloyds Banking Group is closely engaged with the UK Government and regulators on reform proposals, and with the EU on disposal arrangements, to influence and manage colleague uncertainty.

Integration

Definition: The risk that the Group fails to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or incurs unanticipated costs and losses associated with, the acquisition of HBOS plc by Lloyds Banking Group.

Features: The integration of the two heritage organisations continues to be one of the largest integration challenges that has been seen in the UK financial services industry. While there continue to be delivery risks to the programme, not least the risk of new regulatory requirements which may have an effect on resourcing, the Group is now two years into the integration programme and has a fully developed and functioning governance framework to manage these risks. There is a clear understanding of the phased deliverables to ensure effective delivery through to 2012.

Independent auditors' report

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF BANK OF SCOTLAND PLC

We have audited the Group and the Bank financial statements (the 'financial statements') of Bank of Scotland plc for the year ended 31 December 2010 which comprise the Consolidated income statement, the Group and the Bank statements of comprehensive income, the Consolidated and the Bank balance sheets, the Group and the Bank statements of changes in equity, the Group and the Bank cash flow statements and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the Bank financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of directors' responsibilities on page 4, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Bank's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

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 Bank'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 of the Bank's affairs as at 31 December 2010 and of the Group's loss and Group's and the Bank's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the Bank 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 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

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.

Independent auditors' report

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

Ian Rankin (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
24 February 2011

- (a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the Group directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
- (b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Bank of Scotland plc
Consolidated income statement
for the year ended 31 December 2010

	Note	2010 £ million	2009 ¹ £ million
Interest and similar income		18,502	19,246
Interest and similar expense		(9,677)	(12,865)
Net interest income	5	8,825	6,381
Fee and commission income		1,281	1,304
Fee and commission expense		(237)	(208)
Net fee and commission income	6	1,044	1,096
Net trading income	7	771	(556)
Subvention income	8	–	3,000
Other operating income	8	1,665	1,369
Other income		3,480	4,909
Total income		12,305	11,290
Operating expenses	9	(5,162)	(5,581)
Trading surplus		7,143	5,709
Impairment	10	(10,926)	(20,992)
Share of results of joint ventures and associates	11	(88)	(713)
Loss before tax		(3,871)	(15,996)
Taxation	12	68	3,257
Loss for the year		(3,803)	(12,739)
Profit attributable to non-controlling interests		10	13
Loss attributable to equity shareholders		(3,813)	(12,752)
Loss for the year		(3,803)	(12,739)

¹Restated – see note 1.

The accompanying notes are an integral part of the financial statements.

Statements of comprehensive income

for the year ended 31 December 2010

	2010 £ million	2009 ¹ £ million
The Group		
Loss for the year	(3,803)	(12,739)
Other comprehensive income		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	197	2,588
Income statement transfers in respect of disposals	(52)	3
Income statement transfers in respect of impairment	641	1,479
Other income statement transfers	(62)	(147)
Taxation	(228)	(1,048)
	496	2,875
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	(782)	(613)
Net income statement transfers	1,377	895
Taxation	(171)	(79)
	424	203
Currency translation differences:		
Currency translation differences, before tax	(207)	(24)
Taxation	–	(5)
	(207)	(29)
Other comprehensive income for the year, net of tax	713	3,049
Total comprehensive income for the year	(3,090)	(9,690)
Total comprehensive income attributable to non-controlling interests	10	13
Total comprehensive income attributable to equity shareholders	(3,100)	(9,703)
Total comprehensive income for the year	(3,090)	(9,690)
The Bank		
Loss for the year	(4,785)	(14,347)
Other comprehensive income		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	(194)	1,848
Income statement transfers in respect of disposals	46	55
Income statement transfers in respect of impairment	116	275
Other income statement transfers	(62)	(22)
Taxation	15	(604)
	(79)	1,552
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	(787)	(627)
Net income statement transfers	1,377	907
Taxation	(170)	(82)
	420	198
Currency translation differences:		
Currency translation differences, before tax	4	33
Taxation	–	–
	4	33
Other comprehensive income for the year, net of tax	345	1,783
Total comprehensive income for the year	(4,440)	(12,564)

¹Restated – see note 1.

Bank of Scotland plc
Consolidated balance sheet
as at 31 December 2010

	Note	2010 £ million	2009 ¹ £ million	1 January 2009 ¹ £ million
Assets				
Cash and balances at central banks		2,375	2,905	2,502
Items in the course of collection from banks		319	534	445
Trading and other financial assets at fair value through profit or loss	13	24,696	27,867	23,430
Derivative financial instruments	14	29,451	30,222	50,517
Loans and receivables:				
Loans and advances to banks	15	61,349	91,259	12,445
Loans and advances to customers	16	405,525	439,538	488,213
Debt securities	19	23,632	31,211	38,878
		490,506	562,008	539,536
Available-for-sale financial assets	21	14,422	21,565	28,035
Investment properties	22	789	30	43
Investments in joint ventures and associates	11	401	423	1,193
Goodwill	25	376	376	667
Other intangible assets	26	58	91	108
Tangible fixed assets	27	3,433	4,903	5,527
Current tax recoverable		214	745	865
Deferred tax assets	34	4,826	5,153	3,182
Other assets	28	1,928	4,522	3,126
		<u>573,794</u>	<u>661,344</u>	<u>659,176</u>

¹Restated – see note 1.

The accompanying notes are an integral part of the consolidated financial statements.

The directors approved the consolidated financial statements on 24 February 2011.

Sir Winfried Bischoff
Chairman

J Eric Daniels
Chief Executive

Tim J W Tookey
Finance Director

Bank of Scotland plc
Consolidated balance sheet
as at 31 December 2010

Equity and liabilities	Note	2010 £ million	2009 ¹ £ million	1 January 2009 ¹ £ million
Liabilities				
Deposits from banks	29	143,056	174,338	97,066
Customer deposits	30	241,517	265,971	277,399
Items in course of transmission to banks		251	495	521
Trading liabilities	31	18,786	27,372	18,851
Derivative financial instruments	14	27,268	27,452	40,827
Notes in circulation		1,074	981	957
Debt securities in issue	32	100,721	119,157	188,448
Other liabilities	33	5,013	6,291	4,235
Current tax liabilities		42	3	23
Deferred tax liabilities	34	1	–	–
Other provisions	35	786	247	145
Subordinated liabilities	36	15,236	16,684	18,779
Total liabilities		553,751	638,991	647,251
Equity				
Share capital	37	5,847	5,847	1,324
Share premium account	38	27,479	26,684	11,018
Other reserves	39	615	(517)	(3,629)
Retained profits	40	(14,099)	(9,867)	2,948
Shareholders' equity		19,842	22,147	11,661
Non-controlling interests		201	206	264
Total equity		20,043	22,353	11,925
Total equity and liabilities		573,794	661,344	659,176

¹Restated – see note 1.

The accompanying notes are an integral part of the consolidated financial statements.

Statements of changes in equity
for the year ended 31 December 2010

	Attributable to equity shareholders			Non-controlling interests £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million		
The Group					
Balance at 1 January 2009:					
As previously stated	12,342	(4,694)	4,013	264	11,925
Prior year adjustment ¹	–	1,065	(1,065)	–	–
Restated	12,342	(3,629)	2,948	264	11,925
Comprehensive income					
(Loss) profit for the year	–	–	(12,752)	13	(12,739)
<i>Other comprehensive income</i>					
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	2,875	–	–	2,875
Movements in cash flow hedging reserve, net of tax	–	203	–	–	203
Currency translation differences, net of tax	–	(29)	–	–	(29)
Total other comprehensive income	–	3,049	–	–	3,049
Total comprehensive income	–	3,049	(12,752)	13	(9,690)
Transactions with owners					
Dividends	–	–	–	(12)	(12)
Issue of ordinary and preference shares	20,189	–	–	–	20,189
Repayment of capital to non-controlling interests	–	–	–	(23)	(23)
Capital redemption reserve	–	63	(63)	–	–
Extinguishment of non-controlling interests	–	–	–	(36)	(36)
Total transactions with owners	20,189	63	(63)	(71)	20,118
Balance at 31 December 2009 ¹	32,531	(517)	(9,867)	206	22,353
Comprehensive income					
(Loss) profit for the year	–	–	(3,813)	10	(3,803)
<i>Other comprehensive income</i>					
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	496	–	–	496
Movements in cash flow hedging reserve, net of tax	–	424	–	–	424
Currency translation differences, net of tax	–	(207)	–	–	(207)
Total other comprehensive income	–	713	–	–	713
Total comprehensive income	–	713	(3,813)	10	(3,090)
Transactions with owners					
Dividends	–	–	–	(15)	(15)
Issue of ordinary shares	795	–	–	–	795
Capital redemption	–	419	(419)	–	–
Total transactions with owners	795	419	(419)	(15)	780
Balance at 31 December 2010	33,326	615	(14,099)	201	20,043

¹Restated – see note 1.

Statements of changes in equity
for the year ended 31 December 2010

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
The Bank				
Balance at 1 January 2009				
As previously stated	12,342	(2,116)	2,124	12,350
Prior year adjustment ¹	–	460	(460)	–
Restated	<u>12,342</u>	<u>(1,656)</u>	<u>1,664</u>	<u>12,350</u>
Comprehensive income				
Loss for the year	–	–	(14,347)	(14,347)
<i>Other comprehensive income</i>				
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,552	–	1,552
Movements in cash flow hedging reserve, net of tax	–	198	–	198
Currency translation differences, net of tax	–	33	–	33
Total other comprehensive income	–	1,783	–	1,783
Total comprehensive income	<u>–</u>	<u>1,783</u>	<u>(14,347)</u>	<u>(12,564)</u>
Transactions with owners				
Capital redemption reserve	–	63	(63)	–
Issue of ordinary and preference shares	20,189	–	–	20,189
Total transactions with owners	<u>20,189</u>	<u>63</u>	<u>(63)</u>	<u>20,189</u>
Balance at 31 December 2009 ¹	32,531	190	(12,746)	19,975
Comprehensive income				
Loss for the year	–	–	(4,785)	(4,785)
<i>Other comprehensive income</i>				
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(79)	–	(79)
Movements in cash flow hedging reserve, net of tax	–	420	–	420
Currency translation differences, net of tax	–	4	–	4
Total other comprehensive income	–	345	–	345
Total comprehensive income	<u>–</u>	<u>345</u>	<u>(4,785)</u>	<u>(4,440)</u>
Transactions with owners				
Issue of ordinary shares	795	–	–	795
Capital redemption reserve	–	419	(419)	–
Adjustment arising on merger by absorption of Bank of Scotland (Ireland) Limited (note 24)	–	–	1,547	1,547
Total transactions with owners	<u>795</u>	<u>419</u>	<u>1,128</u>	<u>2,342</u>
Balance at 31 December 2010	<u>33,326</u>	<u>954</u>	<u>(16,403)</u>	<u>17,877</u>

¹Restated – see note 1.

Bank of Scotland plc
Bank balance sheet
for the year ended 31 December 2010

	Note	2010 £ million	2009 £ million	1 January 2009 ¹ £ million
Assets				
Cash and balances at central banks		2,318	2,168	1,820
Items in the course of collection from banks		314	538	449
Trading and other financial assets at fair value through profit or loss	13	24,397	27,628	22,920
Derivative financial instruments	14	27,362	26,680	43,260
Loans and receivables:				
Loans and advances to banks	15	61,024	108,133	34,144
Loans and advances to customers	16	415,628	439,967	578,528
Debt securities	19	17,433	23,684	19,259
		494,085	571,784	631,931
Available-for-sale financial assets	21	13,507	19,316	24,339
Investments in subsidiary undertakings	23	1,540	2,451	4,383
Investments in joint ventures and associates		104	104	103
Goodwill	25	376	376	376
Other intangible assets	26	58	85	98
Tangible fixed assets	27	1,178	1,344	1,359
Current tax recoverable		–	975	1,180
Deferred tax assets	34	4,519	4,410	2,563
Other assets	28	1,684	5,792	2,876
		<u>571,442</u>	<u>663,651</u>	<u>737,657</u>

¹Restated – see note 1.

The accompanying notes are an integral part of the financial statements.

Approved by the Board on 24 February 2011 and signed on its behalf by:

Sir Winfried Bischoff
Chairman

J Eric Daniels
Chief Executive

Tim J W Tookey
Finance Director

Bank of Scotland plc
Bank balance sheet
for the year ended 31 December 2010

Equity and liabilities	Note	2010 £ million	2009 £ million	1 January 2009 ¹ £ million
Liabilities				
Deposits from banks	29	141,839	168,246	97,091
Customer deposits	30	271,900	300,124	373,173
Items in course of transmission to banks		251	495	522
Trading liabilities	31	18,786	27,372	18,851
Derivative financial instruments	14	26,986	27,171	39,613
Notes in circulation		1,074	981	957
Debt securities in issue	32	72,811	98,075	172,464
Other liabilities	33	4,012	4,925	4,422
Current tax liabilities		22	–	–
Deferred tax liabilities	34	9	–	–
Other provisions	35	765	235	132
Subordinated liabilities	36	15,110	16,052	18,082
Total liabilities		553,565	643,676	725,307
Equity				
Share capital	37	5,847	5,847	1,324
Share premium account	38	27,479	26,684	11,018
Other reserves	39	954	190	(1,656)
Retained profits	40	(16,403)	(12,746)	1,664
Shareholders' equity		17,877	19,975	12,350
Total equity and liabilities		571,442	663,651	737,657

¹Restated – see note 1.

The accompanying notes are an integral part of the financial statements.

Cash flow statements

for the year ended 31 December 2010

	Note	The Group		The Bank	
		2010 £ million	2009 ¹ £ million	2010 £ million	2009 ¹ £ million
Loss before tax		(3,871)	(15,996)	(4,712)	(17,080)
Adjustments for:					
Change in operating assets	47a	71,910	(24,285)	87,789	34,283
Change in operating liabilities	47b	(79,189)	911	(89,970)	(69,621)
Non-cash and other items	47c	(22)	25,472	2,327	23,570
Tax received		628	374	645	642
Net cash used in operating activities		(10,544)	(13,524)	(3,921)	(28,206)
Cash flows from investing activities					
Purchase of available-for-sale financial assets		(1,561)	(15,760)	(1,045)	–
Proceeds from sale and maturity of available-for-sale financial assets		10,293	10,935	9,937	–
Purchase of fixed assets		(983)	(188)	(274)	(142)
Proceeds from sale of fixed assets		594	54	150	39
Additional capital injections to subsidiaries		–	–	(4,283)	–
Acquisition of businesses, net of cash acquired		(60)	(279)	–	(2,517)
Disposal of businesses, net of cash disposed	47f	2,587	137	–	–
Net cash provided by (used in) investing activities		10,870	(5,101)	4,485	(2,620)
Cash flows from financing activities					
Dividends paid to non-controlling interests	47e	(15)	(12)	–	–
Interest paid on subordinated liabilities		(500)	(816)	(411)	(757)
Proceeds from issue of ordinary shares		–	20,189	–	20,189
Repayment of subordinated liabilities	47e	(331)	(1,781)	(331)	(1,781)
Repayment of capital to non-controlling shareholders	47e	–	(59)	–	–
Net cash (used in) provided by financing activities		(846)	17,521	(742)	17,651
Effects of exchange rate changes on cash and cash equivalents		–	39	–	–
Change in cash and cash equivalents		(520)	(1,065)	(178)	(13,175)
Cash and cash equivalents at beginning of year		6,902	7,967	6,178	19,353
Cash and cash equivalents at end of year	47d	6,382	6,902	6,000	6,178

¹Restated – see note 1.

The accompanying notes are an integral part of the consolidated financial statements.

1 Basis of preparation

The financial statements of Bank of Scotland plc have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB. The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies which are set out in the Principal risks and uncertainties section under Liquidity and funding on page 8 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

During 2010, IFRIC clarified the treatment of amounts previously recognised in equity in respect of assets that were transferred from the available-for-sale category to the loans and receivables category. When an impairment loss is recognised in respect of such transferred financial assets, the unamortised balance of any available-for-sale reserve that remains in equity should be transferred to the income statement and recorded as part of the impairment loss. The Group has changed its accounting policy to reflect this clarification. Under the Group's previous accounting policy, when such a transferred financial asset became impaired, not all of the unamortised amounts previously transferred to equity were recycled to the income statement and therefore continued to be accreted over the expected remaining life of the financial asset. This change is applied retrospectively and the effect on the Group has been to reduce retained profits and increase available-for-sale revaluation reserves by £1,065 million at 1 January 2009; shareholders' equity is unchanged. The effect on the Group's income statement for the year ended 31 December 2009 has been to increase the impairment charge by £937 million; increase net interest income by £186 million; increase other income by £39 million; and increase available-for-sale revaluation reserves by £512 million. The financial statements and capital ratios have been restated accordingly. The effect on the Bank has been to reduce retained profits and increase available-for-sale revaluation reserves by £460 million at 1 January 2009.

The Group has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2010. None of these standards or amendments have had a material impact on these financial statements.

- (i) IFRS 3 *Business Combinations*. This revised standard applies prospectively to business combinations from 1 January 2010. The revised standard continues to require the use of the acquisition method of accounting for business combinations. All payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the non-controlling interest, and all transaction costs are expensed (other than those in relation to the issuance of debt instruments or share capital).
- (ii) IAS 27 *Consolidated and Separate Financial Statements*. Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is remeasured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.
- (iii) IFRIC 17 *Distributions of Non-cash Assets to Owners*. Provides accounting guidance for non-reciprocal distributions of non-cash assets to owners (and those in which owners may elect to receive a cash alternative).
- (iv) Amendment to IAS 39 *Financial Instruments: Recognition and Measurement – 'Eligible Hedged Items'*. Clarifies how the principles underlying hedge accounting should be applied in particular situations.
- (v) *Improvements to IFRSs* (issued April 2009). Sets out minor amendments to IFRS standards as part of the annual improvements process.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2010 and which have not been applied in preparing these financial statements are given in note 48.

2 Accounting policies

The accounting policies are set out below.

a Consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, joint ventures and associates.

(1) Subsidiaries

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 23.

Special purpose entities (SPEs) are consolidated if, in substance, the Group controls the entity. A key indicator of such control, amongst others, is where the Group is exposed to the risks and benefits of the SPE.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Change in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary

2 Accounting policies (continued)

is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(4)) or share capital (see 2o(1)). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates

Joint ventures are entities over which the Group has joint control under a contractual arrangement with other parties. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity and is normally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

b Goodwill

Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

c Other intangible assets

Other intangible assets include brands and capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 5 years
Brands (which have been assessed as having finite lives)	10-15 years

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

d Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group including expected early redemption fees and related penalties and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see accounting policy 2h).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

Dividend income is recognised when the right to receive payment is established.

e Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which

2 Accounting policies (continued)

are held at fair value. Purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

(1) Financial instruments at fair value through profit or loss

Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see accounting policy 2f).

Trading securities are debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains. Such securities are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur. Financial assets and liabilities are designated at fair value through profit or loss on acquisition in the following circumstances:

- it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases.
- the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in accounting policy 2a(2), certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.
- where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 44(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

The Group is permitted to reclassify, at fair value at the date of transfer, non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the trading category if they are no longer held for the purpose of being sold or repurchased in the near term, as follows:

- if the financial assets would have met the definition of loans and receivables (but for the fact that they had to be classified as held for trading at initial recognition), they may be reclassified into loans and receivables where the Group has the intention and ability to hold the assets for the foreseeable future or until maturity;
- if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in 'rare circumstances'.

(2) Available-for-sale financial assets

Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

(3) Loans and receivables

Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see accounting policy 2d) less provision for impairment (see accounting policy 2h).

2 Accounting policies (continued)

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. These loans and advances to customers continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) Borrowings

Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss together with any related costs or fees incurred.

(5) Sale and repurchase agreements

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.

(6) Derecognition of financial assets and liabilities

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either:

- substantially all of the risks and rewards of ownership have been transferred; or
- the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

f Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 44(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement.

Derivatives embedded in financial instruments are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host 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.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of the same. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

The Group designates certain derivatives as either: (1) hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges); (2) hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges); or (3) hedges of net investments in foreign operations (net investment hedges). These are accounted for as follows:

(1) Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedge reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

2 Accounting policies (continued)

(3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instruments used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

g Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

h Impairment of financial assets

(1) Assets accounted for at amortised cost

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition of the financial asset and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's wholesale lending portfolios. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios in both Retail and Wealth & International division that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

Individual assessment

In respect of individually significant financial assets in the Group's wholesale lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watch list where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower, (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate, (iii) disappearance of an active market because of financial difficulties, or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable.

For impaired debt instruments which are held at amortised cost, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows. A reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment.

Collective assessment

In respect of portfolios of smaller balance, homogenous loans, or otherwise where there is no objective evidence of individual impairment, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors, such as the type of asset, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or where the borrower is bankrupt, has entered into an Individual Voluntary Arrangement, or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics noted above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

The collective provision also includes provision for inherent losses, that is loan losses that have been incurred but have not been identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. An assessment is made, based on statistical techniques, of the likelihood of each account becoming recognised as impaired within an emergence period, with the economic loss that each portfolio is likely to

2 Accounting policies (continued)

generate were it to become impaired. The emergence period is the time between the loss event and the date the impairment is recognised. The emergence period is determined by local management for each portfolio. In general the periods used across the Group vary between one month and twelve months based on historical experience.

Loan renegotiations and forbearance

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. There are a number of different types of loan renegotiation, including the capitalisation of arrears, payment holidays, interest rate adjustments and extensions of the due date of payment. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, this results in the asset continuing to be reported as past due and it is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. In other cases, renegotiation may lead to a new agreement, which is treated as a new loan.

Write offs

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

Debt for equity exchanges

Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has significant influence over an entity as a result of the transaction, the investment is accounted for by the equity method of accounting (see (a) above). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

(2) Available-for-sale financial assets

The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; although a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

i Investment property

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income.

j Tangible fixed assets

Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years and the remaining period of the lease
- Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease

Equipment:

- Fixtures and furnishings: 10-20 years
- Other equipment and motor vehicles: 2-8 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

k Leases

(1) As lessee

The leases entered into by the Group are primarily operating leases. Operating lease rentals payable 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 end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

2 Accounting policies (continued)

(2) As lessor

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

l Taxation

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

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

m Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation currency.

Foreign currency transactions are translated into the appropriate functional currency using 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 at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
- The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see accounting policy 2f(3)). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

n Provisions and contingent liabilities

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

o Share capital

(1) Share issue costs

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

(2) Dividends

Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

2 Accounting policies (continued)

p Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

q Investment in subsidiaries

Investments in subsidiaries are carried at historical cost, less any provisions for impairment.

3 Critical accounting estimates and judgements

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows.

The estimates and judgements applied to these areas in the preparation of the Group's financial statements are summarised below.

Allowance for impairment losses on loans and receivables

At 31 December 2010 gross loans and receivables totalled £517,113 million (2009: £585,195 million) against which impairment allowances of £26,607 million (2009: £23,187 million) had been made (see note 20). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2h; this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's wholesale lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing the borrower's cash flows and debt servicing capability together with the realisable value of real estate collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is UK house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were 10 per cent lower than those estimated at 31 December 2010, the related impairment charge would increase by approximately £210 million.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the Group's wholesale business, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £278 million.

Fair value of financial instruments

In accordance with IFRS 7, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models. These require management judgement and contain significant estimation uncertainty.

In particular, significant judgement is required by management in determining appropriate assumptions to be used for level 3 financial instruments. At 31 December 2010, the Group classified £2,915 million of financial assets and £46 million of financial liabilities as level 3. The effect of applying reasonably possible alternative assumptions in determining the fair value of the Group's level 3 financial assets is set out in note 44.

Recoverability of deferred tax assets

At 31 December 2010 the Group carried deferred tax assets on its balance sheet of £4,826 million (2009: £5,153 million) and deferred tax liabilities of £1 million (2009: £nil) (note 34). This presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 34 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward. At 31 December 2010, the Group recognised a deferred tax asset of £3,896 million (2009 £3,624 million) in respect of tax losses carried forward.

The recognition of a deferred tax asset in respect of tax losses is permitted only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. The assessment of future taxable profits involves significant estimation uncertainty, principally relating to management's projections of future taxable income which are based on business plans. These projections include assumptions about the future strategy of the Group, the economic and regulatory environment in which the Group operates, future tax legislation, customer behaviour, and the ability of the Group to deliver expected integration benefits, amongst other variables. At 31 December 2010, management has concluded that future taxable profits generated by the Group companies with tax losses carried forward are expected to be sufficient to utilise the tax losses carried forward in full.

Bank of Scotland plc
Notes to the accounts

4 Segmental analysis

IFRS 8 'Operating Segments' requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee of Lloyds Banking Group. The Bank of Scotland Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the Bank of Scotland Group's performance and allocate resources across any segments, accordingly no segmental information is provided. A brief overview of the Group's sources of income is provided in the Financial review. The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

Geographical areas

The Group's activities are focused in the UK and the analyses of income and assets below are based on the location of the branch or entity recording the income or assets.

	2010			2009 ¹		
	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
Total income	10,683	1,622	12,305	10,336	954	11,290
Total assets	501,075	72,719	573,794	588,559	72,785	661,344

¹Restated – see note 1.

There was no individual non-UK country contributing more than 5 per cent of total income or total assets.

5 Net interest income

	Weighted average effective interest rate		2010 £m	2009 ¹ £m
	2010 %	2009 ¹ %		
Interest and similar income:				
Loans and advances to banks	1.08	0.78	671	399
Loans and advances to customers, excluding lease and hire purchase receivables	3.94	3.59	16,729	17,142
Debt securities held as loans and receivables	2.71	2.36	739	849
Lease and hire purchase receivables	4.41	4.86	24	254
Interest receivable on loans and receivables	3.53	3.24	18,163	18,644
Available-for-sale financial assets	1.79	2.06	339	572
Other	–	–	–	30
Total interest and similar income	3.47	3.22	18,502	19,246
Interest and similar expense:				
Deposits from banks, excluding liabilities under sale and repurchase agreements	1.26	0.77	(1,727)	(1,121)
Customer deposits, excluding liabilities under sale and repurchase agreements	1.92	2.60	(4,279)	(6,133)
Debt securities in issue	2.41	2.31	(2,693)	(3,329)
Subordinated liabilities	2.32	3.82	(430)	(724)
Liabilities under sale and repurchase agreements	1.11	2.22	(548)	(1,261)
Interest payable on liabilities held at amortised cost	1.79	2.09	(9,677)	(12,568)
Other	–	–	–	(297)
Total interest and similar expense	1.79	2.14	(9,677)	(12,865)
Net interest income			8,825	6,381

¹Restated – see note 1.

Included within interest and similar income is £916 million (2009: £969 million) in respect of impaired financial assets. Net interest income also includes a charge of £1,377 million (2009: £890 million) transferred from the cash flow hedging reserve.

6 Net fee and commission income

	2010 £m	2009 £m
Fee and commission income:		
Current accounts	343	329
Credit and debit card fees	203	212
Other	735	763
Total fee and commission income	1,281	1,304
Fee and commission expense	(237)	(208)
Net fee and commission income	1,044	1,096

As discussed in accounting policy 2(d), fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

Bank of Scotland plc
Notes to the accounts

7 Net trading income

	2010 £m	2009 £m
Foreign exchange translation gains	296	65
Gains on foreign exchange trading transactions	82	111
Total foreign exchange	378	176
Investment property gains (losses) (note 22)	22	(13)
Securities and other gains (losses) (see below)	371	(719)
Net trading income	771	(556)

Securities and other gains (losses) comprise net gains (losses) arising on assets and liabilities held at fair value through profit or loss or for trading as follows:

	2010 £m	2009 £m
Net income (expense) arising on assets designated at fair value through profit or loss:		
Debt securities, loans and advances	(71)	–
Equity shares	(160)	7
Total net income arising on assets held at fair value through profit or loss	(231)	7
Net gains (losses) on financial instruments held for trading	602	(726)
Securities and other gains (losses)	371	(719)

8 Other operating income

	2010 £m	2009 ¹ £m
Operating lease rental income	798	1,100
Other rents receivable	9	20
Gains (losses) on disposal of available-for-sale financial assets (note 39)	52	(3)
Gains on capital transactions (see below)	433	125
Rental income from investment properties	1	–
Other income	372	127
Total other operating income	1,665	1,369

¹Restated – see note 1.

During 2010 and 2009, as part of the Lloyds Banking Group's management of capital, the Group exchanged certain existing subordinated debt securities for new securities. These exchanges resulted in a gain on extinguishment of the existing liabilities of £433 million (2009: £125 million), being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs.

Subvention income

During the year ended 31 December 2009, the Bank received a payment of £3,000 million from its then fellow subsidiary, Lloyds TSB Bank plc, to support its financial and reputational position and to facilitate the on-going integration of the group's banking operations.

Bank of Scotland plc
Notes to the accounts

9 Operating expenses

	2010 £m	2009 £m
Staff costs:		
Salaries	1,637	1,829
Social security costs	150	168
Pensions and other post-retirement benefit schemes	237	260
Restructuring costs	54	222
Other staff costs	161	168
	2,239	2,647
Premises and equipment:		
Rent and rates	260	213
Hire of equipment	4	9
Repairs and maintenance	37	48
Other	149	142
	450	412
Other expenses:		
Communications and data processing	261	103
Advertising and promotion	145	128
Professional fees	132	171
Customer goodwill payments provision (note 35)	500	–
Other	534	642
	1,572	1,044
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 27)	825	1,068
Amortisation of other intangible assets (note 26)	24	25
	849	1,093
Impairment of tangible fixed assets (note 27)	52	–
Goodwill impairment (note 25)	–	385
Total operating expenses	5,162	5,581

The average number of persons on a headcount basis employed by the Group during the year was as follows:

	2010	2009
UK	48,560	57,463
Overseas	1,941	3,037
Total	50,501	60,500

Fees payable to the Bank's auditors

During the year the auditors earned the following fees:

	2010 £m	2009 £m
Fees payable for the audit of the Bank's current year annual report	3.8	2.6
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	3.4	5.2
Other services supplied pursuant to legislation	0.3	0.4
Other services – audit-related fees	0.1	–
Services relating to taxation	0.3	0.5
All other services	–	0.2
Total fees payable to the Bank's auditors by the Group	7.9	8.9

During the year, the auditors also earned fees payable by entities outside the consolidated Group in respect of the following:

	2010 £m	2009 £m
Reviews of the financial position of corporate and other borrowers	13.5	12.0

Bank of Scotland plc
Notes to the accounts

10 Impairment

	2010 £m	2009 ¹ £m
Impairment losses on loans and receivables (note 20):		
Loans and advances to customers	10,786	18,231
Debt securities classified as loans and receivables	40	1,199
Total impairment losses on loans and receivables	10,826	19,430
Impairment of available-for-sale financial assets	100	1,557
Other credit risk provisions (note 35)	–	5
Total impairment charged to the income statement	10,926	20,992

¹Restated – see note 1.

11 Investments in joint ventures and associates

The Group's share of results of and investments in joint ventures and associates comprises:

	Joint ventures		Associates		Total	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Share of income statement amounts:						
Income	314	145	131	5	445	150
Expenses	(208)	(445)	(91)	(97)	(299)	(542)
Impairment	(126)	(272)	(92)	(77)	(218)	(349)
Loss before tax	(20)	(572)	(52)	(169)	(72)	(741)
Tax	(15)	26	(1)	2	(16)	28
Share of post-tax results	(35)	(546)	(53)	(167)	(88)	(713)
Share of balance sheet amounts:						
Current assets	3,362	2,658	376	605	3,738	3,263
Non-current assets	2,836	4,553	1,184	1,611	4,020	6,164
Current liabilities	(583)	(2,030)	(433)	(493)	(1,016)	(2,523)
Non-current liabilities	(5,316)	(4,868)	(1,025)	(1,613)	(6,341)	(6,481)
Share of net assets at 31 December	299	313	102	110	401	423
Movements in investments over the year:						
At 1 January	313	970	110	223	423	1,193
Additional investments	66	123	6	12	72	135
Acquisitions	–	3	–	60	–	63
Disposals	(12)	(198)	(2)	(39)	(14)	(237)
Share of post-tax results	(35)	(546)	(53)	(167)	(88)	(713)
Dividends paid	(3)	(21)	(1)	–	(4)	(21)
Exchange and other adjustments	(30)	(18)	42	21	12	3
Share of net assets at 31 December	299	313	102	110	401	423

The Group's unrecognised share of losses of associates for the year is £8 million (2009: £64 million) and of joint ventures is £180 million (2009: £424 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £104 million (2009: £155 million) and of joint ventures is £339 million (2009: £623 million).

The Group's most significant joint venture is Sainsbury's Bank plc, a banking business with operations principally in the UK. Bank of Scotland plc has a 50 per cent stake in the ordinary share capital of Sainsbury's Bank plc, which makes up its statutory accounts to 31 December each year. All other interests in joint ventures are held by subsidiaries. Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

Bank of Scotland plc
Notes to the accounts

12 Taxation

a Analysis of tax credit for the year

	2010 £m	2009 ¹ £m
UK corporation tax:		
Current tax on loss for the year	(19)	354
Adjustments in respect of prior years	49	(121)
	30	233
Foreign tax:		
Current tax on loss for the year	4	(49)
Adjustments in respect of prior years	28	33
	32	(16)
Current tax credit	62	217
Deferred tax (note 34):		
Origination and reversal of temporary differences	225	2,907
Reduction in UK corporation tax rate	(132)	–
Adjustments in respect of prior years	(87)	133
	6	3,040
Tax credit	68	3,257

The tax credit for 2010 and 2009 is based on a UK corporation tax rate of 28.0 per cent.

b Factors affecting the tax credit for the year

A reconciliation of the credit that would result from applying the standard UK corporation tax rate to loss before tax to the tax credit for the year is given below:

	2010 £m	2009 ¹ £m
Loss before tax	(3,871)	(15,996)
Tax credit thereon at UK corporation tax rate of 28.0 per cent (2009: 28.0 per cent)	1,084	4,479
Factors affecting credit:		
UK corporation tax rate change	(132)	–
Goodwill impairment	–	(110)
Disallowed and non-taxable items	(36)	(41)
Overseas tax rate differences	116	(428)
Gains exempted or covered by capital losses	172	(16)
Adjustments in respect of previous years	(10)	45
Impairment of financial instruments	33	43
Effect of profit or loss in joint ventures and associates	(25)	(196)
Losses surrendered for no payment	(626)	–
Tax losses where no deferred tax provided	(510)	(484)
Other items	2	(35)
Tax credit on loss on ordinary activities	68	3,257

¹Restated – see note 1.

Bank of Scotland plc
Notes to the accounts

13 Trading and other financial assets at fair value through profit or loss

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Trading assets	24,274	27,611	24,268	27,611
Other financial assets at fair value through profit or loss	422	256	129	17
Total	24,696	27,867	24,397	27,628

These assets are comprised as follows:

	2010		2009		2010		2009	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to customers	12,282	–	13,307	–	12,282	–	13,307	–
Loans and advances to banks	3,936	–	5,577	–	3,936	–	5,577	–
Debt securities:								
Government securities	1,403	–	2,864	–	1,403	–	2,864	–
Bank and building society certificates of deposit	3,692	–	2,034	–	3,692	–	2,034	–
Asset-backed securities:								
Other asset-backed securities	973	–	891	–	973	–	891	–
Corporate and other debt securities	1,755	101	2,938	4	1,755	101	2,938	4
	7,823	101	8,727	4	7,823	101	8,727	4
Equity shares:								
Listed	–	21	–	13	–	21	–	13
Unlisted	6	300	–	239	–	7	–	–
	6	321	–	252	–	28	–	13
Treasury and other bills	227	–	–	–	227	–	–	–
Total	24,274	422	27,611	256	24,268	129	27,611	17

At 31 December 2010 £2,232 million (2009: £3,939 million) of trading and other financial assets at fair value through profit or loss of the Group and £1,887 million (2009: £3,791 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £864 million (2009: £3,799 million) for the Group and Bank; the value of the related liability is £873 million (2009: £3,009 million). In all cases the transferee has the right to sell or repledge the assets concerned.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £15,513 million (2009: £18,867 million) for the Group and Bank. Collateral is held with a fair value of £7,261 million (2009: £15,776 million) for the Group and Bank, all of which the Group is able to repledge. At 31 December 2010, £10,371 million (2009: £6,559 million) had been repledged by the Group and Bank.

14 Derivative financial instruments

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers; and
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value, cash flow and net investment hedge approaches as described in note 45.

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 44.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

Bank of Scotland plc
Notes to the accounts

14 Derivative financial instruments (continued)

– Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.

– Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

The fair values and notional amounts of derivative instruments are set out in the following table:

	2010			2009		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
The Group						
Trading						
Exchange rate contracts:						
Spot, forwards and futures	22,664	193	218	22,074	281	279
Currency swaps	98,335	3,126	2,568	92,342	4,301	565
Options purchased	117	2	–	–	–	–
Options written	97	–	2	–	–	–
	121,213	3,321	2,788	114,416	4,582	844
Interest rate contracts:						
Interest rate swaps	1,230,066	18,292	18,670	698,522	14,557	14,907
Forward rate agreements	746,795	238	216	796,099	401	381
Options purchased	16,230	565	–	20,018	689	–
Options written	24,876	–	708	25,134	–	791
Futures	21,256	3	–	11,963	–	–
	2,039,223	19,098	19,594	1,551,736	15,647	16,079
Credit derivatives	1,377	51	16	4,980	153	11
Equity and other contracts	12,646	913	804	11,052	895	860
Total derivative assets/liabilities held for trading	2,174,459	23,383	23,202	1,682,184	21,277	17,794
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	42,991	3,432	619	53,979	3,053	557
Cross currency swaps	15,290	631	156	26,162	632	1,675
	58,281	4,063	775	80,141	3,685	2,232
Derivatives designated as cash flow hedges:						
Interest rate swaps	98,683	1,772	3,073	229,390	5,247	7,276
Cross currency swaps	17,911	232	218	8,938	8	144
Options	–	–	–	2,754	4	5
Futures	1,299	1	–	5,137	1	1
	117,893	2,005	3,291	246,219	5,260	7,426
Total derivative assets/liabilities held for hedging	176,174	6,068	4,066	326,360	8,945	9,658
Total recognised derivative assets/liabilities	2,350,633	29,451	27,268	2,008,544	30,222	27,452

Bank of Scotland plc
Notes to the accounts

14 Derivative financial instruments (continued)

Hedged cash flows

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
2010									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	76	246	427	478	373	329	131	143	2,203
Forecast payable cash flows	(85)	(34)	(137)	(82)	(58)	(175)	(286)	(57)	(914)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	76	287	387	478	373	345	136	121	2,203
Forecast payable cash flows	(85)	(79)	(92)	(82)	(58)	(244)	(248)	(26)	(914)
2009									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	39	44	–	49	80	468	374	142	1,196
Forecast payable cash flows	(300)	(569)	(247)	(184)	(82)	(257)	(606)	(84)	(2,329)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	39	44	22	37	123	453	340	138	1,196
Forecast payable cash flows	(300)	(569)	(331)	(130)	(74)	(287)	(563)	(75)	(2,329)

At 31 December 2010 £26,773 million of total recognised derivative assets of the Group and £24,066 million of total recognised derivative liabilities of the Group (2009: £25,822 million of assets and £23,792 million of liabilities) had a contractual residual maturity of greater than one year.

	2010			2009		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
The Bank						
Trading						
Exchange rate contracts:						
Spot, forwards and futures	14,576	203	284	25,388	285	359
Currency swaps	71,917	1,355	2,517	78,328	1,108	554
Options purchased	102	2	–	–	–	–
Options written	95	–	2	–	–	–
	86,690	1,560	2,803	103,716	1,393	913
Interest rate contracts:						
Interest rate swaps	1,018,133	18,286	18,674	697,740	14,503	14,859
Forward rate agreements	729,593	238	216	792,962	401	381
Options purchased	14,778	565	–	19,999	688	–
Options written	22,609	–	708	25,117	–	789
Futures	21,256	3	–	–	–	–
	1,806,369	19,092	19,598	1,535,818	15,592	16,029
Credit derivatives	1,377	51	16	4,980	153	11
Equity and other contracts	8,623	591	503	11,052	585	585
Total derivative assets/liabilities held for trading	1,903,059	21,294	22,920	1,655,566	17,723	17,538
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	41,311	3,432	619	49,554	3,063	544
Cross currency swaps	12,680	631	156	26,162	627	1,675
	53,991	4,063	775	75,716	3,690	2,219
Derivatives designated as cash flow hedges:						
Interest rate swaps	97,812	1,772	3,073	229,812	5,250	7,276
Cross currency swaps	17,911	232	218	8,938	8	130
Options	–	–	–	2,754	8	5
Futures	1,299	1	–	5,137	1	3
	117,022	2,005	3,291	246,641	5,267	7,414
Total derivative assets/liabilities held for hedging	171,013	6,068	4,066	322,357	8,957	9,633
Total recognised derivative assets/liabilities	2,074,072	27,362	26,986	1,977,923	26,680	27,171

Bank of Scotland plc
Notes to the accounts

14 Derivative financial instruments (continued)

Hedged cash flows

For designated cash flow hedges the following table shows when the Bank's hedged cash flows are expected to occur and when they will affect income.

	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
2010									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	76	246	427	478	373	329	131	143	2,203
Forecast payable cash flows	(85)	(34)	(137)	(82)	(58)	(175)	(286)	(57)	(914)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	76	287	387	478	373	345	136	121	2,203
Forecast payable cash flows	(85)	(79)	(92)	(82)	(58)	(244)	(248)	(26)	(914)
2009								Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	39	44	–	49	80	468	374	142	1,196
Forecast payable cash flows	(300)	(569)	(247)	(184)	(82)	(257)	(606)	(84)	(2,329)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	39	44	22	37	123	453	340	138	1,196
Forecast payable cash flows	(300)	(569)	(331)	(130)	(74)	(287)	(563)	(75)	(2,329)

At 31 December 2010 £24,748 million of total recognised derivative assets of the Bank and £23,777 million of total recognised derivative liabilities of the Bank (2009: £22,630 million of assets and £23,467 million of liabilities) had a contractual residual maturity of greater than one year.

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group and Bank should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 45.

15 Loans and advances to banks

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Loans and advances to banks	61,349	91,259	61,024	108,133

No impairment allowances are held against these exposures.

At 31 December 2010, £11,435 million (2009: £2,285 million) of loans and advances to banks of the Group and £11,435 million (2009: £2,247 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £20,664 million for the Group and Bank (2009: £34,423 million for the Group and Bank). Collateral is held with a fair value of £15,318 million for the Group and Bank (2009: £34,362 million for the Group and Bank), all of which the Group and Bank are able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £4 million for the Group and Bank (2009: £19 million for the Group and Bank).

Bank of Scotland plc
Notes to the accounts

16 Loans and advances to customers

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Agriculture, forestry and fishing	602	772	579	521
Energy and water supply	1,145	1,129	1,133	779
Manufacturing	3,881	6,836	3,801	5,236
Construction	6,983	11,169	6,725	7,730
Transport, distribution and hotels	23,232	21,496	21,104	15,841
Postal and telecommunications	1,032	1,449	1,031	1,328
Property companies	58,092	65,144	54,172	49,503
Financial, business and other services	32,029	36,613	27,474	36,298
Personal:				
Mortgages	246,690	252,745	234,793	230,325
Other	16,974	19,518	14,242	16,121
Lease financing	4,458	4,990	171	–
Hire purchase	1,358	3,486	718	2,467
Due from fellow Group undertakings	34,365	35,463	72,407	92,559
Total loans and advances to customers before allowance for impairment losses	430,841	460,810	438,350	458,708
Allowance for impairment losses (note 20)	(25,316)	(21,272)	(22,722)	(18,741)
Total loans and advances to customers	405,525	439,538	415,628	439,967

At 31 December 2010 £320,341 million (2009: £325,855 million) of loans and advances to customers of the Group and £320,931 million (2009: £281,579 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £2,579 million for the Group and the Bank (2009: £nil for the Group and Bank). Collateral is held with a fair value of £10 million for the Group and Bank (2009: £nil for the Group and Bank), all of which the Group and Bank are able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £42 million for the Group and the Bank (2009: £203 million for the Group and Bank).

Loans and advances to customers include finance lease receivables, which may be analysed as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Gross investment in finance leases, receivable:				
Not later than 1 year	614	726	74	–
Later than 1 year and not later than 5 years	1,395	2,106	97	–
Later than 5 years	2,581	2,988	–	–
	4,590	5,820	171	–
Unearned future finance income on finance leases	(132)	(830)	–	–
Net investment in finance leases	4,458	4,990	171	–

The net investment in finance leases represents amounts recoverable as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Not later than 1 year	671	644	74	–
Later than 1 year and not later than 5 years	1,224	1,511	97	–
Later than 5 years	2,563	2,835	–	–
Net investment in finance leases	4,458	4,990	171	–

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2010 and 2009 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £227 million for the Group (2009: £193 million).

Bank of Scotland plc
Notes to the accounts

17 Securitisation and covered bonds

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by Group companies to bankruptcy-remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the Group company, the SPEs are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the SPEs described below, the Group sponsors two conduit programmes, Grampian and Landale (note 18).

Covered bond programmes

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to notes in issue at 31 December, are listed below. The notes in issue are reported in note 32.

	As at 31 December 2010		As at 31 December 2009	
	Gross assets securitised £m	Notes in issue £m	Gross assets securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	102,801	83,367	104,257	95,228
US residential mortgage-backed securities	7,197	7,221	7,897	7,897
Irish residential mortgages	6,061	6,191	6,522	6,585
Credit card receivables	7,372	3,856	5,155	2,699
Dutch residential mortgages	4,551	4,415	4,812	4,834
Personal loans	3,012	2,011	3,730	2,613
Commercial loans	667	633	928	976
Motor vehicle loans	926	975	443	470
	132,587	108,669	133,744	121,302
Less held by the Group		(78,686)		(87,359)
Total securitisation programmes (note 32)		29,983		33,943
Covered bond programmes				
Residential mortgage-backed	55,032	44,271	61,537	49,644
Social housing loan-backed	3,377	2,400	3,407	2,976
	58,409	46,671	64,944	52,620
Less held by the Group		(17,239)		(23,060)
Total covered bond programmes (note 32)		29,432		29,560
Total securitisation and covered bond programmes		59,415		63,503

Cash deposits of £25,139 million (2009: £24,271 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs, covered bonds issued by Bank of Scotland plc and other legal obligations.

Bank of Scotland plc
Notes to the accounts

18 Special purpose entities

In addition to the SPEs discussed in note 17, which are used for securitisation and covered bond programmes, the Group sponsors two asset-backed conduits, Grampian and Landale, which invest in debt securities. All of the external assets in these conduits are consolidated in the Group's financial statements. The total consolidated exposures in these conduits are set out in the table below:

At 31 December 2010	Grampian £m	Landale £m	Total £m
Debt securities classified as loans and receivables	6,967	–	6,967
At 31 December 2009	Grampian £m	Landale £m	Total £m
Debt securities classified as loans and receivables	9,924	698	10,622

19 Debt securities classified as loans and receivables

Debt securities accounted for as loans and receivables comprise:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Asset-backed securities:				
Mortgage-backed securities	12,276	15,555	10,684	11,968
Other asset-backed securities	11,989	16,706	7,749	12,853
Corporate and other debt securities	658	865	269	390
Total debt securities classified as loans and receivables before allowance for impairment losses	24,923	33,126	18,702	25,211
Allowance for impairment losses (note 20)	(1,291)	(1,915)	(1,269)	(1,527)
Total debt securities classified as loans and receivables	23,632	31,211	17,433	23,684

At 31 December 2010, £23,572 million (2009: £31,063 million) of debt securities designated as loans and receivables of the Group and £17,433 million (2009: £22,195 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £8,020 million (2009: £12,238 million) for the Group and Bank; the value of the related liability is £7,081 million (2009: £8,396 million) for the Group and Bank. In all cases the transferee has the right to sell or repledge the assets concerned.

20 Allowance for impairment losses on loans and receivables

The Group	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2009	10,693	923	11,616
Exchange and other adjustments	162	(172)	(10)
Advances written off	(7,459)	(35)	(7,494)
Recoveries of advances written off in previous years	36	–	36
Unwinding of discount	(391)	–	(391)
Charge to the income statement (note 10)	18,231	1,199	19,430
Balance at 31 December 2009	21,272	1,915	23,187
Exchange and other adjustments	330	82	412
Advances written off	(6,605)	(746)	(7,351)
Recoveries of advances written off in previous years	57	–	57
Unwinding of discount	(375)	–	(375)
Charge to the income statement (note 10)	10,786	40	10,826
Disposals of subsidiary undertakings	(149)	–	(149)
Balance at 31 December 2010	25,316	1,291	26,607

Of the Group's total allowance in respect of loans and advances to customers, £22,086 million (2009: £18,440 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £4,900 million (2009: £4,220 million) was assessed on a collective basis.

Bank of Scotland plc
Notes to the accounts

20 Allowance for impairment losses on loans and receivables (continued)

	Loans and advances to customers £m	Debt securities £m	Total £m
The Bank			
Balance at 1 January	10,475	415	10,890
Exchange and other adjustments	(27)	(3)	(30)
Advances written off	(6,812)	(18)	(6,830)
Recoveries of advances written off in previous years	35	–	35
Unwinding of discount	(394)	–	(394)
Charge to the income statement	15,464	1,133	16,597
Balance at 31 December 2009	18,741	1,527	20,268
Exchange and other adjustments	(2)	61	59
Advances written off	(8,411)	(419)	(8,830)
Recoveries of advances written off in previous years	42	–	42
Unwinding of discount	(480)	–	(480)
Charge to the income statement	5,069	100	5,169
Adjustment on merger by absorption of Bank of Scotland (Ireland) Limited (note 24)	7,763	–	7,763
Balance at 31 December 2010	22,722	1,269	23,991

Of the Bank's total allowance in respect of loans and advances to customers, £19,758 million (2009: £14,466 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £4,383 million (2009: £2,946 million) was assessed on a collective basis.

21 Available-for-sale financial assets

	2010 £m	2009 £m
The Group		
Debt securities:		
Government securities	79	326
Bank and building society certificates of deposit	129	285
Asset-backed securities:		
Mortgage-backed securities	15	17
Other asset-backed securities	181	79
Corporate and other debt securities	11,368	18,924
	11,772	19,631
Equity shares:		
Listed	59	85
Unlisted	2,108	1,849
	2,167	1,934
Treasury bills and other bills	483	–
Total available-for-sale financial assets	14,422	21,565
The Bank		
Debt securities:		
Government securities	78	325
Bank and building society certificates of deposit	129	285
Asset-backed securities:		
Other asset-backed securities	945	60
Corporate and other debt securities	10,789	17,569
	11,941	18,239
Equity shares:		
Listed	26	26
Unlisted	1,057	1,051
	1,083	1,077
Treasury bills and other bills	483	–
Total available-for-sale financial assets	13,507	19,316

At 31 December 2010 £10,086 million (2009: £18,810 million) of available-for-sale financial assets of the Group and £9,853 million (2009: £17,021 million) of the Bank had a contractual residual maturity of greater than one year.

Bank of Scotland plc
Notes to the accounts

21 Available-for-sale financial assets (continued)

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £3,007 million (2009: £10,628 million) for the Group and Bank; the value of the related liability is £2,840 million (2009: £9,957 million) for the Group and Bank. In all cases the transferee has the right to sell or repledge the assets concerned.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in accounting policy 2h. Included in available-for-sale financial assets at 31 December 2010 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £160 million and in respect of which no collateral was held (2009: £329 million).

22 Investment properties of the Group

	2010	2009
	£m	£m
At 1 January	30	43
Exchange and other adjustments	(6)	–
Additions:		
Acquisitions of new properties	2	–
Consolidation of new subsidiary undertakings	801	–
Additional expenditure on existing properties	1	–
Total additions	804	–
Disposals	(61)	–
Changes in fair value (note 7)	22	(13)
At 31 December	789	30

The investment properties are valued at least annually at open-market value, by independent, professionally qualified valuers, who have recent experience in the location and categories of the investment properties being valued.

No capital expenditure has been contracted for, but not recognised in the financial statements, at the balance sheet date (2009: £nil).

23 Investment in subsidiary undertakings

	2010	2009
	£m	£m
At 1 January	2,451	4,383
Exchange and other adjustments	(86)	–
Additional capital injections and transfers	4,283	2,517
Impairment	(5,108)	(4,449)
At 31 December	1,540	2,451

A reassessment of the carrying value of the Bank's investments in Bank of Scotland (Ireland) and HBOS Australia, and taking into account the merger of Bank of Scotland (Ireland) Limited into the Bank (see note 24), resulted in the recognition of an impairment charge of £5,108 million which represents a full write down of those investments.

Impairment was determined based on the fair value less cost to sell and was determined by using a discounted cash flow valuation technique. This calculation uses projections of future cash flows based on management's plans covering a five-year period. These cash flows are based on past experience and have been adjusted to take into account expected future market conditions. Cash flows beyond the five-year period have been extrapolated using a steady 2.2 per cent rate of increase. The expected cash flows have been discounted at a rate of 17.75 per cent which has been determined to be in line with available market information.

The impairment charge of £4,449 million in 2009 also related to Bank of Scotland (Ireland) and HBOS Australia and was triggered by the deterioration of the financial performance of those companies, principally due to impairment losses in their lending portfolios.

The principal group undertaking, which has prepared accounts to 31 December and whose results are included in the consolidated accounts of Bank of Scotland plc, is:

	<u>Country of registration/ incorporation</u>	<u>Percentage of equity share capital and voting rights held</u>	<u>Nature of business</u>
Uberior Investments plc	UK	100%	Investment holding

The principal area of operation for this group undertaking is its country of registration/incorporation.

In November 2009, as part of the restructuring plan that was a requirement for European Community (EC) approval of state aid received by the Group, Lloyds Banking Group agreed to suspend the payment of coupons and dividends on certain of the Group preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. The Group has agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, subsidiaries may be prevented from making dividend payments on ordinary shares during this period. In addition, certain subsidiary companies currently have insufficient distributable reserves to make dividend payments.

Subject to the foregoing, there were no further significant restrictions on any of the Bank's subsidiaries in paying dividends or repaying loans and advances. All regulated subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

Bank of Scotland plc
Notes to the accounts

24 Merger of Bank of Scotland (Ireland) Limited into the Bank

On 31 December 2010, the Bank's subsidiary, Bank of Scotland (Ireland) Limited, was merged into the Bank by virtue of a merger by absorption of a wholly-owned subsidiary pursuant to the Companies (Cross-Border Mergers) Regulations 2007. As a consequence of the merger, all of the assets and liabilities of Bank of Scotland (Ireland) Limited were transferred to the Bank and Bank of Scotland (Ireland) Limited was dissolved without going into liquidation. Consideration for the merger was nil and the reserve arising on transfer was reduced by the carrying value of most of the Bank's investment in Bank of Scotland (Ireland) Limited, although this had already been written down to nil value. The assets and liabilities transferred were as follows:

	£m
Loans and advances to customers (net of impairment allowances of £7,763 million)	19,643
Available-for-sale financial assets	1,498
Net funding from the Bank no longer required	(19,354)
Other net liabilities	(240)
	1,547
Consideration paid	–
	1,547
Reduction in the Bank's investment in Bank of Scotland (Ireland) Limited	–
Net amount arising from transfer credited to retained profits	1,547

In accordance with the accounting treatment available under IFRS 3 (Revised) for business combinations involving entities under common control, Bank of Scotland plc was not required to fair value the Bank of Scotland (Ireland) Limited business at the date of merger. Instead, the assets and liabilities were incorporated at the amounts at which they were recorded within the Bank of Scotland Group at that date.

The Bank's investment in Bank of Scotland (Ireland) Limited had previously been held via an intermediate holding company, Scotland International Finance BV, but this investment was transferred under the direct ownership of the Bank on 17 September 2010. As disclosed in note 23, prior to the merger of Bank of Scotland (Ireland) Limited into the Bank, the Bank wrote down its investment in the subsidiary by £3,023 million.

25 Goodwill

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
At 1 January	376	667	376	376
Exchange and other adjustments	–	(5)	–	–
Acquired through business combinations	–	99	–	–
Impairment charged to the income statement (note 9)	–	(385)	–	–
At 31 December	376	376	376	376
Cost ¹	944	944	426	426
Accumulated impairment losses	(568)	(568)	(50)	(50)
At 31 December	376	376	376	376

¹For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's and the Bank's balance sheet, which relates to retail banking operations, is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit, which is principally the retail banking activities. This compares the recoverable amount, being the higher of a cash-generating unit's fair value less costs to sell and its value in use, with the carrying value. When this indicates that the carrying value is not recoverable it is written down through the income statement as goodwill impairment.

The recoverable amount of goodwill carried at 31 December 2010 has been based upon value in use. This calculation uses cash flow projections based upon the Group's business plans where the main assumptions relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are extrapolated using a growth rate of 2.5 per cent reflecting management's view of the expected future long-term trend in growth rate of the respective economies concerned, predominantly being in the UK, and the long term performances of the businesses concerned. The discount rate used in discounting the projected cash flows is 12.5 per cent (pre-tax) reflecting, inter alia, the perceived risks within those businesses. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount to fall below the balance sheet carrying value.

The goodwill impairment charge of £385 million in 2009 included the write-down, triggered primarily by deteriorating economic conditions, of the goodwill arising on the acquisition of Lex Vehicle Leasing Services.

Bank of Scotland plc
Notes to the accounts

26 Other intangible assets

	The Group			The Bank
	Brands £m	Capitalised software enhance- ments £m	Total £m	Capitalised software enhance- ments £m
Cost:				
At 1 January 2009	10	279	289	267
Additions	–	11	11	10
Disposals	–	(2)	(2)	–
At 31 December 2009	10	288	298	277
Additions	–	21	21	22
Disposals	–	(30)	(30)	(22)
At 31 December 2010	10	279	289	277
Accumulated amortisation:				
At 1 January 2009	5	176	181	169
Charge for the year	1	–	1	–
Disposals	1	24	25	23
At 31 December 2009	7	200	207	192
Exchange and other adjustments	3	(3)	–	4
Charge for the year (note 9)	–	24	24	23
At 31 December 2010	10	221	231	219
Balance sheet amount at 31 December 2010	–	58	58	58
Balance sheet amount at 31 December 2009	3	88	91	85

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

27 Tangible fixed assets

	The Group				The Bank			
	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:								
At 1 January 2009	1,452	2,546	6,334	10,332	1,362	2,214	2	3,578
Exchange and other adjustments	–	(3)	(78)	(81)	–	1	(2)	(1)
Additions	59	118	1,478	1,655	43	87	102	232
Disposals	(55)	(55)	(2,511)	(2,621)	(50)	(42)	–	(92)
At 31 December 2009	1,456	2,606	5,223	9,285	1,355	2,260	102	3,717
Exchange and other adjustments	–	7	12	19	–	–	–	–
Transfers to fellow Group undertakings	–	–	(1,263)	(1,263)	–	–	–	–
Additions	52	125	782	959	51	201	–	252
Disposals	(69)	(261)	(1,248)	(1,578)	(42)	(72)	(89)	(203)
At 31 December 2010	1,439	2,477	3,506	7,422	1,364	2,389	13	3,766
Accumulated depreciation and impairment:								
At 1 January 2009	659	1,779	2,367	4,805	641	1,578	–	2,219
Exchange and other adjustments	4	(1)	5	8	3	(2)	–	1
Depreciation charge for the year (note 9)	54	179	835	1,068	50	146	–	196
Disposals	(17)	(28)	(1,454)	(1,499)	(21)	(22)	–	(43)
At 31 December 2009	700	1,929	1,753	4,382	673	1,700	–	2,373
Exchange and other adjustments	–	4	39	43	–	–	–	–
Transfers to fellow Group undertakings	–	–	(258)	(258)	–	–	–	–
Impairment charged to the income statement (note 9)	–	52	–	52	–	–	–	–
Depreciation charge for the year (note 9)	54	246	525	825	51	228	–	279
Disposals	(20)	(319)	(716)	(1,055)	(6)	(58)	–	(64)
At 31 December 2010	734	1,912	1,343	3,989	718	1,870	–	2,588
Balance sheet amount at 31 December 2010	705	565	2,163	3,433	646	519	13	1,178
Balance sheet amount at 31 December 2009	756	677	3,470	4,903	682	560	102	1,344

Bank of Scotland plc
Notes to the accounts

27 Tangible fixed assets (continued)

At 31 December the future minimum rentals receivable by the Group under non-cancellable operating leases were as follows:

	2010 £m	2009 £m
Receivable within 1 year	480	428
1 to 5 years	986	1,376
Over 5 years	588	51
Total future minimum rentals receivable	2,054	1,855

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2010 and 2009 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £nil for the Group and £nil for the Bank at 31 December 2010 (2009: £3 million for the Group and £nil for the Bank) is expected to be received under non-cancellable sub-leases of the Group's premises.

28 Other assets

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Settlement balances	419	1,354	419	1,354
Other assets and prepayments	1,509	3,168	1,265	4,438
Total other assets	1,928	4,522	1,684	5,792

29 Deposits from banks

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Liabilities in respect of securities sold under repurchase agreements	6,155	66,441	5,855	60,275
Other deposits from banks	136,901	107,897	135,984	107,971
Total deposits from banks	143,056	174,338	141,839	168,246

At 31 December 2010 £25,928 million (2009: £6,374 million) of deposits from banks of the Group and £24,783 million (2009: £3,592 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £55,394 million (2009: £66,441 million) for the Group and Bank and a fair value of £56,450 million (2009: £74,166 million for the Group and Bank).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £nil (2009: £19 million) for the Group and the Bank.

30 Customer deposits

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Non-interest bearing current accounts	5,646	2,471	5,645	2,471
Interest bearing current accounts	35,776	80,097	35,746	118,644
Savings and investment accounts	137,188	137,902	137,188	109,439
Liabilities in respect of securities sold under repurchase agreements	8,079	35,330	8,079	35,330
Other customer deposits	54,828	10,171	85,242	34,240
Total customer deposits	241,517	265,971	271,900	300,124

At 31 December 2010 £31,857 million (2009: £19,011 million) of customer deposits of the Group and £35,497 million (2009: £81,598 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £8,279 million (2009: £35,330 million) for the Group and Bank and a fair value of £8,455 million (2009: £35,294 million) for the Group and the Bank.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £122 million (2009: £203 million) for the Group and the Bank.

Bank of Scotland plc
Notes to the accounts

31 Trading liabilities

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Liabilities in respect of securities sold under repurchase agreements	17,906	26,852	17,906	26,852
Short positions in securities	860	–	860	–
Other	20	520	20	520
Trading liabilities	18,786	27,372	18,786	27,372

At 31 December 2010, for both the Group and the Bank, £608 million (2009: £131 million) of trading liabilities had a contractual residual maturity of greater than one year.

32 Debt securities in issue

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Medium-term notes issued	24,430	33,589	24,432	36,455
Covered bonds (note 17)	29,432	29,560	29,432	29,560
Certificates of deposit	3,061	6,413	3,061	6,724
Securitisation notes (note 17)	29,983	33,943	–	–
Commercial paper	11,317	12,786	1,543	3,299
	98,223	116,291	58,468	76,038
Amounts due to fellow Group undertakings	2,498	2,866	14,343	22,037
Total debt securities in issue	100,721	119,157	72,811	98,075

At 31 December 2010 £68,105 million (2009: £76,484 million) of debt securities in issue of the Group and £47,101 million (2009: £46,660 million) of the Bank had a contractual residual maturity of greater than one year.

33 Other liabilities

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Settlement balances	655	1,610	655	1,610
Other creditors and accruals	4,358	4,681	3,357	3,315
	5,013	6,291	4,012	4,925

34 Deferred tax

The movement in the net deferred tax balance is as follows:

	The Group		The Bank	
	2010 £m	2009 ¹ £m	2010 £m	2009 ¹ £m
Asset at 1 January	5,153	3,182	4,410	2,563
Exchange and other adjustments	65	60	(39)	1
Adjustment on acquisition	–	3	–	–
Income statement (charge) credit (note 12):				
Due to change in UK corporation tax rate	(132)	–	(152)	–
Other	138	3,040	446	2,532
	6	3,040	294	2,532
Amount (charged) credited to equity:				
Available-for-sale financial assets (note 39)	(228)	(1,048)	15	(604)
Cash flow hedges (note 39)	(171)	(79)	(170)	(82)
Other	–	(5)	–	–
	(399)	(1,132)	(155)	(686)
Asset at 31 December	4,825	5,153	4,510	4,410

¹Restated – see note 1.

Bank of Scotland plc
Notes to the accounts

34 Deferred tax (continued)

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Statutory position				
Deferred tax asset	4,826	5,153	4,519	4,410
Deferred tax liability	(1)	–	(9)	–
Net deferred tax asset	4,825	5,153	4,510	4,410
Tax disclosure				
Deferred tax asset	5,294	5,325	4,606	4,533
Deferred tax liability	(469)	(172)	(96)	(123)
Net deferred tax asset	4,825	5,153	4,510	4,410

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

	2010 £m	2009 ¹ £m
Accelerated capital allowances	(318)	547
Pensions and other post-retirement benefits	(1)	21
Effective interest rate	14	–
Tax losses carried forward	272	2,277
Provisions	(148)	(121)
Other temporary differences	187	316
Deferred tax credit in the income statement	6	3,040

¹Restated – see note 1.

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Deferred tax assets:				
Employee benefits	39	40	31	27
Capital allowances	–	–	241	174
Other provisions	238	465	195	201
Derivatives	156	326	155	324
Available-for-sale asset revaluation	377	247	–	–
Tax losses carried forward	3,896	3,624	3,895	3,612
Other temporary differences	588	623	89	195
Total deferred tax assets	5,294	5,325	4,606	4,533
Deferred tax liabilities:				
Accelerated capital allowances	(363)	(45)	–	–
Available-for-sale asset revaluation	–	–	(5)	(10)
Effective interest rate	(72)	(86)	(61)	(76)
Other temporary differences	(34)	(41)	(30)	(37)
Total deferred tax liabilities	(469)	(172)	(96)	(123)

The Finance (No.2) Act 2010 includes legislation to reduce the main rate of corporation tax from 28 per cent to 27 per cent with effect from 1 April 2011. This resulted in a reduction in the Group's net deferred tax asset at 31 December 2010 of £160 million.

The proposed further reductions in the rate of corporation tax by 1 per cent per annum to 24 per cent by 1 April 2014 are expected to be enacted separately each year starting in 2011. The effect of these further changes upon the Group's deferred tax balances and leasing business cannot be reliably quantified at this stage.

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised a deferred tax asset of £3,896 million and £3,895 million for the Bank (2009: £3,624 million for the Group and £3,612 million for the Bank) in relation to tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £227 million for the Group and nil for the Bank (2009: £349 million for the Group and nil for the Bank) have not been recognised in respect of trading losses carried forward, mainly in overseas companies, as there are limited predicted future trading profits to offset them. Trading losses can be carried forward indefinitely.

Deferred tax assets of £330 million for the Group and nil for the Bank (2009: £349 million for the Group and nil for the Bank) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

Bank of Scotland plc
Notes to the accounts

34 Deferred tax (continued)

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2010 of £40 million for the Group and the Bank (2009: £40 million for the Group and the Bank), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

35 Other provisions

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Vacant leasehold property and other £m	Total £m
The Group					
At 1 January 2010	5	196	–	46	247
Exchange and other adjustments	9	(1)	–	5	13
Transfers	–	129	–	–	129
Provisions applied	–	(123)	–	(1)	(124)
Charge (release) for the year	–	(4)	500	25	521
At 31 December 2010	14	197	500	75	786
	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Vacant leasehold property and other £m	Total £m
The Bank					
At 1 January 2010	5	194	–	36	235
Exchange and other adjustments	3	(1)	–	5	7
Adjustment on merger by absorption of Bank of Scotland (Ireland) Limited (note 24)	–	–	–	21	21
Transfers	–	129	–	–	129
Provisions applied	–	(121)	–	–	(121)
Charge (release) for the year	–	(4)	500	(2)	494
At 31 December 2010	8	197	500	60	765

Provisions for contingent liabilities and commitments

Provisions are held in cases where the Group is irrevocably committed to advance additional funds, but where there is doubt as to the customer's ability to meet its repayment obligations.

Customer remediation provisions

The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales where the original sales processes have been found to be deficient or where fees and premiums have been overcharged.

Customer goodwill payments

The Lloyds Banking Group has been in discussion with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the 'Halifax' brand. In February 2011, the Lloyds Banking Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Bank has made a provision of £500 million in relation to this programme.

Vacant leasehold property and other

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biennial basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging five years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

Bank of Scotland plc
Notes to the accounts

36 Subordinated liabilities

The movement in subordinated liabilities during the year was as follows:

	The Group £m	The Bank £m
At 1 January 2010	16,684	16,052
Repurchases and redemptions during the year	(331)	(331)
Foreign exchange and other movements	(1,117)	(611)
At 31 December 2010	15,236	15,110

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Preference shares	–	800	–	800
Preferred securities	705	703	301	300
Undated subordinated liabilities	4,871	5,265	5,569	5,667
Dated subordinated liabilities	9,660	9,916	9,240	9,285
Total subordinated liabilities	15,236	16,684	15,110	16,052

Preference shares

6½% Non-cumulative Redeemable preference shares (£800 million)

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
	–	800	–	800

The Group redeemed £800 million of preference shares in exchange for the issue of ordinary shares to its immediate parent, HBOS plc. This transaction gave rise to the transfer of £419 million from the Bank's distributable reserves to the capital redemption reserve (note 39).

Preferred securities

8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class B) (£250 million)

7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B) (£150 million)

£300 million Perpetual Regulatory Tier 1 Securities

Total preferred securities

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
	253	252	–	–
	151	151	–	–
	301	300	301	300
Total preferred securities	705	703	301	300

Undated subordinated liabilities

£200 million 8.625% Perpetual Notes

€500 million Instruments

US\$250 million Floating Rate Primary Capital Notes

£150 million 7.375% Instruments

JPY 17 billion 4.25% Instruments

£100 million 10.25% Instruments

£300 million Instruments

£250 million Perpetual Preferred Notes

£150 million Perpetual Preferred Notes

£150 million Floating Rate Subordinated Notes

£500 million Floating Rate Subordinated Notes

£100 million 12% Perpetual Subordinated Bonds

£100 million 8.75% Perpetual Subordinated Bonds

£75 million 13.625% Perpetual Subordinated Bonds

£50 million 9.375% Perpetual Subordinated Bonds

£500 million Floating Rate Subordinated Notes

£300 million Floating Rate Subordinated Notes

£250 million Floating Rate Subordinated Notes

£2,000 million Floating Rate Subordinated Note

€320 million Floating Rate Subordinated Notes

€22 million Floating Rate Subordinated Notes

Total undated subordinated liabilities

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
	24	62	24	62
	432	445	432	445
	118	146	118	146
	76	77	76	77
	161	136	161	136
	1	60	1	60
	300	300	300	300
	–	–	252	252
	–	–	150	150
	150	150	150	150
	500	500	500	500
	22	104	22	104
	5	103	5	103
	16	78	16	78
	16	54	16	54
	500	500	500	500
	300	300	300	300
	250	250	250	250
	2,000	2,000	2,000	2,000
	–	–	276	–
	–	–	20	–
Total undated subordinated liabilities	4,871	5,265	5,569	5,667

No exercise of any redemption option or purchase by the relevant entity of any of the undated subordinated liabilities may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary, the claims of the holders of undated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary other than creditors whose claims are expressed to rank *pari passu* with or junior to the claims of the holders of the undated loan capital. The undated loan capital is junior in point of subordination to the dated loan capital referred to above.

Bank of Scotland plc
Notes to the accounts

36 Subordinated liabilities (continued)

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Dated subordinated liabilities				
US\$500 million 7.70% Notes 2010	–	326	–	326
US\$150 million 6.50% Notes 2011	99	101	99	101
€12.8 million 6.25% Instruments 2012	10	10	10	–
€325 million 6.125% Notes 2013	296	306	296	306
£250 million 6.375% Instruments 2019	301	287	301	287
€750 million 5.50% Subordinated Fixed Rate Notes 2012	699	725	699	725
US\$1,000 million 4.25% Subordinated Guaranteed Notes 2013	688	621	–	–
£330 million Floating Rate Subordinated Notes 2014	330	330	330	330
£300 million Floating Rate Subordinated Notes 2014	300	300	300	300
£700 million Floating Rate Subordinated Notes 2014	700	700	700	700
£300 million Floating Rate Subordinated Notes 2014	300	300	300	300
£250 million 11% Subordinated Bonds 2014	276	276	276	276
£150 million 10.5% Subordinated Bonds 2018	163	164	163	164
£500 million 9.375% Subordinated Bonds 2021	608	580	608	580
£520 million Floating Rate Subordinated Notes 2014	520	520	520	520
£300 million Floating Rate Subordinated Notes 2014	300	300	300	300
£300 million Floating Rate Subordinated Notes 2014	300	300	300	300
£270 million Floating Rate Subordinated Notes 2014	270	270	270	270
£500 million Floating Rate Subordinated Notes 2014	500	500	500	500
£2,000 million Floating Rate Subordinated Notes 2014	2,000	2,000	2,000	2,000
£1,000 million Floating Rate Subordinated Notes 2014	1,000	1,000	1,000	1,000
€256 million Floating Rate Subordinated Notes on rolling 5 year notice	–	–	221	–
€55 million Floating Rate Subordinated Notes on rolling 5 year notice	–	–	47	–
Total dated subordinated liabilities	9,660	9,916	9,240	9,285

At 31 December 2010 £15,137 million (2009: £16,358 million) of subordinated liabilities of the Group and £15,011 million (2009: £15,726 million) of the Bank had a contractual residual maturity of greater than one year.

No repayment, for whatever reason, of dated subordinated liabilities prior to their stated maturity and no purchase by the relevant entity of its subordinated debt may be made without the consent of the Financial Services Authority. On a winding up of the Bank or subsidiary, the claims of the holders of dated loan capital shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank or subsidiary other than creditors whose claims are expressed to rank *pari passu* with, or junior to, the claims of the holders of the dated loan capital.

37 Share capital

(1) Authorised share capital

	2010 Number of shares	2009 Number of shares	2010 £m	2009 £m
<i>Sterling</i>				
Ordinary shares of 25p				
At 1 January	24,085,301,755	8,085,301,755	6,021	2,021
Increase in authorised share capital	–	16,000,000,000	–	4,000
At 31 December	24,085,301,755	24,085,301,755	6,021	6,021
9.25% non-cumulative irredeemable preference shares of £1 each	–	–	–	–
9.75% non-cumulative irredeemable preference shares of £1 each	–	–	–	–
8.117% non-cumulative perpetual preference shares class 'A' of £10 each	250,000	250,000	3	3
7.754% non-cumulative perpetual preference shares class 'B' of £10 each	150,000	150,000	2	2

On 4 August 2009 the redemption of the Bank's 9.25% and 9.75% non-cumulative irredeemable preference shares was approved. These shares had been classified as subordinated debt rather than as issued share capital due to their terms.

Bank of Scotland plc
Notes to the accounts

37 Share capital (continued)

(2) Issued share capital

	2010 Number of shares	2009 Number of shares	2010 £m	2009 £m
Ordinary shares of 25p each				
At 1 January	23,387,545,644	5,296,712,311	5,847	1,324
Ordinary share issue February 2009	–	13,918,333,333	–	3,480
Ordinary share issue March 2009	–	1,500,000,000	–	375
Ordinary share issue June 2009	–	2,500,000,000	–	625
Ordinary share issue October 2009	–	169,000,000	–	42
Ordinary share issue December 2009	–	3,500,000	–	1
Ordinary share issues in 2010	794,908	–	–	–
At 31 December	23,388,340,552	23,387,545,644	5,847	5,847

Details of movements in preference shares that are treated for accounting purposes as debt are given in note 36.

Ordinary share issuances during 2010

During 2010, a total of 794,908 ordinary shares were issued as consideration for the redemption of certain preference shares and other subordinated liabilities issued by the Group (see also note 8).

38 Share premium account

	Group and Bank	
	2010 £m	2009 £m
At 1 January	26,684	11,018
Issue of ordinary shares (see note 37)	795	15,666
At 31 December	27,479	26,684

39 Other reserves

	The Group		The Bank	
	2010 £m	2009 ¹ (restated) £m	2010 £m	2009 ¹ (restated) £m
Other reserves comprise:				
Merger and other reserves	1,600	1,600	1,600	1,600
Capital redemption reserve	482	63	482	63
Revaluation reserve in respect of available-for-sale financial assets	(899)	(1,395)	(796)	(717)
Cash flow hedging reserve	(415)	(839)	(412)	(832)
Foreign currency translation reserve	(153)	54	80	76
At 31 December	615	(517)	954	190

¹See note 1.

Movements in other reserves were as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Merger and other reserves				
At 1 January	1,600	1,600	1,600	1,600
At 31 December	1,600	1,600	1,600	1,600

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Capital redemption reserve				
At 1 January	63	–	63	–
Redemption of preference shares	419	63	419	63
At 31 December	482	63	482	63

Bank of Scotland plc
Notes to the accounts

39 Other reserves (continued)

	The Group		The Bank	
	2010 £m	2009 ¹ £m	2010 £m	2009 ¹ £m
Revaluation reserve in respect of available-for-sale financial assets				
At 1 January:				
As previously stated		(5,335)		(2,729)
Prior year adjustment		1,065		460
Restated (note 1)	(1,395)	(4,270)	(717)	(2,269)
Change in fair value of available-for-sale financial assets	197	2,588	(194)	1,848
Deferred tax	(95)	(673)	43	(517)
	102	1,915	(151)	1,331
Income statement transfers:				
Disposals (note 8)	(52)	3	46	55
Deferred tax	7	(1)	(13)	(16)
	(45)	2	33	39
Impairment	641	1,479	116	275
Deferred tax	(157)	(415)	(32)	(77)
	484	1,064	84	198
Other transfers to the income statement	(62)	(147)	(62)	(22)
Deferred tax	17	41	17	6
	(45)	(106)	(45)	(16)
At 31 December	(899)	(1,395)	(796)	(717)

¹Restated – see note 1.

	2010 £m	2009 £m	2010 £m	2009 £m
Cash flow hedging reserve				
At 1 January				
Change in fair value of hedging derivatives	(782)	(613)	(787)	(627)
Deferred tax	201	171	202	173
	(581)	(442)	(585)	(454)
Income statement transfer	1,377	895	1,377	907
Deferred tax	(372)	(250)	(372)	(255)
	1,005	645	1,005	652
At 31 December	(415)	(839)	(412)	(832)

	2010 £m	2009 £m	2010 £m	2009 £m
Foreign currency translation reserve				
At 1 January				
Currency translation differences arising in the year	(207)	(29)	4	33
At 31 December	(153)	54	80	76

40 Retained profits

	The Group		The Bank	
	2010 £m	2009 ¹ £m	2010 £m	2009 ¹ £m
At 1 January:				
As previously stated		4,013		2,124
Prior year adjustment		(1,065)		(460)
Restated (note 1)	(9,867)	2,948	(12,746)	1,664
Loss for the year ²	(3,813)	(12,752)	(4,785)	(14,347)
Capital redemption	(419)	(63)	(419)	(63)
Adjustment arising on merger by absorption of Bank of Scotland (Ireland) Limited (note 24)	–	–	1,547	–
At 31 December	(14,099)	(9,867)	(16,403)	(12,746)

¹Restated – see note 1.

²No income statement has been shown for the Bank, as permitted by Section 408 of the Companies Act 2006.

Bank of Scotland plc
Notes to the accounts

41 Dividends

No dividends were paid on the Bank's ordinary shares in 2010 or 2009.

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Lloyds Banking Group, Lloyds Banking Group plc agreed to suspend the payment of coupons and dividends on certain preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. Lloyds Banking Group plc has also agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, the Bank is prevented from making dividend payments on its ordinary shares during this period.

42 Related party transactions

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity. At 31 December 2010 and 2009, the Group's key management personnel are the members of the Lloyds Banking Group plc group executive committee together with its non-executive directors.

The table below details, on an aggregated basis, key management personnel compensation which has been allocated to the Bank on an estimated basis.

	2010 £m	2009 £m
Compensation		
Salaries and other short-term benefits	<u>6</u>	<u>6</u>

The aggregate of the emoluments of the directors for qualifying services to the Bank, on an estimated basis, in 2010 was £4.2 million (2009: £4.0 million). The total for the highest paid director (J E Daniels) was £1,029,000 (2009: (G T Tate) £722,000).

As a result of the acquisition of HBOS plc by Lloyds Banking Group plc on 16 January 2009, the Board of the Bank changed in its entirety. Accordingly, the disclosures for 2009 begin with the balances of key management personnel on 16 January 2009.

	2010 million	2009 million
Share option plans over Lloyds Banking Group plc shares		
At 1 January 2010/16 January 2009	2	2
Granted, including certain adjustments ¹ (includes entitlements of appointed directors)	<u>4</u>	–
At 31 December	<u>6</u>	<u>2</u>

¹Adjustments have been made, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

	2010 million	2009 million
Share plans settled in Lloyds Banking Group plc shares		
At 1 January 2010/16 January 2009	19	7
Granted, including certain adjustments ¹ (includes entitlements of appointed directors)	<u>39</u>	17
Exercised/lapsed (includes entitlements of former directors)	<u>(2)</u>	(5)
At 31 December	<u>56</u>	<u>19</u>

¹Adjustments have been made, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between Lloyds Banking Group and its key management personnel:

	2010 £m	2009 £m
Loans		
At 1 January 2010/16 January 2009	2	3
Advanced (includes loans of appointed directors)	<u>2</u>	–
Repayments (includes loans of former directors)	<u>(1)</u>	(1)
At 31 December	<u>3</u>	<u>2</u>

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 0.50 per cent and 17.90 per cent in 2010 (1.28 per cent and 24.90 per cent in 2009).

Bank of Scotland plc
Notes to the accounts

42 Related party transactions (continued)

No provisions have been recognised in respect of loans given to key management personnel.

	2010 £m	2009 £m
Deposits		
At 1 January 2010/16 January 2009	4	6
Placed (includes deposits of appointed directors)	12	12
Withdrawn (includes deposits of former directors)	(12)	(14)
At 31 December	4	4

Deposits placed by key management personnel attracted interest rates of up to 4.25 per cent in 2010 (2009: 6.50 per cent).

At 31 December 2010 and 2009, the Group did not provide any guarantees in respect of key management personnel.

At 31 December 2010, transactions, arrangements and agreements entered into by the Lloyds Banking Group's banking subsidiaries with directors and connected persons of the Group included amounts outstanding in respect of loans and credit card transactions of £2 million with six directors and four connected persons (2009: £2 million with seven directors and four connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings

Balances and transactions between members of the Bank of Scotland group

In accordance with IAS 27, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Bank, as a result of its position as parent of a banking group, has a large number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Bank as follows:

	2010 £m	2009 £m
Assets, included within:		
Derivative financial instruments	22	144
Loans and receivables:		
Loans and advances to banks	–	17,193
Loans and advances to customers	39,085	57,730
Other	442	3,095
	39,549	78,162
Liabilities, included within:		
Deposits from banks	–	3,402
Customer deposits	36,547	45,346
Derivative financial instruments	109	1,901
Debt securities in issue	14,157	22,037
Subordinated liabilities	66	–
	50,879	72,686

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2010 the Bank earned interest income on the above asset balances of £2,548 million and incurred interest expense on the above liability balances of £2,245 million.

Details of contingent liabilities and commitments entered into on behalf of fellow Lloyds Banking Group undertakings are given in note 43.

Balances and transactions with Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group

The Bank and its subsidiaries have balances due to and from the Bank's ultimate parent company, Lloyds Banking Group plc and fellow subsidiaries of the Lloyds Banking Group. These are included on the balance sheet as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Assets, included within:				
Derivative financial instruments	1,497	664	1,495	664
Loans and receivables:				
Loans and advances to banks	55,053	85,456	55,053	85,456
Loans and advances to customers	34,365	35,721	33,322	34,829
Other	7,194	1,760	4,427	1,760
	98,109	123,601	94,297	122,709

Bank of Scotland plc
Notes to the accounts

42 Related party transactions (continued)

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Liabilities, included within:				
Deposits from banks	131,138	144,876	131,138	144,876
Customer deposits	40,949	33,395	35,065	33,385
Derivative financial instruments	4,196	853	4,196	853
Subordinated liabilities	11,266	10,994	12,216	10,994
Debt securities in issue	2,498	1,578	186	1,578
Trading liabilities	3,294	5,463	3,294	5,463
Other liabilities	145	–	145	–
	193,486	197,159	186,240	197,149

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2010 the Group earned £1,147 million and the Bank earned £923 million of interest income on the above asset balances (2009: Group and Bank £277 million); the Group incurred £2,565 million and the Bank incurred £2,532 million of interest expense on the above liability balances (2009: Group and Bank £823 million).

HM Treasury

In January 2009, HM Treasury became a related party of Lloyds Banking Group plc, the Bank's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 31 December 2010, HM Treasury held a 41 per cent interest (December 2009: 43 per cent) in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of the Bank and its subsidiaries throughout 2010.

Capital transactions

During 2010 there were no further subscriptions by HM Treasury for Lloyds Banking Group plc's ordinary or preference share capital, with the decline in the percentage of ordinary shares held by HM Treasury reflecting the issuance by Lloyds Banking Group plc of ordinary shares.

Lending commitments

On 23 March 2010, Lloyds Banking Group plc entered into a deed poll in favour of HM Treasury, the Department for Business, Innovation and Skills and the Departments for Communities and Local Government confirming its lending commitments for the 12 month period commencing 1 March 2010. Lloyds Banking Group plc agreed, subject to, amongst other things, sufficient customer demand, to provide gross new lending to UK businesses of £44,000 million and to adjust the undertakings (but not the level of lending agreed in 2009) given in connection with lending to homeowners for the 12 month period. This additional lending is expressed to be subject to the Group's prevailing commercial terms and conditions (including pricing and risk assessment) and, in relation to mortgage lending, the Group's standard credit and other acceptance criteria.

Credit Guarantee Scheme

HM Treasury launched the Credit Guarantee Scheme in October 2008 as part of a range of measures announced by the UK Government intended to ease the turbulence in the UK banking system. It charges a commercial fee for the guarantee of new short and medium-term debt issuance. The fee payable to HM Treasury on guaranteed issues is based on a per annum rate of 50 basis points plus the median five-year credit default swap spread. At 31 December 2010, the Group had £6,030 million (2009: £8,725 million) of debt issued under the Credit Guarantee Scheme. During 2010, the Group redeemed £2,695 million of bonds. The Group's income statement includes fees of £89 million (2009: £236 million) payable to HM Treasury in respect of guaranteed funding.

There were no other material transactions between the Group and HM Treasury during 2010 that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party disclosures

The Group provides both administration and processing services to its principal joint venture Sainsbury's Bank plc. The amounts receivable by the Group during the year were £31 million (2009: £34 million), of which £8 million was outstanding at the year end (2009: £10 million). At 31 December 2010, Sainsbury's Bank plc also had balances with the Group and the Bank that were included in loans and advances to banks of £1,277 million (2009: £1,218 million) and deposits by banks of £1,358 million (2009: £1,405 million).

The Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2010, these companies had total assets of approximately £4,713 million (2009: £11,816 million), total liabilities of approximately £4,199 million (2009: £12,106 million) and for the year ended 31 December 2010 had turnover of approximately £744 million (2009: £8,766 million) and made a net profit of approximately £164 million (2009: net loss of £557 million). In addition, the Group has provided £1,406 million (2009: £5,245 million) of financing to these companies on which it received £19 million (2009: £140 million) of interest income in the year.

Banking transactions are entered into by the Bank with its subsidiaries in the normal course of business and are at normal commercial terms. These include loans, deposits and foreign currency transactions.

At 31 December 2010 the Group had loans and advances to customers of £5,660 million (2009: £12,216 million), the Bank had loans and advances to customers of £5,628 million (2009: £12,197 million), and the Group and Bank had outstanding balances within customer accounts of £151 million (2009: £174 million) relating to jointly controlled entities and associated undertakings.

Taxation: Group relief was surrendered for no payment as per note 12.

43 Contingent liabilities and commitments

Legal proceedings

Unarranged overdraft charges

In April 2007, the Office of Fair Trading (OFT) commenced an investigation into the fairness of personal current accounts and unarranged overdraft charges. At the same time, it commenced a market study into wider questions about competition and price transparency in the provision of personal current accounts.

The Supreme Court of the United Kingdom published its judgment in respect of the fairness of unarranged overdraft charges on personal current accounts on 25 November 2009, finding in favour of the litigant banks. On 22 December 2009, the OFT announced that it will not continue its investigation into the fairness of these charges. The Group is working with the regulators to ensure that outstanding customer complaints are concluded as quickly as possible and anticipates that most cases in the county courts will be discontinued. The Group expects that some customers will argue that despite the test case ruling they are entitled to a refund of unarranged overdraft charges on the basis of other legal arguments or challenges. It is not practicable to quantify the claims. The Group is robustly defending any such complaints or claims and does not expect any such complaints or claims to have a material adverse effect on the Group.

The OFT however continued to discuss its concerns in relation to the personal current account market with the banks, consumer groups and other organisations under the auspices of its Market Study into personal current accounts. In October 2009, the OFT published voluntary initiatives agreed with the industry and consumer groups to improve transparency of the costs and benefits of personal current accounts and improvements to the switching process. On 16 March 2010 the OFT published a further update announcing several further voluntary industry wide initiatives to improve a customer's ability to control whether they used an unarranged overdraft and to assist those in financial difficulty. However, in light of the progress it noted in the unarranged overdraft market since July 2007 and the progress it expects to see over the next two years, it has decided to take no further action at this time and will review the unarranged overdraft market again in 2012.

Interchange fees

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the General Court). Lloyds TSB Bank plc and the Bank (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of a uniform fallback interchange fee are compatible with European Commission competition laws. MasterCard has announced that it has reached an understanding with the European Commission on a new methodology for calculating intra European Economic Area multi-lateral interchange fees on an interim basis pending the outcome of the appeal. Meanwhile, the European Commission and the UK's OFT are pursuing investigations with a view to deciding whether arrangements adopted by other payment card schemes for the levying of uniform fallback interchange fees in respect of domestic and/or cross-border payment transactions also infringe European Commission and/or UK competition laws. As part of this initiative, the OFT will also intervene in the General Court appeal supporting the European Commission's position and Visa reached an agreement with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by MasterCard. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

Payment protection insurance

There has been extensive scrutiny of the Payment Protection Insurance (PPI) market in recent years.

In October 2010, the UK Competition Commission (Competition Commission) confirmed its decision to prohibit the active sale of PPI by a distributor to a customer within seven days of a sale of credit. This followed the completion of its formal investigation into the supply of PPI services (other than store card PPI) to non-business customers in the UK in January 2009 and a referral of the proposed prohibition to the Competition Appeal Tribunal. Following an earlier decision to stop selling single premium PPI products, the Group ceased to offer PPI products its customers in July 2010.

On 1 July 2008, the Financial Ombudsman Service (FOS) referred concerns regarding the handling of PPI complaints to the Financial Services Authority (FSA) as an issue of wider implication. On 29 September 2009 and 9 March 2010, the FSA issued consultation papers on PPI complaints handling. The FSA proposed new guidance on the fair assessment of a complaint and the calculation of redress and a new rule requiring firms to reassess historically rejected complaints. The FSA published its Policy Statement on 10 August 2010, setting out a new set of rules for PPI complaints handling and redress which had to be implemented by 1 December 2010.

On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA is seeking an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial hearing was held in late January 2011 and the judgment (which may be subject to appeal) is expected shortly.

This legal challenge has affected the implementation of the Policy Statement, since the challenge has called into question the standards to be applied when assessing PPI complaints. As a result of that challenge, a large number of complaints cannot be decided until the outcome of the legal challenge is clear and implemented.

The ultimate impact on the Group of the FSA's complaints handling policy (if implemented in full) and the FOS's most recent approach to PPI complaints could be material to the Group's financial position, although the precise effect can only be assessed once the legal proceedings have been finally determined and the steps the Group may be required to take identified and implemented. In addition, it is not practicable to quantify the potential financial impact of the implementation of the Policy Statement given the material uncertainties around, for example, applicable time periods, the extent of application of root cause analysis, the treatment of evidence and the ultimate emergence period for complaints, driven in large part by the activities of the claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs. No provision has been made in these financial statements to reflect implementation of the FSA's complaint handling policy in its current form.

Following concerns by the FSA, it announced in its statement on 29 September 2009 that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. The Group has agreed in principle that it will undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. The precise details of the review are still being discussed with the FSA. The ultimate impact on the Group of any review could be material but can only be known at the conclusion of these discussions.

Bank of Scotland plc
Notes to the accounts

43 Contingent liabilities and commitments (continued)

Other legal proceedings and regulatory matters

In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters, especially in relation to retail products including packaged bank accounts, mortgages, structured products and pensions. The Group is keen to ensure that any regulatory concerns regarding product governance or contract terms are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

In addition, during the ordinary course of business the Group is subject to other threatened and actual legal proceedings (which may include class action lawsuits brought on behalf of customers, shareholders or other third parties), regulatory investigations, regulatory challenges and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisors where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed properly to assess the merits of the case and no provisions are held against such matters. However the Group does not currently expect the final outcome of any such matter to have a material adverse effect on its financial position.

Contingent liabilities and commitments arising from the banking business

Acceptances and endorsements arise where the Group agrees to guarantee payment on a negotiable instrument drawn up by a customer.

Other items serving as direct credit substitutes include standby letters of credit, or other irrevocable obligations, where the Group has an irrevocable obligation to pay a third party beneficiary if the customer fails to repay an outstanding commitment; they also include acceptances drawn under letters of credit or similar facilities where the acceptor does not have specific title to an identifiable underlying shipment of goods.

Performance bonds and other transaction-related contingencies (which include bid or tender bonds, advance payment guarantees, VAT Customs & Excise bonds and standby letters of credit relating to a particular contract or non-financial transaction) are undertakings where the requirement to make payment under the guarantee depends on the outcome of a future event.

The Group's maximum exposure to loss is represented by the contractual nominal amount detailed in the table below. Consideration has not been taken of any possible recoveries from customers for payments made in respect of such guarantees under recourse provisions or from collateral held.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Contingent liabilities				
Acceptances and endorsements	1	5	1	3
Other:				
Other items serving as direct credit substitutes	103	99	103	99
Performance bonds and other transaction-related contingencies	575	1,251	511	2,332
	678	1,350	614	2,431
Total contingent liabilities	679	1,355	615	2,434

The contingent liabilities of the Group, as detailed above, arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Commitments				
Documentary credits and other short-term trade-related transactions	2	69	2	34
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	6,875	6,188	6,875	6,085
Other commitments	32,130	30,130	37,253	50,955
	39,005	36,318	44,128	57,040
1 year or over original maturity	12,617	17,665	11,668	16,510
Total commitments	51,624	54,052	55,798	73,584

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £22,476 million (2009: £30,124 million) for the Group and £20,544 million (2009: £63,207 million) for the Bank were irrevocable.

Bank of Scotland plc
Notes to the accounts

43 Contingent liabilities and commitments (continued)

Operating lease commitments

Where a Group company is the lessee the future minimum lease payments under non-cancellable premises operating leases are as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Not later than 1 year	160	174	144	138
Later than 1 year and not later than 5 years	564	608	521	492
Later than 5 years	1,015	1,095	903	701
Total operating lease commitments	1,739	1,877	1,568	1,331

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

Capital commitments

Excluding commitments of the Group in respect of investment property (note 22), capital expenditure contracted but not provided for at 31 December 2010 amounted to £89 million for the Group and £6 million for the Bank (2009: £127 million for the Group and £nil for the Bank). Of the capital commitments of the Group, £44 million (2009: £107 million) related to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

44 Financial instruments

(1) Measurement basis of financial assets and liabilities

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
The Group							
As at 31 December 2010							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	2,375	2,375
Items in the course of collection from banks	-	-	-	-	-	319	319
Trading and other financial assets at fair value through profit or loss	-	24,274	422	-	-	-	24,696
Derivative financial instruments	6,068	23,383	-	-	-	-	29,451
Loans and receivables:							
Loans and advances to banks	-	-	-	-	61,349	-	61,349
Loans and advances to customers	-	-	-	-	405,525	-	405,525
Debt securities	-	-	-	-	23,632	-	23,632
	-	-	-	-	490,506	-	490,506
Available-for-sale financial assets	-	-	-	14,422	-	-	14,422
Total financial assets	6,068	47,657	422	14,422	490,506	2,694	561,769
Financial liabilities							
Deposits from banks	-	-	-	-	-	143,056	143,056
Customer deposits	-	-	-	-	-	241,517	241,517
Items in course of transmission to banks	-	-	-	-	-	251	251
Trading liabilities	-	18,786	-	-	-	-	18,786
Derivative financial instruments	4,066	23,202	-	-	-	-	27,268
Debt securities in issue	-	-	-	-	-	100,721	100,721
Subordinated liabilities	-	-	-	-	-	15,236	15,236
Total financial liabilities	4,066	41,988	-	-	-	500,781	546,835

Bank of Scotland plc
Notes to the accounts

44 Financial instruments (continued)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
The Group							
As at 31 December 2009							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	2,905	2,905
Items in the course of collection from banks	-	-	-	-	-	534	534
Trading and other financial assets at fair value through profit or loss	-	27,611	256	-	-	-	27,867
Derivative financial instruments	8,945	21,277	-	-	-	-	30,222
Loans and receivables:							
Loans and advances to banks	-	-	-	-	91,259	-	91,259
Loans and advances to customers	-	-	-	-	439,538	-	439,538
Debt securities	-	-	-	-	31,211	-	31,211
	-	-	-	-	562,008	-	562,008
Available-for-sale financial assets	-	-	-	21,565	-	-	21,565
Total financial assets	8,945	48,888	256	21,565	562,008	3,439	645,101
Financial liabilities							
Deposits from banks	-	-	-	-	-	174,338	174,338
Customer deposits	-	-	-	-	-	265,971	265,971
Items in course of transmission to banks	-	-	-	-	-	495	495
Trading liabilities	-	27,372	-	-	-	-	27,372
Derivative financial instruments	9,658	17,794	-	-	-	-	27,452
Debt securities in issue	-	-	-	-	-	119,157	119,157
Subordinated liabilities	-	-	-	-	-	16,684	16,684
Total financial liabilities	9,658	45,166	-	-	-	576,645	631,469

Bank of Scotland plc
Notes to the accounts

44 Financial instruments (continued)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
The Bank							
As at 31 December 2010							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	2,318	2,318
Items in the course of collection from banks	-	-	-	-	-	314	314
Trading and other financial assets at fair value through profit or loss	-	24,268	129	-	-	-	24,397
Derivative financial instruments	6,068	21,294	-	-	-	-	27,362
Loans and receivables:							
Loans and advances to banks	-	-	-	-	61,024	-	61,024
Loans and advances to customers	-	-	-	-	415,628	-	415,628
Debt securities	-	-	-	-	17,433	-	17,433
	-	-	-	-	494,085	-	494,085
Available-for-sale financial assets	-	-	-	13,507	-	-	13,507
Total financial assets	6,068	45,562	129	13,507	494,085	2,632	561,983
Financial liabilities							
Deposits from banks	-	-	-	-	-	141,839	141,839
Customer deposits	-	-	-	-	-	271,900	271,900
Items in course of transmission to banks	-	-	-	-	-	251	251
Trading liabilities	-	18,786	-	-	-	-	18,786
Derivative financial instruments	4,066	22,920	-	-	-	-	26,986
Debt securities in issue	-	-	-	-	-	72,811	72,811
Subordinated liabilities	-	-	-	-	-	15,110	15,110
Total financial liabilities	4,066	41,706	-	-	-	501,911	547,683
As at 31 December 2009							
Financial assets							
Cash and balances at central banks	-	-	-	-	-	2,168	2,168
Items in the course of collection from banks	-	-	-	-	-	538	538
Trading and other financial assets at fair value through profit or loss	-	27,611	17	-	-	-	27,628
Derivative financial instruments	8,957	17,723	-	-	-	-	26,680
Loans and receivables:							
Loans and advances to banks	-	-	-	-	108,133	-	108,133
Loans and advances to customers	-	-	-	-	439,967	-	439,967
Debt securities	-	-	-	-	23,684	-	23,684
	-	-	-	-	571,784	-	571,784
Available-for-sale financial assets	-	-	-	19,316	-	-	19,316
Total financial assets	8,957	45,334	17	19,316	571,784	2,706	648,114
Financial liabilities							
Deposits from banks	-	-	-	-	-	168,246	168,246
Customer deposits	-	-	-	-	-	300,124	300,124
Items in course of transmission to banks	-	-	-	-	-	495	495
Trading liabilities	-	27,372	-	-	-	-	27,372
Derivative financial instruments	9,633	17,538	-	-	-	-	27,171
Debt securities in issue	-	-	-	-	-	98,075	98,075
Subordinated liabilities	-	-	-	-	-	16,052	16,052
Total financial liabilities	9,633	44,910	-	-	-	582,992	637,535

Bank of Scotland plc
Notes to the accounts

44 Financial instruments (continued)

(2) Reclassification of financial assets

No assets were reclassified in 2010.

In accordance with the amendment to IAS 39 that became applicable during 2008, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, the Group reclassified the following financial assets:

- In January 2009, the Group reclassified £1,825 million of debt securities classified as held for trading to debt securities classified as loans and receivables.
- In addition, the Group reclassified £649 million of securities classified as available-for-sale to debt securities classified as loans and receivables.
- With effect from 1 July 2008, the Group transferred £12,210 million of assets previously classified as held for trading into available-for-sale.
- With effect from 1 November 2008, the Group transferred £35,446 million of assets previously classified as available-for-sale financial assets into loans and receivables.

At the time of these transfers, the Group had the intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 0.7 per cent to 9.5 per cent with estimated recoverable cash flows of £56,743 million.

Carrying value and fair value of reclassified assets

The table below sets out the carrying value and fair value of reclassified financial assets.

	31 December 2010		31 December 2009		31 December 2008	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
From held for trading to loans and receivables	949	965	1,428	1,120	–	–
From held for trading to available-for-sale	6,116	6,431	10,478	10,176	13,542	13,542
From available-for-sale to loans and receivables	21,508	21,522	29,153	27,820	37,173	36,191
Total carrying value and fair value	28,573	28,918	41,059	39,116	50,715	49,733

During the year ended 31 December 2010, the carrying value of reclassified assets decreased by £12,486 million due to sales and maturities of £13,603 million, accretion of discount of £420 million and foreign exchange and other movements of £697 million.

Additional fair value gains (losses) that would have been recognised had the reclassifications not occurred

The table below shows the additional gains (losses) that would have been recognised since the date of reclassification in the Group's income statement or through the Group's available-for-sale revaluation reserve if the reclassifications had not occurred.

	2010				2009			2008	
	Reclassified in 2010 £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables	–	14	–	14	13	–	13	–	–
From held for trading to available-for-sale	–	–	136	136	–	904	904	981	981
From available-for-sale to loans and receivables	–	–	(134)	(134)	70	1,147	1,217	708	708
Total additional fair value gains	–	14	2	16	83	2,051	2,134	1,689	1,689

Bank of Scotland plc
Notes to the accounts

44 Financial instruments (continued)

Actual amounts recognised in respect of reclassified assets

After reclassification the reclassified financial assets contributed the following amounts to the Group income statement:

	2010				2009			2008	
	Reclassified in 2010 £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables:									
Net interest income	-	23	-	23	45	-	45	-	-
Impairment losses	-	-	-	-	(110)	-	(110)	-	-
Gains on disposal	-	109	-	109	17	-	17	-	-
Total amounts recognised	-	132	-	132	(48)	-	(48)	-	-
From held for trading to available-for-sale:									
Net interest income	-	-	184	184	-	281	281	442	442
Impairment losses	-	-	1	1	-	(305)	(305)	(215)	(215)
Gains on disposal	-	-	95	95	-	70	70	-	-
Total amounts recognised	-	-	280	280	-	46	46	227	227
From available-for-sale to loans and receivables:									
Net interest income	-	14	443	457	25	377	402	82	82
Impairment losses	-	-	(33)	(33)	-	(371)	(371)	(558)	(558)
Gains (losses) on disposal	-	(9)	(128)	(137)	-	(152)	(152)	16	16
Total amounts recognised	-	5	282	287	25	(146)	(121)	(460)	(460)

(3) Fair values of financial assets and liabilities

The following table summarises the carrying values of financial assets and liabilities presented on the Group's and Bank's balance sheets. The fair values presented in the table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

	The Group				The Bank			
	Carrying value 2010 £m	Carrying value 2009 £m	Fair value 2010 £m	Fair value 2009 £m	Carrying value 2010 £m	Carrying value 2009 £m	Fair value 2010 £m	Fair value 2009 £m
Financial assets								
Trading and other financial assets at fair value through profit or loss	24,696	27,867	24,696	27,867	24,397	27,628	24,397	27,628
Derivative financial instruments	29,451	30,222	29,451	30,222	27,362	26,680	27,362	26,680
Loans and receivables:								
Loans and advances to banks	61,349	91,259	61,368	91,322	61,024	108,133	61,043	108,193
Loans and advances to customers	405,525	439,538	391,564	418,005	415,628	439,967	402,519	419,440
Debt securities	23,632	31,211	23,790	37,736	17,433	23,684	16,466	29,045
Available-for-sale financial assets	14,422	21,565	14,422	21,565	13,507	19,316	13,507	19,316
Financial liabilities								
Deposits from banks	143,056	174,338	143,650	174,413	141,839	168,246	142,334	168,319
Customer deposits	241,517	265,971	242,575	266,005	271,900	300,124	272,958	299,659
Trading liabilities	18,786	27,372	18,786	27,372	18,786	27,372	18,786	27,372
Derivative financial instruments	27,268	27,452	27,268	27,452	26,986	27,171	26,986	27,171
Debt securities in issue	100,721	119,157	98,176	116,133	72,811	98,075	70,749	95,318
Subordinated liabilities	15,236	16,684	15,587	15,548	15,110	16,052	15,462	14,915

44 Financial instruments (continued)

Valuation methodology

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been estimated using market prices for instruments held by the Group. Where market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics either identical or similar to those of the instruments held by the Group. These estimation techniques are necessarily subjective in nature and involve several assumptions.

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group's financial position.

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, premises, equipment and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

Valuation control framework

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

Fair value of financial instruments carried at amortised cost

Loans and receivables

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of asset-backed securities and secondary loans, which were previously within assets held for trading and were reclassified to loans and receivables, are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market-standard consensus pricing services, broker quotes and other research data.

Deposits from banks and customers

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Debt securities in issue and subordinated liabilities

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

Valuations of financial instruments carried at fair value

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 portfolios

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise government securities.

Level 2 portfolios

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

Level 3 portfolios

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Bank of Scotland plc
Notes to the accounts

44 Financial instruments (continued)

The table below provides an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

Valuation hierarchy

At 31 December 2010

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading and other financial assets at fair value through profit or loss	(i) 1,215	22,897	584	24,696
Available-for-sale financial assets	(ii) 337	12,019	2,066	14,422
Derivative financial instruments	(iii) –	29,186	265	29,451
Financial assets	1,552	64,102	2,915	68,569
Trading and other financial liabilities at fair value through profit or loss	(iv) 864	17,922	–	18,786
Derivative financial instruments	(iii) –	27,234	34	27,268
Financial guarantees	–	–	12	12
Financial liabilities	864	45,156	46	46,066

At 31 December 2009

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading and other financial assets at fair value through profit or loss	2,881	23,861	1,125	27,867
Available-for-sale financial assets	1,819	17,881	1,865	21,565
Derivative financial instruments	20	30,128	74	30,222
Financial assets	4,720	71,870	3,064	79,654
Trading and other financial liabilities at fair value through profit or loss	511	26,861	–	27,372
Derivative financial instruments	22	27,234	196	27,452
Financial liabilities	533	54,095	196	54,824

Movement in level 3 portfolio

The table below analyses movements in the level 3 financial assets portfolio:

	Trading and other financial assets at fair value through profit or loss £m	Available- for-sale £m	Derivative assets £m	Total financial assets £m
At 1 January 2009	3,155	2,290	569	6,014
Losses recognised in the income statement	(244)	(600)	(555)	(1,399)
Gains recognised in other comprehensive income	–	141	–	141
Purchases	8	403	60	471
Sales	(51)	(259)	–	(310)
Transfers into the level 3 portfolio	–	11	–	11
Transfers out of the level 3 portfolio	(1,743)	(121)	–	(1,864)
At 31 December 2009	1,125	1,865	74	3,064
Exchange and other adjustments	29	12	2	43
Gains (losses) recognised in the income statement	44	(56)	(37)	(49)
Gains recognised in other comprehensive income	–	265	–	265
Purchases	190	497	–	687
Sales	(75)	(502)	–	(577)
Transfers into the level 3 portfolio	9	–	226	235
Transfers out of the level 3 portfolio	(738)	(15)	–	(753)
At 31 December 2010	584	2,066	265	2,915
Gains (losses) recognised in the income statement relating to those assets held at 31 December 2010	34	(88)	(37)	(91)
Gains (losses) recognised in other comprehensive income relating to those assets held at 31 December 2010	–	269	–	269

Bank of Scotland plc
Notes to the accounts

44 Financial instruments (continued)

The table below analyses movements in the level 3 financial liabilities portfolio:

	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities £m
At 1 January 2009	1,102	–	1,102
Gains recognised in the income statement	(123)	–	(123)
Transfers out of the level 3 portfolio	(783)	–	(783)
At 31 December 2009	196	–	196
Exchange and other adjustments	14	–	14
Purchases	–	12	12
Sales	(210)	–	(210)
Transfers into the level 3 portfolio	34	–	34
At 31 December 2010	34	12	46

Gains (losses) recognised in the income statement relating to those liabilities held at 31 December 2010	–	–	–
Gains (losses) recognised in other comprehensive income relating to those liabilities held at 31 December 2010	–	–	–

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

Included within the gains (losses) recognised in the income statement are losses of £91 million (2009: £977 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

Included within the gains (losses) recognised in other comprehensive income are gains of £269 million (2009: £118 million) related to financial instruments that are held in the level 3 portfolio at the year end.

There were no significant transfers between Level 1 and Level 2 portfolios during the year.

Level 3 portfolio

	Valuation basis/technique	Main assumptions	At 31 December 2010			31 December 2009	
			Carrying value £m	Effect of reasonably possible alternative assumptions		Carrying value £m	Effect of reasonably possible alternative assumptions £m
			Favourable changes £m	Unfavourable changes £m			
Trading and other financial assets at fair value through profit or loss:							
Asset-backed securities	Lead manager or broker quote/consensus pricing from market data provider	Use of single pricing source	191	6	(6)	891	74
Equity investments	Various valuation techniques	Earnings, net asset value and earnings multiples, property prices, forecast cash flows	390	74	(58)	234	–
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	3	–	–	–	–
			584			1,125	
Available-for-sale financial assets							
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	2,066	141	(91)	1,865	–
			2,066			1,865	
Derivative financial assets	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	265	34	(8)	74	31
Financial assets			2,915			3,064	
Derivative financial liabilities	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	34	–	–	196	8
Financial guarantees			12			–	
Financial liabilities			46			196	

The main products where level 3 valuations have been used are described below:

44 Financial instruments (continued)

Asset-backed securities

Where there is no trading activity in asset-backed securities, valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes are used to determine an appropriate valuation. Asset-backed securities are then classified as either level 2 or level 3 depending on whether there is more than one consistent independent source of data. If there is a single, uncorroborated market source for a significant valuation input or where there are materially inconsistent levels then the valuation is reported as level 3. Asset classes classified as level 3 mainly comprise certain residential mortgage-backed securities, collateralised loan obligations and collateralised debt obligations.

Equity investments (including venture capital)

Unlisted equities and fund investments are accounted for as trading and other financial assets at fair value through profit or loss or as available-for-sale financial assets. These investments are valued using different techniques as a result of the variety of investments across the portfolio in accordance with the Group's valuation policy and are calculated using International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation (EBITDA). The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

Derivatives

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives, except for the items classified as level 3 which are valued using publicly available yield and credit default swap (CDS) curves; the Group uses standard models with observable inputs.
- Less complex interest rate and foreign exchange option products which are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the securities are referred to as negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

Sensitivity of level 3 valuations

Asset-backed securities

Reasonably possible alternative valuations have been calculated for asset-backed securities by using alternative pricing sources and calculating an absolute difference. The pricing difference is defined as the absolute difference between the actual price used and the closest, alternative price available.

Derivative financial instruments

In respect of credit default swaps written on level 3 negative basis asset-backed securities, reasonably possible alternative valuations have been calculated by flexing the spread between the underlying asset and the credit default swap, or adjusting market yields, by a reasonable amount. The sensitivity is determined by applying a 60 bps increase/decrease in the spread between the asset and the credit default swap.

Venture capital and equity investments

The valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment. Further details of these are given below. Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds. As these factors differ for each investment depending on the nature of the valuation technique used and the inputs there is no single common factor that could be adjusted to provide a reasonable alternative valuation for these investment portfolios.

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

Valuation adjustments are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These valuation adjustments reflect the different credit and funding exposures that such counterparties represent.

44 Financial instruments (continued)

A Credit Valuation Adjustment (CVA) is applied to the Group's over-the-counter uncollateralised derivative exposures to adjust the derivative valuations provided by standard interbank lending rate curves. The Group uses a bilateral simulation model to develop expected future exposures. This calculates a CVA for scenarios where the Group has a positive future exposure (asset) and a Debit Valuation Adjustment (DVA) where the Group has a negative future exposure (liability).

At 31 December 2010, the total reserve booked was £388 million (31 December 2009: £585 million).

45 Financial risk management

Financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The Group has adopted the heritage Lloyds TSB approach to risk management.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and currency risk; and liquidity risk. Qualitative and quantitative information about the Group's management of these risks is given below.

QUALITATIVE INFORMATION

(1) Credit risk

Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Risk appetite

Credit risk appetite is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio performance measures, which in turn use the various credit risk rating systems as inputs. These metrics are supported by a comprehensive suite of policies, sector caps, product and country limits to manage concentration risk and exposures within the Group's approved risk appetite.

Exposures

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit can be cancelled and the creditworthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are regularly monitored.

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 14 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2010. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 14.

Measurement

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components:

(i) the 'probability of default' by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

The Group's rating systems assess probability of default and if Advanced, exposure at default and loss given default, in order to derive an expected loss. (If not Advanced, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss). In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment (see note 20 to the consolidated financial statements). Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios and a number of wholesale lending portfolios, exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale.

45 Financial risk management (continued)

Mitigation

The Group uses a range of approaches to mitigate credit risk.

Internal control

The Group follows a through the economic cycle, relationship based, business model with risk management processes, appetites and experienced staff in place. These policies and procedures define chosen target market and risk acceptance criteria. These have been, and will continue to be fine-tuned as appropriate and include the use of early warning indicators to help anticipate future areas of concern and allow us to take early and proactive mitigating actions.

- Credit principles and policy: risk specialists set out the Group credit principles and policy according to which credit risk is managed, which in turn is the basis for business unit credit policy. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Business unit policies include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions.
- Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.
- Credit scoring: In the principal retail portfolios statistically-based decisioning techniques (primarily credit scoring models are used). Risk departments review model effectiveness, while new models and model changes are referred by them to model governance committees for approval. The most material changes are referred to the Lloyds Banking Group Model Governance Committee.
- Individual credit assessment and sanction: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting are the same as that for assets intended to be held over the period to maturity.
- Controls over rating systems: An independent team sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently, and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating systems are developed by risk functions with the business unit managing directors having ownership of the systems. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions.
- Cross-border and cross-currency exposures: Country limits are authorised by the country limits panel, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support the approved business and strategic plans of the Group.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to risk appetites and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 16 to the financial statements provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. Large exposures are reported in accordance with regulatory reporting requirements.
- Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group-wide level and business unit level and by rating model and portfolio, for example, within a specific industry sector.
- Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from market transactions on any single day.
- Risk assurance and oversight: Oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Lloyds Banking Group credit risk assurance, a group level function comprising experienced credit professionals, is also in place. In conjunction with group risk senior management, this team carries out independent risk-based credit reviews, providing individual business unit assessment of the effectiveness of risk management practices and adherence to risk controls across the diverse range of the Group's wholesale and retail businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical ('standard') credit reviews, non-standard reviews, project reviews, credit risk rating model reviews and bespoke assignments, including impairment reviews as required. The work of group credit risk assurance continues to provide executive and senior management with assurance and guidance on credit quality, effectiveness of credit risk controls and accuracy of impairments.

Collateral

The principal collateral types for loans and advances are:

- Mortgages over residential and commercial real estate;
- Charges over business assets such as premises, inventory and accounts receivables;
- Charges over financial instruments such as debt securities and equities; and
- Guarantees received from third parties.

Guidelines on the acceptability of specific classes of collateral are maintained.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Collateral or other security is also not usually obtained for credit risk exposures on derivative instruments, except where the Group requires margin deposits from counterparties.

45 Financial risk management (continued)

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. In order to minimise the credit loss, Additional collateral from the counterparty may be sought as soon as impairment indicators are identified for the relevant individual loans and advances.

The Group considers risk concentrations by collateral providers and collateral type, as appropriate, with a view to ensuring that any potential undue concentrations of risk are identified and suitably managed by changes to strategy, policy and/or business plans.

Master netting agreements

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), master netting agreements are put in place. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since it is affected by each transaction subject to the agreement.

Other credit risk transfers

Asset sales, securitisations and credit derivative based transactions are also undertaken as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

Monitoring

In conjunction with Lloyds Banking Group risk, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Lloyds Banking Group Risk in turn produces an aggregated review of credit risk throughout the Lloyds Banking Group, including reports on significant credit exposures, which are presented to Lloyds Banking Group Credit Risk Committee, the Lloyds Banking Group Business Risk Committee and Lloyds Banking Group Risk Committee.

The performance of all rating models is monitored on a regular basis, in order to seek to ensure that models provide appropriate risk differentiation capability, the generated ratings remain as accurate and robust as practical, and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that monthly monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated.

(2) Market Risk

Definition

The risk of reductions in earnings, value and/or reserves, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, inflation rates, exchange rates, credit spreads and prices for bonds, commodities, equities, property and other instruments. It arises in all areas of the Group's activities and is managed by a variety of different techniques.

Risk appetite

Market risk appetite is defined with regard to the quantum and composition of market risk that exists currently in the Group and the direction in which the Group wishes to manage this.

Exposures

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products. However, some interest rate, exchange rate and credit spread positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises predominantly from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Foreign currency risk also arises from the Group's investment in its overseas operations.

Measurement

The following market risk measures are used for risk reporting and setting risk appetite limits and triggers:

- Value at Risk (VaR): for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used
- Standard Stresses: Interest Rates 25bp; Equities 10 per cent; Credit Spreads relative 30 per cent widening
- Bespoke Extreme Stress Scenarios: e.g. stock market crash

Both VaR and standard stress measures are also used in setting market risk appetite limits and triggers.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in

45 Financial risk management (continued)

certain portfolios and at group level, to simulate extreme conditions to supplement these core measures. Trading book VaR (1-day 99 per cent) is back-tested daily against profit and loss.

Banking – trading assets and other treasury positions

It is the policy of Lloyds Banking Group to monitor and report its trading and other treasury positions on a consolidated basis to facilitate management and control and capture diversification benefits. It is therefore not appropriate to report this data separately for the Bank of Scotland plc.

Banking – non-trading

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates including the margin between interbank and central bank rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly using, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

Base case market value is calculated on the basis of the Lloyds Banking Group current balance sheet with re-pricing dates adjusted according to behavioural assumptions. The above sensitivities show how this projected market value would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

Mitigation

Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

Banking – non-trading activities

Interest rate risk arising from the different repricing characteristics of non-trading assets and liabilities, and from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled.

Monitoring

The Lloyds Banking Group Senior Asset and Liability Committee and the Group Market Risk Forum regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Lloyds Banking Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by Lloyds Banking Group Risk. Where appropriate, escalation procedures are in place.

Banking activities

Trading is restricted to a number of specialist centres, the most important centre being the Lloyds Banking Group treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in retail portfolios and in capital and funding activities is managed centrally within limits defined in the Lloyds Banking Group detailed policy for interest rate risk in the banking book, which is reviewed and approved annually.

The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

(3) Liquidity and funding risk

Definition

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost.

Funding risk is further defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

Risk appetite

Liquidity and funding risk appetite for the banking businesses is defined and reported through various metrics that enable the Group to manage liquidity and funding constraints.

Exposure

Liquidity exposure represents the amount of potential outflows in any future period less committed inflows. Liquidity is considered from both an internal and regulatory perspective.

45 Financial risk management (continued)

Measurement

A series of measures are used to monitor both short and long term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Mitigation

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term funding. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise inter-bank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on a qualitative analysis of the market's capacity for the Group's credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to corporate customers, to supplement its retail deposit base.

Monitoring

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular the Group Asset and Liability Committee and the Senior Asset and Liability Committee which meet monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent oversight.

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components:

- Firstly, Lloyds Banking Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both Lloyds Banking Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.
- Secondly, Lloyds Banking Group has a contingency funding plan embedded within Lloyds Banking Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

During the year, the individual entities within the Group, and the Group, complied with all of the externally imposed liquidity and funding requirements to which they are subject.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

QUANTITATIVE INFORMATION

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; and liquidity risk. Information about the Group's exposure to each of the above risks, the Group's objectives, policies and processes for measuring and managing risk and the Group's management of capital can be found below. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

(1) Credit risk

The Group's credit risk exposure arises predominantly in the United Kingdom, the European Union, Australia and the United States.

The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Loans and receivables:				
Loans and advances to banks	61,349	91,259	61,024	108,133
Loans and advances to customers	430,841	460,810	438,350	458,708
Debt securities	24,923	33,126	18,702	25,211
Deposit amounts available for offset ¹	(3,920)	(9,257)	(3,920)	(9,257)
Impairment losses	(26,607)	(23,187)	(23,991)	(20,268)
	486,586	552,751	490,165	562,527
Available-for-sale financial assets (excluding equity shares)	12,255	19,631	12,424	18,239
Trading and other financial assets at fair value through profit or loss (excluding equity shares)	24,369	27,615	24,369	27,615
Derivative assets, before netting	29,451	30,222	27,362	26,680
Amounts available for offset under master netting arrangements ¹	(18,799)	(19,910)	(18,799)	(19,910)
	10,652	10,312	8,563	6,770
Financial guarantees	9,227	8,025	9,047	26,974
Irrevocable loan commitments and other credit-related contingencies ²	23,155	31,479	21,159	65,641
Maximum credit risk exposure	566,244	649,813	565,727	707,766
Maximum credit risk exposure before offset items	588,963	678,980	588,446	736,933

¹Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

²See note 43 – Contingent liabilities and commitments for further information.

Loans and advances to banks – the Group may require collateral before entering into a credit commitment with another bank, depending on the type of the financial product and the counterparty involved, and netting agreements are obtained whenever possible and to the extent that such agreements are legally enforceable.

Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 13 and a similar analysis for available-for-sale financial assets is included in note 21.

Derivative assets – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 14. Of the net derivative assets of £10,652 million for the Group and £8,563 million for the Bank (2009: £10,312 million for the Group and £6,770 million for the Bank), cash collateral of £1,322 million was held for the Group and £1,322 million for the Bank (2009: £568 million for the Group and £76 million for the Bank) and a further £2,441 million for the Group and £636 million for the Bank was due from OECD banks (2009: £3,879 million for the Group and £1,160 million for the Bank).

Financial guarantees – these represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

Reverse repurchase and repurchase transactions – for reverse repurchase transactions which are accounted for as collateralised loans, it is the Group's policy to seek collateral which is at least equal to the amount loaned. At 31 December 2010, the fair value of collateral accepted under reverse repurchase transactions that the Group is permitted by contract or custom to sell or repledge was £40,735 million (2009: £53,072 million). Of this, £22,590 million (2009: £50,138 million) was sold or repledged as at 31 December 2010. The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £85,077 million (2009: £138,728 million).

Stock lending – in addition to the financial assets on the Group's balance sheet which are subject to repurchase agreements, there are financial assets on the Group's balance sheet pledged as collateral as part of securities lending transactions which amounted to £75,363 million at 31 December 2010 (2009: £87,191 million).

Stock borrowing – Securities held as collateral for stock borrowed or under reverse repurchase agreements amounted to £106,501 million at 31 December 2010 (2009: £137,635 million); of which £94,739 million at 31 December 2010 (2009: £128,236 million) had been resold or repledged.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

Loans and advances – The Group

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
31 December 2010						
Neither past due nor impaired	6,296	230,124	14,889	85,275	330,288	12,220
Past due but not impaired	–	10,729	429	2,992	14,150	–
Impaired – no provision required	–	1,532	61	4,394	5,987	–
– provision held	–	4,358	1,291	40,402	46,051	–
Gross	6,296	246,743	16,670	133,063	396,476	12,220
Allowance for impairment losses (note 20)	–	(1,783)	(683)	(22,850)	(25,316)	–
Net	6,296	244,960	15,987	110,213	371,160	12,220
Due from fellow Lloyds Banking Group undertakings	55,053				34,365	3,998
	61,349				405,525	16,218
31 December 2009						
Neither past due nor impaired ¹	91,259	236,050	17,672	144,763	398,485	18,884
Past due but not impaired	–	9,793	805	4,708	15,306	–
Impaired – no provision required	–	1,515	26	5,015	6,556	–
– provision held	–	4,405	1,438	34,620	40,463	–
Gross	91,259	251,763	19,941	189,106	460,810	18,884
Allowance for impairment losses (note 20)	–	(1,412)	(749)	(19,111)	(21,272)	–
Net	91,259	250,351	19,192	169,995	439,538	18,884

¹At 31 December 2009 loans and advances which were neither past due nor impaired included amounts due from fellow Group undertakings as follows: loans and advances to banks £85,456 million, loans and advances to customers in Wholesale £35,721 million and loans and advances designated at fair value through profit or loss £876 million.

The analysis of lending between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2h. All impaired loans which exceed certain thresholds are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £44,969 million (2009: £39,788 million) which have associated collateral with a fair value of £13,022 million (2009: £9,558 million).

Loans and advances which are neither past due nor impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
31 December 2010						
Good quality	6,296	224,271	10,490	16,481		12,219
Satisfactory quality	–	4,217	2,934	19,046		1
Lower quality	–	834	513	37,748		–
Below standard, but not impaired	–	802	952	12,000		–
Total loans and advances which are neither past due nor impaired	6,296	230,124	14,889	85,275	330,288	12,220
31 December 2009						
Good quality	91,259	227,558	11,237	56,148		18,884
Satisfactory quality	–	6,296	4,212	32,262		–
Lower quality	–	746	632	38,712		–
Below standard, but not impaired	–	1,450	1,591	17,641		–
Total loans and advances which are neither past due nor impaired	91,259	236,050	17,672	144,763	398,485	18,884

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

Loans and advances which are past due but not impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers			Loans and advances designated at fair value through profit or loss £m	
		Retail – mortgages £m	Retail – other £m	Wholesale £m		Total £m
31 December 2010						
0-30 days	–	5,256	293	1,098	6,647	–
30-60 days	–	2,183	108	478	2,769	–
60-90 days	–	1,483	25	350	1,858	–
90-180 days	–	1,807	3	313	2,123	–
Over 180 days	–	–	–	753	753	–
Total loans and advances which are past due but not impaired	–	10,729	429	2,992	14,150	–
Fair value of collateral held		9,286	n/a	n/a	n/a	
31 December 2009						
0-30 days	–	4,693	503	2,123	7,319	–
30-60 days	–	2,087	150	787	3,024	–
60-90 days	–	1,337	47	740	2,124	–
90-180 days	–	1,676	47	538	2,261	–
Over 180 days	–	–	58	520	578	–
Total loans and advances which are past due but not impaired	–	9,793	805	4,708	15,306	–
Fair value of collateral held		8,578	n/a	n/a	n/a	

A financial asset is 'past due' if a counterparty has failed to make a payment when contractually due.

Collateral held against retail mortgage lending is principally comprised of residential properties; their fair value has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations. The resulting valuation has been limited to the principal amount of the outstanding advance in order to provide a clearer representation of the Group's credit exposure.

Lending decisions are based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values for non-mortgage lending are assessed more rigorously at the time of loan origination or when taking enforcement action and may fluctuate, as in the case of floating charges, according to the level of assets held by the customer. Whilst collateral is reviewed on a regular basis in accordance with business unit credit policy, this varies according to the type of lending and collateral involved. It is therefore not practicable to estimate and aggregate current fair values of collateral for non-mortgage lending.

Loans and advances – The Bank

	Loans and advances to banks £m	Loans and advances to customers			Loans and advances designated at fair value through profit or loss £m	
		Retail – mortgages £m	Retail – other £m	Wholesale £m		Total £m
31 December 2010						
Neither past due nor impaired	5,971	220,107	12,062	74,142	306,311	12,220
Past due but not impaired	–	9,682	256	2,757	12,695	–
Impaired – no provision required	–	1,386	61	4,146	5,593	–
– provision held	–	3,671	1,163	36,510	41,344	–
Gross	5,971	234,846	13,542	117,555	365,943	12,220
Allowance for impairment losses	–	(1,537)	(636)	(20,549)	(22,722)	–
Net	5,971	233,309	12,906	97,006	343,221	12,220
Due from fellow Lloyds Banking Group undertakings	55,053				72,407	3,998
	61,024				415,628	16,218
31 December 2009						
Neither past due nor impaired ¹	108,133	216,001	13,044	181,929	410,974	18,884
Past due but not impaired	–	8,322	489	3,131	11,942	–
Impaired – no provision required	–	787	2	2,340	3,129	–
– provision held	–	3,672	1,259	25,217	30,148	–
Gross	108,133	228,782	14,794	212,617	456,193	18,884
Allowance for impairment losses	–	(1,145)	(590)	(14,491)	(16,226)	–
Net	108,133	227,637	14,204	198,126	439,967	18,884

¹At 31 December 2009 loans and advances which were neither past due nor impaired included amounts due from fellow Group undertakings as follows: loans and advances to banks £102,649 million, loans and advances to customers in Wholesale £92,559 and loans and advances designated at fair value through profit or loss £876 million.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

Loans and advances which are neither past due nor impaired – The Bank

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
31 December 2010						
Good quality	5,971	214,547	7,914	15,543		12,219
Satisfactory quality	–	3,983	2,728	12,830		1
Lower quality	–	801	494	34,633		–
Below standard, but not impaired	–	776	926	11,136		–
Total loans and advances which are neither past due nor impaired	5,971	220,107	12,062	74,142	306,311	12,220
31 December 2009						
Good quality	108,133	211,471	8,557	111,494		18,884
Satisfactory quality	–	3,302	2,545	22,879		–
Lower quality	–	444	569	34,516		–
Below standard, but not impaired	–	784	1,373	13,040		–
Total loans and advances which are neither past due nor impaired	108,133	216,001	13,044	181,929	410,974	18,884

Loans and advances which are past due but not impaired – The Bank

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
31 December 2010						
0-30 days	–	4,829	175	960	5,964	–
30-60 days	–	1,966	69	434	2,469	–
60-90 days	–	1,314	12	323	1,649	–
90-180 days	–	1,573	–	313	1,886	–
Over 180 days	–	–	–	727	727	–
Total loans and advances which are past due but not impaired	–	9,682	256	2,757	12,695	–
Fair value of collateral held	–	8,437	n/a	n/a	n/a	–
31 December 2009						
0-30 days	–	4,139	286	1,592	6,017	–
30-60 days	–	1,652	87	372	2,111	–
60-90 days	–	1,065	17	405	1,487	–
90-180 days	–	1,466	42	311	1,819	–
Over 180 days	–	–	57	451	508	–
Total loans and advances which are past due but not impaired	–	8,322	489	3,131	11,942	–
Fair value of collateral held	–	7,234	n/a	n/a	n/a	–

Renegotiated loans and advances

Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2010 totalled £4,820 million (2009: £3,702 million) for the Group and £4,207 million (2009: £2,072 million) for the Bank.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Repossessed collateral				
Residential property	820	1,143	694	981
Other	8	17	1	–
Total repossessed collateral	828	1,160	695	981

In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Loan-to-value ratio of mortgage lending				
Analysis by loan-to-value ratio of residential mortgage lending which is neither past due nor impaired:				
Less than 70 per cent	85,718	88,795	83,631	82,981
70 per cent to 80 per cent	39,600	37,214	38,264	34,422
80 per cent to 90 per cent	38,799	37,177	36,764	34,443
Greater than 90 per cent	66,007	72,864	61,448	64,155
Total mortgage lending which is neither past due nor impaired	230,124	236,050	220,107	216,001

Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating:

The Group	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2010							
Debt securities, treasury and other bills held at fair value through profit or loss							
<i>Trading assets</i>							
Government securities	518	885	–	–	–	–	1,403
Bank and building society certificates of deposit	–	3,086	506	100	–	–	3,692
Other asset-backed securities	191	633	149	–	–	–	973
Corporate and other debt securities	1,125	200	411	19	–	–	1,755
Total debt securities held as trading assets	1,834	4,804	1,066	119	–	–	7,823
Treasury and other bills	219	8	–	–	–	–	227
Total held as trading assets	2,053	4,812	1,066	119	–	–	8,050
<i>Other assets held at fair value through profit or loss</i>							
Corporate and other debt securities	–	–	–	–	–	101	101
Total held at fair value through profit or loss	2,053	4,812	1,066	119	–	101	8,151
Derivative financial instruments							
Trading	49	5,462	11,107	457	–	4,854	21,929
Hedging	35	1,985	3,936	46	–	24	6,026
	84	7,447	15,043	503	–	4,878	27,955
Due from fellow Group undertakings							1,496
Total derivative financial instruments							29,451

Debt securities classified as loans and receivables

Asset-backed securities:							
Mortgage-backed securities	6,746	2,832	1,143	869	58	85	11,733
Other asset-backed securities	7,467	2,265	1,237	330	596	94	11,989
	14,213	5,097	2,380	1,199	654	179	23,722
Corporate and other debt securities	–	–	–	–	–	658	658
	14,213	5,097	2,380	1,199	654	837	24,380
Due from fellow Group undertakings: mortgage-backed securities							543
Total debt securities classified as loans and receivables							24,923

Available-for-sale financial assets

Debt securities:							
Government securities	1	78	–	–	–	–	79
Bank and building society certificates of deposit	–	–	129	–	–	–	129
Asset-backed securities:							
Mortgage-backed securities	15	–	–	–	–	–	15
Other asset-backed securities	61	–	105	–	–	15	181
	76	–	105	–	–	15	196
Corporate and other debt securities	1,135	3,990	4,744	735	42	9	10,655
	1,212	4,068	4,978	735	42	24	11,059
Treasury and other bills	483	–	–	–	–	–	483
	1,695	4,068	4,978	735	42	24	11,542
Due from fellow Group undertakings: corporate and other debt securities							713
Total held as available-for-sale financial assets							12,255

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

Debt securities and derivative financial instruments – analysis by credit rating:

The Group	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2009							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Government securities	2,059	805	–	–	–	–	2,864
Corporate and other debt securities	1,331	1,613	2,608	283	28	–	5,863
Total held as trading assets	3,390	2,418	2,608	283	28	–	8,727
<i>Other assets held at fair value through profit or loss</i>							
Corporate and other debt securities	–	–	–	–	–	4	4
Total held at fair value through profit or loss	3,390	2,418	2,608	283	28	4	8,731
Derivative financial instruments							
Trading	649	3,689	10,188	516	118	5,403	20,563
Hedging	628	2,526	5,672	91	–	15	8,932
	1,277	6,215	15,860	607	118	5,418	29,495
Due from fellow Group undertakings							727
Total derivative financial instruments							30,222
Debt securities classified as loans and receivables							
Asset-backed securities:							
Mortgage-backed securities	9,192	2,917	1,524	890	1,032	–	15,555
Other asset-backed securities	11,768	2,308	1,383	412	835	–	16,706
	20,960	5,225	2,907	1,302	1,867	–	32,261
Corporate and other debt securities	–	–	–	–	–	865	865
Total debt securities classified as loans and receivables	20,960	5,225	2,907	1,302	1,867	865	33,126
Available-for-sale financial assets							
Debt securities:							
Government securities	12	314	–	–	–	–	326
Bank and building society certificates of deposit	22	142	99	22	–	–	285
Asset-backed securities:							
Mortgage-backed securities	17	–	–	–	–	–	17
Other asset-backed securities	69	10	–	–	–	–	79
	86	10	–	–	–	–	96
Corporate and other debt securities	2,011	6,653	8,667	1,350	228	15	18,924
Total debt securities held as available-for-sale financial assets	2,131	7,119	8,766	1,372	228	15	19,631

There are no material amounts for debt securities, treasury and other bills which are past due but not impaired.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating:

The Bank	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2010							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Government securities	518	885	–	–	–	–	1,403
Bank and building society certificates of deposit	–	3,086	506	100	–	–	3,692
Other asset-backed securities	191	633	149	–	–	–	973
Corporate and other debt securities	1,125	200	411	19	–	–	1,755
Total debt securities held as trading assets	1,834	4,804	1,066	119	–	–	7,823
Treasury and other bills	219	8	–	–	–	–	227
Total held as trading assets	2,053	4,812	1,066	119	–	–	8,050
<i>Other assets held at fair value through profit or loss</i>							
Corporate and other debt securities	–	–	–	–	–	101	101
Total held at fair value through profit or loss	2,053	4,812	1,066	119	–	101	8,151
Derivative financial instruments							
Trading	43	5,322	9,480	457	–	4,517	19,819
Hedging	35	1,985	3,936	46	–	24	6,026
	78	7,307	13,416	503	–	4,541	25,845
Due from fellow Group undertakings							1,517
Total derivative financial instruments							27,362
Available-for-sale financial assets							
<i>Debt securities:</i>							
Government securities	–	78	–	–	–	–	78
Bank and building society certificates of deposit	–	–	129	–	–	–	129
Asset-backed securities	41	–	105	–	–	799	945
Corporate and other debt securities	1,135	3,990	4,744	735	42	38	10,684
Total debt securities held as available-for-sale assets	1,176	4,068	4,978	735	42	837	11,836
Treasury and other bills	483	–	–	–	–	–	483
	1,659	4,068	4,978	735	42	837	12,319
Due from fellow Group undertakings: corporate and other debt securities							105
Total held as available-for-sale securities							12,424

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

The Bank	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2009							
Debt securities held at fair value through profit or loss							
<i>Trading assets</i>							
Government securities	2,059	805	–	–	–	–	2,864
Corporate and other debt securities	1,331	1,613	2,608	283	28	–	5,863
Total held as trading assets	<u>3,390</u>	<u>2,418</u>	<u>2,608</u>	<u>283</u>	<u>28</u>	<u>–</u>	<u>8,727</u>
<i>Other assets held at fair value through profit or loss</i>							
Corporate and other debt securities	–	–	–	–	–	4	4
Total held at fair value through profit or loss	<u>3,390</u>	<u>2,418</u>	<u>2,608</u>	<u>283</u>	<u>28</u>	<u>4</u>	<u>8,731</u>
Derivative financial instruments							
Trading	649	3,366	7,400	516	118	5,088	17,137
Hedging	628	2,526	5,672	91	–	15	8,932
	<u>1,277</u>	<u>5,892</u>	<u>13,072</u>	<u>607</u>	<u>118</u>	<u>5,103</u>	<u>26,069</u>
Due from fellow Group undertakings							611
Total derivative financial instruments							<u>26,680</u>
Available-for-sale financial assets							
Debt securities:							
Government securities	12	313	–	–	–	–	325
Bank and building society certificates of deposit	22	142	99	22	–	–	285
Asset-backed securities	50	10	–	–	–	–	60
Corporate and other debt securities	2,011	6,382	7,633	1,313	228	2	17,569
Total debt securities held as available-for-sale assets	<u>2,095</u>	<u>6,847</u>	<u>7,732</u>	<u>1,335</u>	<u>228</u>	<u>2</u>	<u>18,239</u>

(2) Market Risk

Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There are a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However a significant proportion of the Group's lending assets, for example personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio.

At 31 December 2010 the aggregate notional principal of interest rate swaps designated as fair value hedges was £42,991 million (2009: £53,979 million) with a net fair value asset of £2,813 million (2009: £2,496 million) (see note 44). The gains on the hedging instruments were £651 million (2009: losses of £1,125 million). The losses on the hedged items attributable to the hedged risk were £740 million (2009: gains of £1,103 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next five years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2010 was £98,683 million (2009: £229,390 million) with a net fair value liability of £1,301 million (2009: £2,029 million) (see note 44). In 2010, ineffectiveness recognised in the income statement that arises from cash flow hedges was £94 million (2009: £5 million). There were no transactions for which cash flow hedge accounting had to be ceased in 2010 or 2009 as a result of the highly probable cash flows no longer being expected to occur.

Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market risk function.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using cross currency borrowings.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

The Group's main overseas operations are in the Americas, Australia and Europe. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Functional currency of Group operations				
Euro:				
Gross exposure	1,479	1,906	–	–
Net investment hedge	(3,356)	(1,906)	–	–
	(1,877)	–	–	–
US dollar:				
Gross exposure	138	(62)	200	(14)
Net investment hedge	(145)	62	(145)	14
	(7)	–	55	–
Australian Dollar:				
Gross exposure	1,571	1,869	–	–
Net investment hedge	(1,634)	(1,832)	–	–
	(63)	37	–	–
Other non-sterling	–	(2)	–	–
Total structural foreign currency exposures, after net investment hedges	(1,947)	35	55	–

(3) Liquidity risk

The table below analyses financial instrument liabilities of the Group, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2010						
Deposits from banks	68,614	37,934	13,898	23,256	2,151	145,853
Customer deposits	147,597	11,511	26,238	42,052	10,660	238,058
Trading liabilities	14,865	2,086	2,352	102	–	19,405
Debt securities in issue	18,168	1,167	19,159	50,567	18,581	107,642
Subordinated liabilities	2,084	9,117	154	2,555	1,864	15,774
Total non-derivative financial liabilities	251,328	61,815	61,801	118,532	33,256	526,732
Derivative financial liabilities:						
Gross settled derivatives – outflow	11,238	12,300	8,591	49,162	29,794	111,085
Gross settled derivatives – inflow	(11,131)	(12,522)	(8,679)	(49,381)	(29,714)	(111,427)
Gross settled derivatives – netflow	107	(222)	(88)	(219)	80	(342)
Gross settled derivatives liabilities	2,029	1,608	5,884	11,970	3,464	24,955
Total derivative financial liabilities	2,136	1,386	5,796	11,751	3,544	24,613
As at 31 December 2009						
Deposits from banks	82,967	71,519	16,167	2,281	2,493	175,427
Customer deposits	159,232	29,194	23,271	20,267	35,997	267,961
Trading liabilities	15,471	5,120	6,684	134	–	27,409
Debt securities in issue	14,169	11,938	18,722	69,671	20,270	134,770
Subordinated liabilities	28	60	658	3,396	15,306	19,448
Total non-derivative financial liabilities	271,867	117,831	65,502	95,749	74,066	625,015
Derivative financial liabilities:						
Gross settled derivatives – outflow	14,582	6,021	8,282	37,602	37,720	104,207
Gross settled derivatives – inflow	(14,399)	(6,134)	(8,364)	(37,097)	(36,202)	(102,196)
Gross settled derivatives – netflow	183	(113)	(82)	505	1,518	2,011
Net settled derivative liabilities	16,135	1,017	3,349	3,254	93	23,848
Total derivative financial liabilities	16,318	904	3,267	3,759	1,611	25,859

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £30 million (2009: £11 million) for the Group and the Bank per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

The Bank	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
As at 31 December 2010						
Deposits from banks	72,050	37,885	14,869	22,130	3,841	150,775
Customer deposits	169,316	13,039	26,889	48,608	18,184	276,036
Trading liabilities	14,865	2,086	2,352	102	–	19,405
Debt securities in issue	12,765	4,045	12,880	30,599	32,220	92,509
Subordinated liabilities	12,084	18	154	1,908	1,465	15,629
Total non-derivative financial liabilities	281,080	57,073	57,144	103,347	55,710	554,354
Derivative financial liabilities:						
Gross settled derivatives – outflow	10,420	8,569	8,591	49,162	29,794	106,536
Gross settled derivatives – inflow	(10,316)	(8,844)	(8,679)	(49,381)	(29,714)	(106,934)
Gross settled derivatives – netflow	104	(275)	(88)	(219)	80	(398)
Net settled derivative liabilities	2,001	1,608	5,884	11,970	3,464	24,927
Total derivative financial liabilities	2,105	1,333	5,796	11,751	3,544	24,529
As at 31 December 2009						
Deposits from banks	81,295	72,141	11,601	2,081	5,254	172,372
Customer deposits	140,095	24,417	20,438	53,462	74,138	312,550
Trading liabilities	15,471	5,120	6,684	134	–	27,409
Debt securities in issue	5,659	10,611	20,750	42,282	23,830	103,132
Subordinated liabilities	28	60	915	2,699	15,194	18,896
Total non-derivative financial liabilities	242,548	112,349	60,388	100,658	118,416	634,359
Derivative financial liabilities:						
Gross settled derivatives – outflow	14,567	7,440	8,354	37,592	37,393	105,346
Gross settled derivatives – inflow	(14,399)	(7,472)	(8,434)	(37,095)	(36,172)	(103,572)
Gross settled derivatives – netflow	168	(32)	(80)	497	1,221	1,774
Net settled derivative liabilities	16,083	1,003	3,291	3,029	308	23,714
Total derivative financial liabilities	16,251	971	3,211	3,526	1,529	25,488

Bank of Scotland plc
Notes to the accounts

45 Financial risk management (continued)

The following tables set out the amounts and residual maturities of the Group's off balance sheet contingent liabilities and commitments.

The Group	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2010					
Acceptances and endorsements	1	–	–	–	1
Other contingent liabilities	440	46	99	93	678
Total contingent liabilities	441	46	99	93	679
Lending commitments	38,559	3,904	7,121	2,038	51,622
Other commitments	2	–	–	–	2
Total commitments	38,561	3,904	7,121	2,038	51,624
Total contingents and commitments	39,002	3,950	7,220	2,131	52,303
	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2009					
Acceptances and endorsements	5	–	–	–	5
Other contingent liabilities	489	54	753	54	1,350
Total contingent liabilities	494	54	753	54	1,355
Lending commitments	36,318	3,283	10,787	3,595	53,983
Other commitments	55	–	14	–	69
Total commitments	36,373	3,283	10,801	3,595	54,052
Total contingents and commitments	36,867	3,337	11,554	3,649	55,407
	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2010					
Acceptances and endorsements	1	–	–	–	1
Other contingent liabilities	440	42	99	33	614
Total contingent liabilities	441	42	99	33	615
Lending commitments	44,677	2,702	6,883	1,534	55,796
Other commitments	2	–	–	–	2
Total commitments	44,679	2,702	6,883	1,534	55,798
Total contingents and commitments	45,120	2,744	6,982	1,567	56,413
	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2009					
Acceptances and endorsements	3	–	–	–	3
Other contingent liabilities	392	11	748	1,280	2,431
Total contingent liabilities	395	11	748	1,280	2,434
Lending commitments	57,040	2,647	10,609	3,254	73,550
Other commitments	20	–	14	–	34
Total commitments	57,060	2,647	10,623	3,254	73,584
Total contingents and commitments	57,455	2,658	11,371	4,534	76,018

Bank of Scotland plc
Notes to the accounts

46 Capital

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the Lloyds Banking Group Asset and Liability Committee. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

The Group's regulatory capital is divided into tiers defined by the European Community Banking Consolidation Directive as implemented in the UK by the Financial Services Authority's (FSA) General Prudential Sourcebook. Tier 1 capital comprises mainly shareholders' equity, tier 1 capital instruments and minority interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected losses over accounting provisions and certain securitisation positions. During the year the FSA has defined Core Tier 1 capital. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and available-for-sale assets. Tier 2 capital mainly comprises qualifying subordinated debt after deducting 50 per cent of the excess of expected losses over accounting provisions, and certain securitisation positions. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. Total capital is reduced by deducting investments in subsidiaries, joint ventures and associates that are not consolidated for regulatory purposes.

The Group's capital resources are summarised as follows:

	2010 £m	2009 ¹ £m
Tier 1 capital	21,470	23,988
Tier 2 capital	15,002	14,112
	36,472	38,100
Supervisory deductions	(1,672)	(1,062)
Total capital	34,800	37,038

¹Restated to reflect a prior year adjustment to the available-for-sale revaluation reserve (note 1).

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities.

The FSA sets Individual Capital Guidance (ICG) for each UK bank calibrated by reference to its Capital Resources Requirement, broadly equivalent to 8 per cent of risk-weighted assets and thus representing the capital required under Pillar 1 of the Basel II framework. Also a key input into the FSA's ICG setting process, (which addresses the requirements of Pillar 2 of the Basel II framework), is each bank's Internal Capital Adequacy Assessment Process. The FSA's approach is to monitor the available capital resources in relation to the ICG requirement. Lloyds Banking Group has been given ICG by the FSA and the board has also agreed a formal buffer to be maintained in addition to this requirement. Any breaches of the formal buffer must be notified to the FSA, together with proposed remedial action. The FSA has made it clear that each ICG remains a confidential matter between each bank and the FSA.

During the year, the individual entities within the Group and the Group complied with all of the externally imposed capital requirements to which they are subject.

47 Cash flow statements

a Change in operating assets

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Change in loans and receivables	66,274	(55,770)	81,695	19,644
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	2,996	15,858	1,762	11,872
Change in other operating assets	2,640	15,627	4,332	2,767
Change in operating assets	71,910	(24,285)	87,789	34,283

b Change in operating liabilities

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Change in deposits from banks	(29,717)	77,272	(26,407)	71,155
Change in customer deposits	(21,059)	(11,428)	(28,224)	(73,049)
Change in debt securities in issue	(18,397)	(69,291)	(25,264)	(74,389)
Change in derivative financial instruments and trading liabilities	(8,758)	(4,854)	(8,771)	(3,921)
Change in other operating liabilities	(1,258)	9,212	(1,304)	10,583
Change in operating liabilities	(79,189)	911	(89,970)	(69,621)

Bank of Scotland plc
Notes to the accounts

47 Cash flow statements (continued)

c Non-cash and other items

	The Group		The Bank	
	2010 £m	2009 ¹ £m	2010 £m	2009 £m
Depreciation and amortisation	849	1,093	302	219
Impairment of tangible fixed assets	52	–	–	–
Revaluation of investment properties	(22)	13	–	–
Allowance for loan losses	7,732	19,430	5,169	16,597
Write-off of allowance for loan losses	(8,788)	(7,458)	(8,788)	(6,795)
Impairment of available-for-sale securities	100	1,557	(10)	99
Impairment of goodwill	–	385	–	–
Impairment losses on investments in subsidiaries	–	–	5,108	4,449
Customer goodwill payments provision	500	–	500	–
Other provision movements	20	102	23	103
Other non-cash items	(2,244)	9,508	(1,680)	8,127
Total non-cash items	(1,801)	24,630	624	22,889
Interest expense on subordinated liabilities	472	742	269	681
Loss on disposal of businesses	1,307	100	1,434	–
Total other items	1,779	842	1,703	681
Non-cash and other items	(22)	25,472	2,327	23,570

¹Restated – see note 1.

d Analysis of cash and cash equivalent as shown in the balance sheet

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Cash and balances with central banks	2,375	2,905	2,318	2,168
Less: mandatory reserve deposits ¹	(303)	(336)	(303)	(323)
	2,072	2,569	2,015	1,845
Loans and advances to banks	61,349	91,259	61,024	108,133
Less: amounts with a maturity of three months or more and amounts due from fellow Lloyds Banking Group undertakings	(57,039)	(86,926)	(57,039)	(103,800)
	4,310	4,333	3,985	4,333
Total cash and cash equivalents	6,382	6,902	6,000	6,178

¹Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

e Analysis of changes in financing during the year

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Share capital (including share premium account and merger reserve):				
At 1 January	34,131	13,942	34,131	13,942
Issue of ordinary shares	795	20,189	795	20,189
At 31 December	34,926	34,131	34,926	34,131
Non-controlling interests:				
At 1 January	206	264	–	–
Repayment of capital to minority shareholders	–	(59)	–	–
Non-controlling share of profit after tax	10	13	–	–
Dividends to minority shareholders	(15)	(12)	–	–
At 31 December	201	206	–	–

Bank of Scotland plc
Notes to the accounts

47 Cash flow statements (continued)

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Subordinated liabilities:				
At 1 January	16,684	18,779	16,052	18,082
Exchange and other adjustments	(1,117)	(314)	(611)	(249)
Repayments of subordinated liabilities	(331)	(1,781)	(331)	(1,781)
At 31 December	15,236	16,684	15,110	16,052

f Disposal and closure of group undertakings, joint ventures and associates

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Derivatives, trading and other financial assets at fair value through profit or loss	164	-	-	-
Loans and advances to banks	3,469	-	-	-
Loans and advances to customers	2,774	-	-	-
Debt securities	69	-	-	-
Tangible fixed assets	1,015	-	-	-
Deposits from banks	(1,563)	-	-	-
Customer accounts	(3,397)	-	-	-
Other net assets and liabilities	18	-	-	-
	2,549	-	-	-
Profit (loss) on sale of businesses	38	(100)	-	-
Cash and cash equivalents disposed of	-	-	-	-
Net cash inflow from disposals	2,587	(100)	-	-
Capital redemptions in joint ventures and associates	-	237	-	-
At 31 December	2,587	137	-	-

Bank of Scotland plc
Notes to the accounts

48 Future accounting developments

The following pronouncements will be relevant to the Group but were not effective at 31 December 2010 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	Effective date
Amendment to IAS 32 <i>Financial Instruments: Presentation – ‘Classification of Rights Issues’</i>	Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated.	Annual periods beginning on or after 1 February 2010.
<i>Improvements to IFRSs</i> (issued May 2010)	Sets out minor amendments to IFRS standards as part of annual improvements process.	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 July 2010.
IFRIC 19 <i>Extinguishing Financial Liabilities with Equity Instruments</i>	Clarifies that when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor, a gain or loss is recognised in the income statement representing the difference between the carrying value of the financial liability and the fair value of the equity instruments issued; the fair value of the financial liability is used to measure the gain or loss where the fair value of the equity instruments cannot be reliably measured. This interpretation is consistent with the Group's existing accounting policy.	Annual periods beginning on or after 1 July 2010.
Amendments to IAS 24 <i>Related Party Disclosures</i>	Simplifies the definition of a related party and provides a partial exemption from the disclosure requirements for related party transactions with government related entities.	Annual periods beginning on or after 1 January 2011.
Amendments to IFRS 7 <i>Financial Instruments Disclosures – ‘Disclosures-Transfers of Financial Assets’</i>	Requires additional disclosures in respect of risk exposures arising from transferred financial assets.	Annual periods beginning on or after 1 July 2011.
Amendments to IAS 12 <i>Income Taxes – ‘Deferred Tax: Recovery of Underlying Assets’</i>	Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis.	Annual periods beginning on or after 1 January 2012.
IFRS 9 <i>Financial Instruments</i> : ¹	Replaces those parts of ‘IAS 39 Financial Instruments: Recognition and Measurement’ relating to the classification, measurement and derecognition of financial assets and liabilities. Requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of entity's business model for managing its financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity investment categories in the existing IAS 39 will be eliminated. The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39.	Annual periods beginning on or after 1 January 2013.

¹IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting. Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39. The effective date of the standard is annual periods beginning on or after 1 January 2013.

At the date of this report, IFRS 9, the Amendments to IFRS 7 and the Amendments to IAS 12 are awaiting EU endorsement.

Bank of Scotland plc
Notes to the accounts

49 Post balance sheet events

The Lloyds Banking Group has been in discussion with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the 'Halifax' brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Group has made a provision of £500 million in relation to this programme.

50 Approval of financial statements and other information

These financial statements were approved by the directors of Bank of Scotland plc on 24 February 2011.

Bank of Scotland plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and in certain locations overseas.

Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

