

OFFERING MEMORANDUM SUPPLEMENT
(To Offering Memorandum dated April 30, 2003)



\$750,000,000

HBOS plc
as Issuer

6.00% SUBORDINATED NOTES DUE 2033

Interest payable on May 1 and November 1 of each year

The Notes (as defined herein) will be issued by HBOS plc (the "Issuer"). In the event that payments in respect of the Notes become subject to certain taxation, the Issuer may be entitled to redeem the Notes as set forth in the accompanying Offering Memorandum. Otherwise, the Notes are not redeemable prior to the Final Maturity Date (as defined herein). Pursuant to the requirements of the Financial Services Authority relating to Tier 2 Capital as at the date of this Offering Memorandum Supplement (i) a Holder's rights and remedies (including the right to accelerate) upon a default are limited and (ii) any optional tax redemption of Notes would require the prior consent of the Financial Services Authority. See "Description of Notes – Events of Default; Defaults; Limited Right of Acceleration" below and "Description of the Notes and Guarantee – Optional Tax Redemption" in the accompanying Offering Memorandum.

References herein to the "Offering Memorandum Supplement" are to this document (including Appendix A) together with the Offering Memorandum dated April 30, 2003 (the "Offering Memorandum"). This document should be read and construed together with the Offering Memorandum. This document supplements, and in certain places modifies and supersedes, the information contained in the Offering Memorandum.

Application has been made by the Issuer to the United Kingdom Financial Services Authority in its capacity as competent authority for the purposes of Part VI of the Financial Services and Markets Act 2000 (the "UK Listing Authority") for the Notes to be admitted to the Official List of the UK Listing Authority (the "Official List") and to the London Stock Exchange plc (the "London Stock Exchange") for the Notes to be admitted to trading by the London Stock Exchange which together will constitute official listing on the London Stock Exchange. A copy of the Offering Memorandum Supplement which comprises listing particulars (the "Listing Particulars") issued in compliance with the listing rules made under Part VI of the Financial Services and Markets Act 2000 (the "FSMA"), has been delivered to the Registrar of Companies in Scotland for registration in accordance with Section 83 of the FSMA.

EACH PURCHASER OF THE NOTES OFFERED HEREBY IN MAKING ITS PURCHASE WILL BE DEEMED TO HAVE MADE CERTAIN ACKNOWLEDGEMENTS, REPRESENTATIONS AND AGREEMENTS AS SET FORTH ON THE INSIDE FRONT COVER OF THE OFFERING MEMORANDUM.

ISSUE PRICE 98.807% PLUS ACCRUED INTEREST, IF ANY

Interest on the Notes will accrue from October 30, 2003.

There is currently no public market for the Notes. The Notes have not been and will not be registered under the U.S. Securities Act of 1933 (the "Securities Act") or the securities laws of any other jurisdiction. The Notes may be offered only in transactions that are exempt from registration under the U.S. Securities Act or the securities laws of any other jurisdiction. Accordingly, the Issuer is offering the Notes only to qualified institutional buyers, in accordance with Rule 144A under the Securities Act ("Rule 144A"), and to certain accredited investors pursuant to Section 4(2) of the Securities Act and Regulation D promulgated thereunder ("Regulation D"), and to non-U.S. persons outside the United States in compliance with Regulation S under the Securities Act ("Regulation S").

The Initial Purchasers (as defined herein) are offering the Notes subject to various conditions. It is expected that delivery of the Notes will be made on or about October 30, 2003 (the "Closing Date"), which will be the sixth Business Day following the pricing of the Notes.

Joint Bookrunning Lead Managers

Lehman Brothers

Merrill Lynch & Co.

Morgan Stanley

The date of this Offering Memorandum Supplement is October 24, 2003

IN CONNECTION WITH THE ISSUE AND DISTRIBUTION OF THE NOTES, LEHMAN BROTHERS INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED AND MORGAN STANLEY & CO. INCORPORATED OR THEIR RESPECTIVE AGENTS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WITH A VIEW TO SUPPORTING THE MARKET PRICE OF THE NOTES AT A LEVEL HIGHER THAN THAT WHICH MIGHT OTHERWISE PREVAIL FOR A LIMITED PERIOD. IN ANY JURISDICTION WHERE THERE CAN BE ONLY ONE STABILIZING AGENT, LEHMAN BROTHERS INTERNATIONAL (EUROPE) OR ITS AGENTS SHALL EFFECT ANY SUCH TRANSACTION. HOWEVER, NONE OF THE TRANSACTIONS DESCRIBED IN THIS PARAGRAPH ARE REQUIRED AND SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME AND MUST BE BROUGHT TO AN END AFTER A LIMITED PERIOD.

THIS DOCUMENT TOGETHER WITH THE OFFERING MEMORANDUM COMPRISES LISTING PARTICULARS ISSUED IN COMPLIANCE WITH THE LISTING RULES MADE BY THE UK LISTING AUTHORITY UNDER PART VI OF THE FSMA FOR THE PURPOSE OF GIVING INFORMATION WITH REGARD TO THE ISSUER AND THE NOTES.

ANY REFERENCE IN THIS DOCUMENT TO LISTING PARTICULARS MEANS THIS DOCUMENT AND ALL ITS APPENDICES TOGETHER WITH THE OFFERING MEMORANDUM EXCLUDING ALL INFORMATION INCORPORATED BY REFERENCE. THE ISSUER HAS CONFIRMED THAT ANY INFORMATION INCORPORATED BY REFERENCE, INCLUDING ANY SUCH INFORMATION TO WHICH READERS OF THE LISTING PARTICULARS ARE EXPRESSLY REFERRED, HAS NOT BEEN AND DOES NOT NEED TO BE INCLUDED IN THE LISTING PARTICULARS TO SATISFY THE REQUIREMENTS OF THE FSMA OR THE LISTING RULES MADE UNDER SECTION 74 OF THE FSMA BY THE UK LISTING AUTHORITY. THE ISSUER BELIEVES THAT NONE OF THE INFORMATION INCORPORATED IN THE LISTING PARTICULARS BY REFERENCE CONFLICTS IN ANY MATERIAL RESPECT WITH THE INFORMATION INCLUDED IN THE LISTING PARTICULARS.

THE ISSUER ACCEPTS RESPONSIBILITY FOR THE INFORMATION CONTAINED IN THE LISTING PARTICULARS. TO THE BEST OF THE KNOWLEDGE AND BELIEF OF THE ISSUER (WHO HAS TAKEN ALL REASONABLE CARE TO ENSURE THAT SUCH IS THE CASE) THE INFORMATION CONTAINED IN THE LISTING PARTICULARS IS IN ACCORDANCE WITH THE FACTS AND DOES NOT OMIT ANYTHING LIKELY TO AFFECT THE IMPORT OF SUCH INFORMATION.

Neither the delivery of this Offering Memorandum Supplement nor any pricing supplement nor the offering, sale or delivery of any Notes shall, in any circumstances, create any implication that there has been no adverse change in the financial situation of the Issuer since the date of this document.

The distribution of this Offering Memorandum Supplement and any pricing supplement and the offering, sale and delivery of the Notes in certain jurisdictions may be restricted by law. Persons into whose possession this Offering Memorandum Supplement or any pricing supplement comes are required by the Issuer to inform themselves about and to observe any such restrictions.

Neither this Offering Memorandum Supplement nor any pricing supplement may be used for the purpose of an offer or solicitation by anyone in any jurisdiction in which such offer or solicitation is not authorized or to any person to whom it is unlawful to make such offer or solicitation.

The Issuer has not authorized any offer of the Notes to the public in the U.K. within the meaning of the Public Offers of Securities Regulations 1995 (as amended) (the "POS Regulations"). The Notes may not lawfully be offered or sold to persons in the U.K. except in circumstances which do not result in an offer to the public in the U.K. within the meaning of the POS Regulations or otherwise in compliance with all applicable provisions of the POS Regulations.

Neither this Offering Memorandum Supplement nor any pricing supplement constitutes an offer or an invitation to subscribe for or purchase any Notes and should not be considered as a recommendation by the Issuer that any recipient of this Offering Memorandum Supplement or any pricing supplement

should subscribe for or purchase any Notes. Each recipient shall be taken to have made its own investigation and appraisal of the financial condition of the Issuer.

Each person receiving this Offering Memorandum Supplement acknowledges that (i) such person has been afforded an opportunity to request from the Issuer, and to review, and has received, all additional information considered by it to be necessary to verify the accuracy and completeness of the information contained herein, and (ii) no person has been authorized to give any information or to make any representation concerning the Issuer or the Notes other than those contained herein and, if given or made, such information or representation should not be relied upon as having been authorized by the Issuer.

RECENT DEVELOPMENTS

On May 9, 2003, the Issuer announced that it had made a proposal to the Board of Bank of Western Australia Ltd (“BankWest”) in which it currently holds the majority interest of 57%. Under the proposal the Issuer’s Australian subsidiary, Scottish Western Australia Holdings Pty Ltd, would acquire all the outstanding shares it does not already control and all options would be cancelled through two Schemes of Arrangement.

The Federal Court of Australia made orders approving the Schemes of Arrangement on August 26, 2003 which had previously been approved by BankWest’s minority shareholders and option holders at Scheme Meetings held on August 18, 2003. The Schemes of Arrangement became unconditional following lodgment of the Court orders with the Australian Securities and Investments Commission.

The consideration of A\$4.25 per share for all shares not held by the Issuer and the cash payment for cancellation of options, a total consideration of approximately A\$1.05 billion (approximately £434 million, based on current exchange rates) was paid from the Issuer’s existing capital resources on September 10, 2003 when the transaction completed.

On 3rd October, 2003 Gordon McQueen, a director of the Issuer and of the Governor and Company of the Bank of Scotland and Chairman and Chief Executive of HBOS Treasury Services plc (“Treasury Services”), announced his intention to retire at the end of the year from these positions. He will be succeeded as Chief Executive of Treasury Services by Lindsay Mackay, currently Head of Treasury of Treasury Services.

CAPITALIZATION AND INDEBTEDNESS

The following table and notes thereto show the unaudited capitalization and indebtedness of the Issuer and its subsidiaries (the “HBOS Group”) as at the date set forth below.

	As at June 30, 2003
	(£ millions)
Authorized capital	
9 ¹ / ₄ % Non-Cumulative Irredeemable Preference Shares (of £1 each).....	375
9 ³ / ₄ % Non-Cumulative Irredeemable Preference Shares (of £1 each).....	125
6.125% Non-Cumulative Redeemable Preference Shares (of £1 each)	200
Sterling Preference Shares (of £1 each)	2,000
8.117% Non-Cumulative Perpetual Preference Shares Class A (of £10 each)	3
7.754% Non-Cumulative Perpetual Preference Shares Class B (of £10 each)	1
Ordinary Shares (of 25p each)	1,185
	<u>3,889</u>
	<u><u>3,889</u></u>
	As at June 30, 2003
	(€ millions)
Euro Preference Shares	1,500
	<u>1,500</u>
	<u><u>1,500</u></u>
	As at June 30, 2003
	(US\$ millions)
US\$ Preference Shares.....	2,500
	<u>2,500</u>
	<u><u>2,500</u></u>
	As at June 30, 2003
	(£ millions)
Issued Capital	
9 ¹ / ₄ % Non-Cumulative Irredeemable Preference Shares (of £1 each, fully paid)	300
9 ³ / ₄ % Non-Cumulative Irredeemable Preference Shares (of £1 each, fully paid)	100
Ordinary Shares (of 25p each, fully paid).....	959
Reserves.....	13,495
	<u>14,854</u>
Shareholders’ Funds (including non-equity interests)	14,854
Minority Interests – Equity	461
Minority and Other Interests – Non Equity ⁽¹⁾	2,350
	<u>2,811</u>
Subordinated loan capital⁽²⁾	
– Undated ⁽³⁾	4,048
– Dated ⁽⁴⁾	7,427
	<u>11,475</u>
Total Capital Resources	29,140

	As at June 30, 2003
	(£ millions)
Other Borrowings⁽⁵⁾	
Deposits by banks	41,712
Customer accounts.....	161,333
Debt securities in issue	91,817
Total Indebtedness	294,862
Total Capitalization and Indebtedness⁽⁶⁾	324,002

(1) The Minority and Other Interests – Non Equity were comprised as follows:

	As at June 30, 2003
	(£ millions)
US\$1 billion Preferred Securities ⁽ⁱ⁾	641
£600 million Preferred Securities ⁽ⁱ⁾	600
£250 million Preferred Securities ⁽ⁱⁱ⁾	250
£150 million Preferred Securities ⁽ⁱⁱ⁾	150
£245 million Preferred Securities ⁽ⁱ⁾	245
€415 million Preferred Securities ⁽ⁱ⁾	289
£198 million non-cumulative preference shares	198
Unamortized Premiums, Discounts and Issue Costs.....	(23)
	2,350

(i) The Issuer provides a subordinated guarantee in respect of each of the issue of US\$1 billion 6.85% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities issued by HBOS Capital Funding No. 1 L.P., the issue of £600,000,000 6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities issued by HBOS Capital Funding L.P., the issue of £245,000,000 7.881% Guaranteed Non-voting, Non-cumulative, Preferred Securities issued by HBOS Sterling Finance (Jersey) L.P. and the issue of €415,000,000 Fixed to Floating Guaranteed Non-voting, Non-cumulative, Preferred Securities issued by HBOS Euro Finance (Jersey) L.P.

(ii) The Governor and Company of the Bank of Scotland ("Bank of Scotland") has provided a subordinated guarantee in respect of each of the issues of £250,000,000 8.117% Non-cumulative Perpetual Preferred Securities Class A and £150,000,000 7.754% Non-cumulative Perpetual Preferred Securities Class B by Bank of Scotland Capital Funding L.P. All other non-equity minority interests are unguaranteed.

(2) All loan capital issued by the HBOS Group, as detailed in the tables below, has been issued on an unsecured basis. Unless otherwise stated, issues of loan capital are unguaranteed.

(3) The Subordinated Undated Loan Capital was comprised as follows:

	As at June 30, 2003
	(£ millions)
€500 million Fixed to Floating Rate Undated Subordinated Notes	348
£150 million 7.286% Series A Perpetual Regulatory Tier 1 Securities	150
£150 million 7.281% Series B Perpetual Regulatory Tier 1 Securities	150
£300 million 7.5% Undated Subordinated Step-Up Notes	300
JPY 42.5 billion 3.50% Undated Subordinated Yen Step-Up Notes	214
US\$300 million Reset Notes	182
£200 million Perpetual Notes	200
£200 million 7.375% Undated Subordinated Guaranteed Bonds ⁽ⁱ⁾	200
€300 million Floating Rate Undated Subordinated Step-Up Notes	209
US\$250 million Floating Rate Primary Capital Notes	151
£150 million Instruments	150
£150 million Instruments	150
JPY 17 billion Instruments	97
£100 million Instruments	100
£100 million 12% Perpetual Subordinated Bonds	100
£100 million 8.75% Perpetual Subordinated Bonds	100
£75 million 13.625% Perpetual Subordinated Bonds	75
JPY 9 billion Instruments	46
£50 million 9.375% Perpetual Subordinated Bonds	50
£500 million 5.75% Undated Subordinated Step-up Note	500
£600 million 5.75% Undated Subordinated Step up Notes	600
Unamortized Premiums, Discounts and Issue Costs	(24)
	4,048

(i) Clerical Medical Investment Group (Holdings) Limited ("CMIG") (a wholly owned subsidiary of the Issuer) has provided a subordinated guarantee to Clerical Medical Finance plc ("CMF") (a wholly owned subsidiary of CMIG) in relation to the issue by CMF of £200 million 7.375% Undated Subordinated Guaranteed Bonds.

(4) The Subordinated Dated Loan Capital was comprised as follows:

	As at June 30, 2003
	(£ millions)
US\$300 million 8.80% Notes 2004 ⁽ⁱ⁾	182
£400 million 8.75% Subordinated Notes 2006	400
US\$150 million 8.85% Notes 2006 ⁽ⁱ⁾	91
£75 million 9.125% Subordinated Notes 2006	75
£60 million 9.00% Instruments 2006	60
€650 million 4.75% Subordinated Bonds 2009	452
US\$500 million Floating Rate Subordinated Step-up Callable Notes 2009	303
€500 million 5.50% Instruments 2009.....	348
£75 million Floating Rate Subordinated Notes 2009	75
US\$500 million Notes 2010 ⁽ⁱ⁾	303
£75 million Floating Rate Instruments 2010	75
US\$150 million Notes 2011 ⁽ⁱ⁾	91
€ million Floating Rate Notes 2011	5
€750 million Subordinated Fixed Rate Notes 2012	522
US\$450 million Subordinated Floating Rate Notes 2012	272
£200 million Floating Rate Step-up Callable Subordinated Notes 2012	200
€12.8 million 6.25% Instruments 2012	9
A\$75 million Callable Notes 2012	31
€1,000 million Subordinated Callable Fixed/Floating Rate Instruments 2013	696
€325 million 6.125% Notes 2013	226
US\$1 billion Subordinated Guaranteed Notes 2013 (ii)	605
JPY 60 billion 0.55% Subordinated Callable Notes 2013.....	307
£250 million 11% Subordinated Bonds 2014	250
€1 billion 4.875% Subordinated Notes 2015	696
£150 million 10.5% Subordinated Bonds 2018.....	150
£250 million 6.375% Instruments 2019	250
£500 million 9.375% Subordinated Bonds 2021	500
€400 million 6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023 ⁽ⁱⁱⁱ⁾	278
Unamortized Premiums, Discounts and Issue Costs.....	(25)
	7,427

(i) These notes, the proceeds of which are on-lent to Bank of Scotland are liabilities of Scotland International Finance No. 2 B.V. ("SIF No. 2") a wholly owned subsidiary undertaking of Bank of Scotland, and are guaranteed by Bank of Scotland on a subordinated basis.

(ii) These notes, the proceeds of which are on-lent to the Issuer, are liabilities of SIF No. 2, a wholly owned subsidiary undertaking of Bank of Scotland, and are guaranteed on a subordinated basis jointly and severally by the Issuer and Bank of Scotland.

(iii) CMIG has provided a subordinated guarantee to CMF in relation to the issue by CMF of 6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023.

(5) As indicated in the table on page S-6, as at June 30, 2003, the HBOS Group had other borrowings of £294,862 million (including deposits by banks of £41,712 million, customer accounts of £161,333 million and debt securities in issue of £91,817 million). Save for £295 million of the HBOS Group's debt securities in issue which are unguaranteed but secured on advances to customers and certain other assets of the HBOS Group and £10,830 million of the HBOS Group's debt securities in issue which are unguaranteed but secured on asset backed securities of the HBOS Group, none of the other borrowings listed is secured or guaranteed. As at June 30, 2003, the HBOS Group had contingent liabilities (including guarantees) of £3,255 million. No account has been taken of intra-HBOS Group guarantees.

- (6) Since June 30, 2003 there have been no material changes in the HBOS Group's capitalization, indebtedness, contingent liabilities or guarantees, save for the issue by the Issuer of €750,000,000 Undated Subordinated Fixed to Floating Rate Notes on 14 October 2003.

DESCRIPTION OF NOTES

The following description of the particular terms of the Notes offered hereby supplements, and in certain places modifies and supersedes, the description of the general terms and provisions of the Notes set forth in the accompanying Offering Memorandum, to which description reference is hereby made. Capitalized terms not defined herein have the meanings assigned to such terms in the accompanying Offering Memorandum. The section references used below refer to the Amended and Restated Indenture dated as of April 30, 2003, as amended, supplemented or otherwise modified and in effect from time to time among the Issuer, Bank of Scotland, SIF No. 2 and The Bank of New York as Trustee and as amended, supplemented and modified by the Supplemental Indenture to be dated October 30, 2003 between the Issuer and Bank of New York as Trustee (the “Indenture”). The following summaries of the Indenture do not purport to be complete and are qualified in their entirety by reference to all the provisions of the Indenture.

General

The Notes will be designated as the Issuer’s 6.00% Subordinated Notes due 2033 (the “Notes”) and will bear interest from October 30, 2003, payable semi-annually in arrears, on each May 1 and November 1, beginning May 1, 2004, to the persons in whose names the Notes are registered at the close of business on April 15 or October 15, as the case may be, next preceding such May 1 or November 1. The first payment on May 1, 2004 will be a long first coupon of 181 days. The Notes will mature on November 1, 2033 (the “Final Maturity Date”) and be redeemed at par. The Notes are not redeemable prior to the Final Maturity Date by the Issuer, except in the event that the Notes become subject to certain taxation in which case the Issuer may be entitled to redeem the Notes as set forth under “Description of the Notes and the Guarantees – Optional Tax Redemption” in the accompanying Offering Memorandum. The Notes will be issued under the Indenture. The place of payment for the Notes shall be The City of New York and payments in respect of the Notes shall be made on days which are Business Days in New York.

The Notes will constitute unsecured and subordinated debt obligations of the Issuer. By purchasing Notes, each Holder of Notes is deemed to acknowledge that its claims against the Issuer under the Notes are subordinated to the claims of Senior Creditors of the Issuer. See “Subordination” below. The Notes will be sold in denominations of \$1,000 and integral multiples of \$1,000 in excess thereof (or, in the case of any sale to an “accredited investor” as defined in Regulation D promulgated under the Securities Act, in minimum amounts of \$250,000 and integral multiples of \$1,000 in excess thereof). See “Description of the Notes and the Guarantees – General” in the accompanying Offering Memorandum.

Additional Notes may be issued with the same terms as the Notes offered hereby without the consent of any Holder, which will be consolidated and form one series with the Notes previously offered hereby).

The Notes sold to qualified institutional buyers (“QIBs”) in reliance on Rule 144A, will initially be represented by interests in one or more global notes in registered form (the “Rule 144A Global Notes”). The Notes sold to investors in reliance on Regulation S under the Securities Act will initially be represented by interests in one or more global notes in registered form (the “Regulation S Global Notes” and, together with the Rule 144A Global Notes, the “Global Notes”). On the Closing Date, the Global Notes will be deposited with the Trustee as custodian for DTC, in New York, and registered in the name of DTC or its nominee, in each case for credit to an account of a direct or indirect participant in DTC as described below. Beneficial interests in the Rule 144A Global Notes may not be exchanged for beneficial interests in the Regulation S Global Notes at any time except in the limited circumstances described in the accompanying Offering Memorandum. See “Description of the Notes and the Guarantees – Depositary Procedures – Exchange Among the Global Notes” in the accompanying Offering Memorandum.

Notes sold to “accredited investors” as defined in Regulation D promulgated under the Securities Act, if any, will be represented by Notes in definitive form.

The Global Notes may be transferred, in whole and not in part, only to another nominee of DTC or to a successor of DTC or its nominee. Beneficial interests in the Global Notes may not be exchanged

for Notes in definitive form except in the limited circumstances described in the accompanying Offering Memorandum. See “Description of the Notes and the Guarantees – Depositary Procedures – Exchange of Global Notes for Definitive Notes” in the accompanying Offering Memorandum.

Notes sold to QIBs in reliance on Rule 144A (including beneficial interests in the Rule 144A Global Notes) will be subject to certain restrictions on transfer and will bear a restrictive legend as described under “Notice to Purchasers” in the accompanying Offering Memorandum. In addition, transfers of beneficial interests in the Global Notes will be subject to the applicable rules and procedures of DTC and its direct or indirect participants (including, if applicable, those of Euroclear and Clearstream, Luxembourg) which may change from time to time.

There are no time limits affecting the validity of claims to interest and repayment of principal under the Notes.

Subordination

The rights and claims of the Trustee and the Holders of Notes against the Issuer are subordinated to the claims of Senior Creditors of the Issuer. See “Description of the Notes and the Guarantees – Subordinated Notes (other than Undated Notes) issued by Issuers other than Bank of Scotland – Subordination” in the accompanying Offering Memorandum.

Events of Default, Defaults and Limited Right of Acceleration

An Event of Default shall occur only in the case of the winding up, liquidation or sequestration of the Issuer (other than in connection with a scheme of amalgamation or reconstruction not involving bankruptcy or insolvency). If an Event of Default shall occur, the principal amount of the Notes shall, without any act by the Trustee or the Holders of Notes, become immediately due and payable without presentment, demand, protest or other notice of any kind (Indenture §§ 501 and 502). There will be no other right of acceleration of the maturity of the outstanding Notes, whether upon a default in the making of any payment of principal or interest with respect to the Notes or in the performance of any covenant of the Issuer or otherwise. The Trustee may, however, petition for the winding up, liquidation or sequestration of the Issuer upon the occurrence of a Default, as described below.

The following shall be a Default with respect to the Notes: (a) failure by the Issuer to pay any interest on any Notes when due, continued for 30 days, or (b) failure by the Issuer to pay principal or the Redemption Price of any Note when due. If a Default occurs, the Issuer shall, upon demand of the Trustee, pay to the Trustee for the benefit of the Holders the amount then due and payable on such Notes, and if the Issuer fails to pay such amounts forthwith upon such demand, the remedies of the Trustee shall be limited to petitioning for the winding up, liquidation or sequestration of the Issuer and proving the amounts due and payable and claiming in such winding up, liquidation or sequestration; provided that the Trustee or any Holder may not, by virtue of a Default, accelerate the maturity of any of the outstanding Notes. Upon the occurrence of a Default with respect to the Notes, the Holders shall not at any time be entitled to exercise any right of set-off or counterclaim which may be available to a Holder against amounts owing by the Issuer in respect of the Notes. If, notwithstanding the provisions of the preceding sentence, any of the rights and claims of any Holder is discharged by set-off, such Holder will immediately pay an amount equal to the amount of such discharge to the Issuer or, if applicable, the liquidator or trustee or receiver in bankruptcy of the Issuer to be held on trust for the unsubordinated creditors of the Issuer and until such time as payment is made will hold a sum equal to such amount in trust for the Issuer or, if applicable, the liquidator or trustee or receiver in bankruptcy of the Issuer. Accordingly, such discharge will be deemed not to have taken place (Indenture §§ 503 and 507).

Certain Additional Limitations

In the event of the bankruptcy, liquidation, sequestration or winding up of the Issuer, if any payment or distribution of assets of the Issuer of any kind or character, whether in cash, property or securities, including any such payment or distribution which may be payable or deliverable by reason of the payment of any other indebtedness of the Issuer being subordinated to the payment of the Notes issued by the Issuer, shall be received by the Trustee or the Holders of the Notes, before the

claims of all Senior Creditors (as such term is defined in “Description of the Notes and the Guarantees – Subordinated Notes (other than Undated Notes) issued by Issuers other than Bank of Scotland – Subordination”) of the Issuer have been paid in full, such payment or distribution shall be held in trust by the Trustee or such Holders, as applicable, and shall be immediately returned by it or them to the liquidator or trustee or receiver in bankruptcy of the Issuer. Thereupon, such payment or distribution will be deemed not to have been made or received. If any of the said rights and claims of any Holder of the Notes against the Issuer is discharged by set-off, such Holder will immediately pay an amount equal to the amount of such discharge to the liquidator or trustee or receiver in bankruptcy of the Issuer and until such time as payment is made will hold a sum equal to such amount in trust for the liquidator or trustee or receiver in bankruptcy of the Issuer. Accordingly, such discharge will be deemed not to have taken place. (Subordinated Indenture § 1006(d)).

Other Provisions

The subordination provisions of the Indenture apply only to amounts payable under the Notes and nothing contained therein shall affect or prejudice any claim by the Trustee against the Issuer in respect of the costs, charges, expenses, liabilities, indemnification or remuneration of the Trustee. (Subordinated Indenture § 1006(e)).

Nothing contained in the subordination provisions of the Indenture in any way restricts the right of the Issuer to issue debt obligations, or to give any guarantee or indemnity of any nature, ranking in priority to or pari passu with or junior to the obligations of the Issuer in respect of the Notes and, if in the opinion of the Trustee, any modification to the subordination provisions to permit such ranking is necessary or expedient, the Trustee is authorized without the consent of the Holders of the Notes to concur with the Issuer in executing a supplemental indenture effecting such modification. (Subordinated Indenture § 1006(g)).

USE OF PROCEEDS

The net proceeds from the issuance of the Notes, which are expected to be \$736,365,000, after deduction of underwriting commission and selling concession incurred in connection with the issue of the Notes, will be used by the Issuer to strengthen the capital base of the Issuer and its subsidiaries and to support the continuing growth of their business.

MANAGEMENT

Board of Directors of the Issuer

Name	Position in the Issuer	Principal outside activities (if any) of significance to the Issuer
Lord Stevenson of Coddendam	Chairman – Non-executive Director	Pearson plc
Sir Ronald Garrick	Deputy Chairman – Non-executive Director	—
James Crosby	Chief Executive	—
Mike Ellis	Group Finance Director	—
Philip Hodgkinson	Chief Executive – Insurance & Investment	—
Andrew Hornby	Chief Executive – Retail Banking	—
Gordon McQueen	Chief Executive – Treasury	—
Colin Matthew	Chief Executive – Business Banking	—
George Mitchell	Chief Executive – Corporate Banking	—
Charles Dunstone	Non-executive Director	Carphone Warehouse Group plc
Anthony Hobson	Non-executive Director	—
Brian Ivory	Non-executive Director	—
John Maclean	Non-executive Director	—
Coline McConville	Non-executive Director	Clear Channel International Limited
Sir Bob Reid	Non-executive Director	—
Louis Sherwood	Non-executive Director	—
Philip Yea	Non-executive Director	Investcorp International Limited

The business address for each of the Directors of the Issuer is The Mound, Edinburgh EH1 1YZ.

TAXATION

The Offering Memorandum contains a summary of certain tax consequences of the acquisition, ownership and disposition of the Notes under the law and practice of the United States, the Netherlands and the United Kingdom. See “Taxes” in the accompanying Offering Memorandum.

The following is not intended as tax advice and does not purport to describe all of the tax considerations that may be relevant to a prospective purchaser of Notes. **PROSPECTIVE PURCHASERS ARE URGED TO SATISFY THEMSELVES AS TO THE OVERALL TAX CONSEQUENCES OF PURCHASING, HOLDING AND/OR SELLING THE NOTES.**

United Kingdom

It is expected that interest will be payable on the Notes without withholding or deduction on account of United Kingdom taxation.

No stamp duty or stamp duty reserve tax should be payable in respect of the Notes.

Proposed European Withholding Tax

On June 3, 2003 the European Union Council of Economic and Finance Ministers (“**ECOFIN**”) agreed on proposals under which, with effect from 1st January 2005, member states of the European Union will be required to provide to the tax authorities of another member state details of payments on interest or other similar income paid by a person within its jurisdiction to an individual resident in that other member state, except that Belgium, Luxembourg and Austria will instead be required to operate a withholding system for a transitional period in relation to such payments (the ending of such transitional period being by reference to the conclusion of certain other agreements relating to information exchange with certain other countries).

PLAN OF DISTRIBUTION

Under the terms of and subject to the conditions contained in a Terms Agreement (the “Terms Agreement”), dated October 24, 2003, which supplements the Amended and Restated Private Placement Agreement dated April 30, 2003 between, among others, the Issuer and the agents named below (the “Initial Purchasers”), the Initial Purchasers have severally agreed to purchase, and the Issuer has agreed to sell to them severally, the respective principal amounts of Notes set forth opposite their respective names below):

Name	Principal Amount of Notes
Lehman Brothers Inc.	\$250,000,000
Merrill Lynch, Pierce, Fenner & Smith Incorporated	\$250,000,000
Morgan Stanley & Co. Incorporated	\$250,000,000
Total	<u>\$750,000,000</u>

The Terms Agreement provides that the obligations of the Initial Purchasers to pay for and accept delivery of the Notes is subject to approval of certain legal matters by their counsel and to certain other conditions. The Initial Purchasers are obligated to take and pay for all, and not some only, of the Notes that they have agreed to purchase, if any are taken.

The Initial Purchasers initially propose to offer the Notes at the offering price set forth on the cover page of this Offering Memorandum Supplement and may offer the Notes to certain dealers at a price that represents a concession not in excess of 0.40% of the principal amount of the Notes. The Initial Purchasers may allow and such dealers may reallow a concession not in excess of 0.20% of such principal amount to certain other dealers. After the initial offering of the Notes, the offering price and such concessions may be changed.

The Notes are not being registered under the Securities Act in reliance upon Regulation S and the exemptions from registration provided by Rule 144A and Section 4(2) of the Securities Act and Regulation D promulgated thereunder. The Notes are being offered hereby only (A) to QIBs in reliance on Rule 144A, (B) outside the United States to persons other than U.S. Persons (as defined in Regulation S) (“Regulation S Purchasers”) in offshore transactions in reliance upon Regulation S and (C) to institutional investors that qualify as “accredited investors” as defined in Regulation D. The minimum principal amount of Notes which may be purchased for any account is (i) \$1,000 (or the equivalent thereof in another currency or composite currency) in the case of any sale pursuant to clauses (A) or (B) of the preceding sentence and (ii) \$250,000 (or the equivalent thereof in another currency or composite currency) in the case of any sale pursuant to clause (C) of the preceding sentence.

Prior to any issuance of Notes, each Initial Purchaser will be deemed to represent and agree that:

- (i) it has not offered or sold and will not offer or sell any such Notes to persons in the United Kingdom prior to the admission of such Notes to listing in accordance with Part VI of the FSMA, except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the POS Regulations or the FSMA;
- (ii) it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer, as issuer;
- (iii) it has complied and will comply with all applicable provisions of the FSMA (and all rules and regulations made pursuant to the FSMA) with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom; and

- (iv) with respect to offers and sales outside the United States, it will send to each distributor, dealer or person receiving a selling concession, fee or other remuneration that purchases Notes from them during the distribution compliance period (as defined in Regulation S) a confirmation or notice substantially to the following effect:

“The Notes covered hereby have not been registered under the U.S. Securities Act of 1933 (the “Securities Act”) and may not as a matter of U.S. law be offered and sold within the United States or to, or for the account or benefit of, U.S. persons (i) as part of their distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the offering and the closing date, except in either case in accordance with Regulation S (or Rule 144A, if available) under the Securities Act. Terms used above have the meaning given to them by Regulation S”.

Until the expiration of the period ending 40 days after the later of the commencement of the offering and the date of issue of the Notes, an offer or sale of Notes within the United States by a dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A or pursuant to another exemption from registration under the Securities Act. Furthermore, if any Notes are sold within the United States or to, or for the account or benefit of, a U.S. person (as defined in Regulation S) pursuant to Rule 144A or pursuant to another exemption from registration under the Securities Act, DTC’s current procedures require that such person (i) must hold its interest in the Notes offshore through Euroclear or Clearstream, Luxembourg, as the case may be, until the expiration of the distribution compliance period (as defined in Regulation S) and (ii) upon the expiration of such distribution compliance period, certify that it bought such Notes pursuant to Rule 144A or pursuant to another exemption from registration under the Securities Act.

There is no undertaking to register the Notes hereafter and they cannot be resold except pursuant to an effective registration statement or an exemption from the registration requirements of the Securities Act. Each purchaser of the Notes offered hereby in making its purchase shall be deemed to have made the acknowledgments, representations and agreements as set forth under “Notice to Purchasers” contained on pages 2 and 3 of the accompanying Offering Memorandum.

The Initial Purchasers have agreed that the Notes may not be offered, sold, transferred or delivered in or from The Netherlands, as part of their initial distribution or as part of any re-offering, and neither this Offering Memorandum Supplement nor any other document in respect of the offering may be distributed or circulated in The Netherlands, other than to individuals or legal entities which include, but are not limited to, banks, brokers, dealers, institutional investors and undertakings with a treasury department, who or which trade or invest in securities in the conduct of a business or profession.

The Issuer has agreed to indemnify the Initial Purchasers against and to make contributions relating to certain liabilities, including liabilities under the Securities Act. The Initial Purchasers may engage in transactions with, or perform services for the Issuer in the ordinary course of business.

The Initial Purchasers may from time to time purchase and sell Notes in the secondary market, but they are not obligated to do so, and there can be no assurance that there will be a secondary market for the Notes or liquidity in the secondary market if one develops. From time to time, the Initial Purchasers may make a market in the Notes.

Some of the Initial Purchasers or their affiliates have, directly or indirectly, performed investment and/or commercial banking or financial advisory services for the Issuer or its affiliates, for which they may have received customary fees and commissions, and they expect to provide these services to the Issuer and its affiliates in the future, for which they may also receive customary fees and commissions.

In connection with the offering of the Notes, Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Morgan Stanley & Co. Incorporated (the “Representatives”) may engage in transactions that stabilize, maintain or support the price of the Notes, as the case may be, for a limited period. Specifically, the Representatives may over-allot in connection with the offering, creating a short position in the Notes for their own account. In addition, to cover over-allotments or to stabilize the price of the Notes, the Representatives may bid for, and purchase, Notes in the open market. Finally, the Representatives may also impose a penalty bid. This means that if the

Representatives purchase Notes in the open market to reduce the Representatives' initial short position or to stabilize the price of the Notes, they may reclaim the amount of the selling concession from underwriters who sold those Notes as part of the initial offering. Any of these activities may stabilize or maintain the market price of the Notes above independent market levels. In addition, the imposition of a penalty bid might have an effect on the price of a Note to the extent that it were to discourage resales of the Notes by purchasers in the offering. The Representatives are not required to engage in any of these activities, and may end any of them at any time.

The Representatives will make the Notes available for distribution on the Internet through a proprietary website and/or a third party system operated by Market Axess Inc., an Internet-based communications technology provider. Market Axess Inc. is providing the system as a conduit for communications between the Representatives and their customers and is not a party to any transaction. Market Axess Inc., a registered broker-dealer, will receive compensation from the Representatives based on transactions the Representatives conduct through the system. The Representatives will make the Notes available to their customers through Internet distributions, whether made through a proprietary or third-party system, on the same terms as distributions made through other channels.

GENERAL INFORMATION

1. This Offering Memorandum Supplement, which, together with the Offering Memorandum comprises listing particulars, was published on October 24, 2003 and it is expected that listing of the Notes on the Official List and admission to trading by the London Stock Exchange will be granted on or around 30 October 2003, subject only to the issue of the Global Note.
2. Neither the Issuer nor any of its subsidiaries is or has been involved in any legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Issuer is aware) which may have or have had during the 12 months preceding the date of this Offering Memorandum Supplement, a significant effect on the financial position of the Issuer and its subsidiaries taken as a whole.
3. The financial statements of the HBOS Group for the three years ended December 31, 2000, December 31, 2001 and December 31, 2002 have been audited without qualification by KPMG Audit plc (“KPMG”), chartered accountants, registered auditors and independent auditors, whose address is Saltire Court, 20 Castle Terrace, Edinburgh EH1 2EG. The report of KPMG dated February 24, 2003 in respect of the HBOS Group for the year ended December 31, 2002 stated that the report was made solely to the Issuer’s members, as a body, in accordance with section 235 of the Companies Act 1985. It further stated that KPMG’s audit work had been undertaken so that KPMG might state to the Issuer’s members those matters KPMG were required to state to them in an auditor’s report and for no other purpose. To the fullest extent permitted by law, KPMG did not accept or assume responsibility to anyone other than the Issuer and the Issuer’s members as a body, for their audit work, for their report, or for the opinions KPMG formed. The Issuer has been advised that KPMG included this statement in its audit report in accordance with recent guidance issued by the Institute of Chartered Accountants in England and Wales. Whether this statement effectively limits your ability to rely on the audit report of KPMG is untested.
4. There has been no significant change in the financial or trading position of the HBOS Group since June 30, 2003 nor any material adverse change in the financial position or prospects of the HBOS Group since December 31, 2002.
5. For the period of fourteen days after the date of this Offering Memorandum Supplement and throughout the life of the Notes, copies of the following documents may be inspected during normal business hours at the specified office of the Principal Paying Agent and at the registered office of the Issuer namely:
 - the memorandum and articles of association of the Issuer;
 - the Amended and Restated Indenture dated April 30, 2003;
 - the Supplemental Indenture to be dated October 30, 2003;
 - the Amended and Restated Paying Agent and Registrar Agreement dated April 30, 2003;
 - the Amended and Restated Authenticating Agent Agreement dated April 30, 2003;
 - the Amended and Restated Private Placement Agreement dated April 30, 2003;
 - the Terms Agreement dated October 24, 2003;
 - this Supplemental Offering Memorandum and the Offering Memorandum;
 - the audited financial statements of the HBOS Group for the two years ended December 31, 2001 and December 31, 2002, and each financial year and six monthly intervals thereafter in respect of which interim or audited financial statements have been prepared;
 - the unaudited financial statements of the HBOS Group for the six monthly period ended June 30, 2003;
 - the letter of consent from KPMG referred to in paragraph 10 below; and
 - the Pricing Supplement relating to the Notes to be dated October 30, 2003.

6. The Notes may be accepted for clearance through DTC, Euroclear and Clearstream, Luxembourg. The appropriate CUSIP number for DTC and common codes for Euroclear and Clearstream, Luxembourg for the Notes, together with the relevant ISIN number, are:

	Regulation S	Rule 144A
CUSIP:	4041A3AG7	4041A2AF1
ISIN:	US4041A3AG79	US4041A2AF14
Common Code:	017938908	017938924

7. The listing of the Notes on the Official List of the UK Listing Authority will be expressed as a percentage of their principal amount (excluding accrued interest). It is expected that the Notes will be admitted to listing by the UK Listing Authority and to trading by the London Stock Exchange, subject only to the issue of a Global Note.
8. Settlement arrangements for the Notes are set forth in greater detail under “Description of the Notes and the Guarantees – Depositary Procedures” in the accompanying Offering Memorandum.
9. The Issuer has appointed Citibank N.A., London Office, 5 Carmelite Street, London EC4Y 0PA as its agent for the payment, authentication, transfer and exchange of the Notes pursuant to the Amended and Restated Paying Agent and Registrar Agreement and the Amended and Restated Authenticating Agent Agreement, in each case dated April 30, 2003, between, among others, Citibank, N.A., London branch, as agent, and the Issuer.
10. KPMG have given and have not withdrawn their written consent to the inclusion in this Offering Memorandum Supplement of their independent review report to the Issuer dated July 30, 2003 and their independent auditors’ report of February 24, 2003 as set out, respectively, on pages S-29 and F-3 and, in each case, in the form and context in which it is included, and have authorized the contents of those parts of the Listing Particulars for the purposes of Regulation 6(1)(e) of The Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations 2001.

APPENDIX A: INTERIM FINANCIAL RESULTS

Accounting Policies

The HBOS Group's accounting policies are unchanged from those stated in the HBOS Group's Annual Report and Accounts for the year ended December 31, 2002.

The comparative figures at June 30, 2002 have been restated to reflect the impact at that date of the change in policy at December 31, 2002 to unsmoothed asset values in recognising income from long term assurance business. The impact of this change of accounting policy was to reduce income from long term assurance business and profit before tax for the half year to June 30, 2002 by £71m and to reduce the taxation charge by £16m. The value of the Group's reserves at June 30, 2002 has been reduced by £238m and minority interests (equity) reduced by £17m.

Consolidated Profit & Loss Account

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 Restated £m	Half year ended 31.12.2002 £m	Year ended 31.12.2002 £m
Interest receivable				
Interest receivable and similar income arising from debt securities	357	531	351	882
Other interest receivable	8,372	6,934	8,875	15,809
	8,729	7,465	9,226	16,691
Interest payable	(6,081)	(5,171)	(6,750)	(11,921)
Net interest income	2,648	2,294	2,476	4,770
Fees and commissions receivable	1,211	1,001	1,156	2,157
Fees and commissions payable	(382)	(305)	(367)	(672)
Dealing profits	70	85	69	154
Income from long-term assurance business	216	124	109	233
Other operating income	503	441	463	904
Net operating income (all from continuing operations)				
(Note 1)	4,266	3,640	3,906	7,546
Administrative expenses (Note 2)	(1,614)	(1,506)	(1,622)	(3,128)
Depreciation and amortisation				
Tangible fixed assets	(138)	(130)	(129)	(259)
Operating lease assets	(159)	(124)	(165)	(289)
Goodwill amortisation	(46)	(42)	(44)	(86)
Operating expenses	(1,957)	(1,802)	(1,960)	(3,762)
General insurance claims	(42)	(43)	(36)	(79)
Provisions for bad and doubtful debts (Note 3)	(499)	(379)	(453)	(832)
Amounts written off fixed asset investments	(9)	(7)	(17)	(24)
Operating profit (all from continuing operations)	1,759	1,409	1,440	2,849
Before exceptional items	1,803	1,478	1,524	3,002
Exceptional items (Note 4)	(44)	(69)	(84)	(153)
Share of operating profits/(losses) of joint ventures	11	15	(7)	8
Share of operating profits of associated undertakings	11	14	13	27
Profit on disposal of business			25	25
Profit on ordinary activities before taxation	1,781	1,438	1,471	2,909
Before exceptional items	1,825	1,507	1,555	3,062
Exceptional items (Note 4)	(44)	(69)	(84)	(153)
Tax on profit on ordinary activities (Note 5)	(516)	(414)	(421)	(835)
Profit on ordinary activities after taxation	1,265	1,024	1,050	2,074
Before exceptional items	1,296	1,075	1,111	2,186
Exceptional items (Note 4)	(31)	(51)	(61)	(112)
Minority interests: (equity)	(29)	(12)	(23)	(35)
(non-equity)	(73)	(64)	(59)	(123)
Profit attributable to Shareholders	1,163	948	968	1,916
Dividends				
Ordinary	392	400	740	1,140
Preference	19	19	18	37
Retained profit	752	529	210	739
Underlying earnings per share	32.4p	27.9p	28.2p	56.1p
Basic earnings per share	30.3p	25.3p	25.3p	50.6p
Diluted earnings per share	30.1p	25.1p	25.1p	50.2p

It is estimated that HBOS Group's profit on ordinary activities before taxation and retained profit of the half year calculated solely on a historical cost basis would not differ materially from those stated in the consolidated profit and loss account above.

Consolidated Balance Sheet

	As at 30.06.2003 £m	As at 30.06.2002 Restated £m	As at 31.12.2002 £m
Assets			
Cash and balances at central banks	1,147	1,137	1,373
Items in course of collection	1,361	1,198	1,093
Treasury bills and other eligible bills	8,093	2,398	5,964
Loans and advances to banks	12,603	10,017	11,838
Loans and advances to customers	263,408	218,746	240,879
Less: non-returnable finance	(12,931)	(6,594)	(6,564)
	250,477	212,152	234,315
Debt securities	47,420	45,713	44,324
Equity shares	231	219	223
Interest in joint ventures			
Share of gross assets	4,119	2,495	3,674
Share of gross liabilities	(3,871)	(2,230)	(3,393)
	248	265	281
Interest in associated undertakings	191	150	172
Intangible fixed assets	1,507	1,463	1,434
Tangible fixed assets	1,683	1,603	1,671
Operating lease assets	2,824	2,353	2,625
Other assets	9,076	3,309	7,434
Prepayments and accrued income	1,437	2,204	1,458
Long term assurance business attributable to shareholders	3,716	3,199	3,544
	342,014	287,380	317,749
Long term assurance assets attributable to policyholders	40,205	38,135	37,331
Total Assets	382,219	325,515	355,080
Liabilities			
Deposits by banks	41,712	36,274	45,637
Customer accounts	161,333	144,556	150,221
Debt securities in issue	91,817	71,101	80,771
Notes in circulation	731	742	821
Corporate & deferred taxation	1,045	848	880
Dividends payable	408	383	754
Other liabilities	11,068	5,253	8,912
Accruals and deferred income	4,543	4,326	4,486
Other provisions	217	286	232
Subordinated liabilities			
Dated loan capital	7,427	4,986	5,690
Undated loan capital	4,048	2,976	3,437
	11,475	7,962	9,127
	324,349	271,731	301,841

Consolidated Balance Sheet (*Continued*)

	As at 30.06.2003 £m	As at 30.06.2002 Restated £m	As at 31.12.2002 £m
Capital and Reserves			
Called up share capital			
Ordinary shares.....	959	944	946
Preference shares (non-equity)	400	400	400
	1,359	1,344	1,346
Share premium account	1,296	1,252	1,292
Other reserves	505	502	496
Profit and loss account	11,694	10,408	10,635
Shareholders' funds (including non-equity interests)	14,854	13,506	13,769
Minority interests (equity).....	461	453	436
Minority and other interests (non-equity).....	2,350	1,690	1,703
	17,665	15,649	15,908
	342,014	287,380	317,749
Long term assurance liabilities attributable to policyholders.....	40,205	38,135	37,331
Total Liabilities	382,219	325,515	355,080
	As at 30.06.2003 £m	As at 30.06.2002 £m	As at 31.12.2002 £m
Memorandum Items			
Contingent Liabilities			
Acceptances and endorsements.....	117	210	157
Guarantees and assets pledged as collateral security.....	3,138	2,652	2,672
	3,255	2,862	2,829
Commitments			
Other commitments	54,793	43,617	49,024

Reconciliation of Shareholders' Funds

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 Restated £m	Year ended 31.12.2002 £m
Profit attributable to shareholders	1,163	948	1,916
Dividends	(411)	(419)	(1,177)
Other recognised gains and losses	9	7	4
Dividends retained on account of share dividends	302	267	283
Contribution to Employee Share Trust	—	(6)	(12)
Release relating to the cost of employee options granted under company share ownership plans	5	19	23
Ordinary capital subscribed.....	17	1,277	1,319
	1,085	2,093	2,356
Shareholders' Funds at 1 January	13,769	11,413	11,413
Shareholders' Funds at 30 June/31 December	14,854	13,506	13,769
of which:			
Attributable to non-equity interests	400	400	400
Attributable to equity interests	14,454	13,106	13,369
	14,854	13,506	13,769

Consolidated Statement of Total Recognised Gains and Losses

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 Restated £m	Year ended 31.12.2002 £m
Profit attributable to shareholders	1,163	948	1,916
Exchange translation and other movements	9	7	4
Total Recognised Gains and Losses in the period	1,172	955	1,920

Consolidated Cash Flow Statement

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 £m	Year ended 31.12.2002 £m
Net cash inflow/(outflow) from operating activities (Note 7).....	11	(481)	(994)
Dividends received from joint ventures	14	25	48
Dividends received from associated undertakings	2	2	
Returns on investments and servicing of finance	(365)	(344)	(700)
Taxation	(223)	(85)	(445)
Capital expenditure and financial investment	(1,335)	1,561	2,199
Acquisitions and disposals.....	(157)	(45)	(114)
Equity dividends paid	(436)	(430)	(782)
Net cash (outflow)/inflow before financing	(2,489)	201	(786)
Financing	2,812	1,257	2,543
Increase in cash	323	1,458	1,757

Notes on the Accounts

1. Net Operating Income

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 £m	Half year ended 31.12.2002 £m	Year ended 31.12.2002 £m
Net operating income includes:				
Mortgage incentives	(598)	(524)	(582)	(1,106)
Interest payable on subordinated liabilities..	(304)	(256)	(262)	(518)
Dealing profits (arising from the Group's trading book)				
Foreign exchange	7	21	38	59
Interest rate related	63	64	31	95
Finance lease rental income	317	387	339	726
Operating lease rental income	252	213	255	468
General insurance premium income	171	177	143	320
Profit on sale of investment securities	32	19	18	37
Dividend income from equity shares	5	5	1	6

2. Administrative Expenses (excluding exceptional items)

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 £m	Half year ended 31.12.2002 £m	Year ended 31.12.2002 £m
Staff costs	842	752	800	1,552
Property rentals	64	74	54	128
Hire of equipment	15	14	11	25

3. Provisions for bad and doubtful debts

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 £m	Half year ended 31.12.2002 £m	Year ended 31.12.2002 £m
Provisions for bad and doubtful debts comprises:				
Specific	460	356	439	795
General	39	23	14	37
	<u>499</u>	<u>379</u>	<u>453</u>	<u>832</u>

4. Exceptional Items

Included within administrative expenses, exceptional costs have been charged as follows:

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 £m	Half year ended 31.12.2002 £m	Year ended 31.12.2002 £m
HBOS merger integration costs.....	(44)	(69)	(84)	(153)
Tax effect	13	18	23	41

HBOS merger integration costs cover the cost of integrating and reorganising Bank of Scotland Group and Halifax Group following merger.

5. Taxation

The tax charge for the half year of £516m (2002 restated £414m) represents 29.0% (2002 restated 28.8%) of profit before tax compared with a UK corporation tax rate applicable to the half year of 30% (2002 30%). The effective rate is lower than the UK corporation tax rate mainly due to the net effect of lower tax rates overseas and interest deductible on Innovative Tier 1 Securities.

6. Acquisitions

Transnational

On 14 March 2003 the Group acquired, for a total consideration of £96m the assets and undertaking of the Joint Affinity Credit Card Business developed through Transnational Group Services International Inc. and its UK based subsidiary, Transnational Financial Services Ltd. Net assets with a fair value of £23m were acquired creating goodwill on acquisition of £73m. The goodwill arising on the acquisition is being amortised over 20 years to reflect the minimum period over which the economic benefits associated with the acquisition are expected to arise.

Rothschild Asset Management International Holdings BV

On 31 January 2003 the Group acquired Rothschild Asset Management International Holdings BV for £60m (including costs of acquisition). Net assets with a provisional fair value of £17m were acquired, creating a balance of goodwill on acquisition of £43m. The goodwill arising on the acquisition is being amortised over a period of 10 years to reflect the strategic rationale of the acquisition and the minimum period over which the economic benefits associated with the acquisition are expected to arise.

7. Reconciliation of Operating Profit to Net Cash Inflow/(Outflow) from Operating Activities

	Half year ended 30.06.2003 £m	Half year ended 30.06.2002 Restated £m	Year ended 31.12.2002 £m
Group operating profit.....	1,759	1,409	2,849
Decrease in prepayments and accrued income	24	37	806
Increase/(decrease) in accruals and deferred income	12	(841)	(684)
Provision for bad and doubtful debts	499	379	832
Depreciation and goodwill amortisation	343	296	634
Amortisation of premiums/(discounts) on debt securities ..	10	(39)	(6)
Income from long term assurance business.....	(216)	(124)	(233)
Interest on subordinated liabilities	304	256	518
Profits on sale of investment securities	(32)	(19)	(37)
Profits on sale of fixed assets.....	(8)	(9)	(14)
Provisions utilised	(86)	(63)	(236)
Provisions for liabilities and charges	72	97	216
Provision against debt securities and equity shares	9	7	24
Exchange differences and other non cash movements	171	497	384
Net cash inflow from trading activities	2,861	1,883	5,053
Net (decrease)/increase in notes in circulation	(90)	5	84
Net increase in items in course of collection.....	(268)	(215)	(110)
Net (increase)/decrease in treasury and other eligible bills	(2,129)	1,673	(1,893)
Net increase in loans and advances to banks and customers	(16,834)	(10,510)	(34,879)
Net increase in deposits by banks and customer accounts	7,187	9,861	24,893
Net increase in debt securities in issue	11,046	1,573	11,243
Net (increase)/decrease in other assets	(1,607)	899	(3,217)
Net increase in other liabilities	2,113	100	3,759
Net increase in debt securities	(2,268)	(5,750)	(5,927)
Net cash inflow/(outflow) from operating activities	11	(481)	(994)

- 8.** The financial information included in this announcement is unaudited and does not constitute statutory accounts within the meaning of section 240 of the Companies Act 1985 (“the Act”). The statutory accounts for HBOS plc for the year ended 31 December 2002 have been filed with the Registrar of Companies for Scotland. The Auditors have reported on those accounts; their report was unqualified and did not contain a statement under section 237(2) or (3) of the Companies Act 1985.

Independent Review Report by KPMG Audit Plc to HBOS plc

Introduction

We have been engaged by the company to review the financial information contained within the HBOS plc Interim Results 2003, which is reproduced on pages S-21 to S-28 and we have read the other information contained in the Interim Results 2003 Stock Exchange Announcement (“Interim Report”) and considered whether it contains any apparent misstatements or material inconsistencies with the financial information.

This report is made solely to the company in accordance with the terms of our engagement to assist the company in meeting the requirements of the Listing Rules of the Financial Services Authority. Our review has been undertaken so that we might state to the company those matters we are required to state to it in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company for our review work, for this report, or for the conclusions we have reached.

Directors’ responsibilities

The Interim Report, including the financial information contained therein, is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the Interim Report in accordance with the Listing Rules which require that the accounting policies and presentation applied to the interim figures should be consistent with those applied in preparing the preceding annual accounts except where they are to be changed in the next annual accounts in which case any changes, and the reasons for them, are to be disclosed.

Review work performed

We conducted our review in accordance with guidance contained in Bulletin 1999/4: *Review of interim financial information* issued by the Auditing Practices Board for use in the United Kingdom. A review consists principally of making enquiries of group management and applying analytical procedures to the financial information and underlying financial data and, based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review is substantially less in scope than an audit performed in accordance with Auditing Standards and therefore provides a lower level of assurance than an audit. Accordingly we do not express an audit opinion on the financial information.

Review conclusion

On the basis of our review we are not aware of any material modifications that should be made to the financial information as presented for the six months ended 30 June 2003.

KPMG Audit Plc
Chartered Accountants
Edinburgh
30 July 2003

**HBOS plc***as Issuer and Guarantor***The Governor and Company of the Bank of Scotland***as Issuer and Guarantor***HBOS Treasury Services plc****Scotland International Finance No. 2 B.V.***and other designated subsidiaries of HBOS plc from time to time**as Issuers*

MEDIUM-TERM NOTES

Due Nine Months or More From Date of Issue

The Medium-Term Notes (the "Notes") are being offered on a continuous basis by HBOS plc ("HBOS" or the "Company"), The Governor and Company of the Bank of Scotland ("Bank of Scotland"), HBOS Treasury Services plc ("Treasury Services"), Scotland International Finance No. 2 B.V. ("SIF No. 2"), and other designated subsidiaries of the Company (each, an "Issuer" and, collectively, the "Issuers") from time to time through one or more of the agents specified below or otherwise appointed by an Issuer from time to time for the purpose of soliciting offers to purchase the Notes from such Issuer (for so long as each shall so remain, an "Agent" and, collectively, the "Agents"), who have agreed to use their best efforts to solicit offers to purchase the Notes. Each Issuer has also reserved the right to sell, and may solicit and accept offers to purchase, Notes directly on its own behalf. The Notes are being offered and sold without registration under the United States Securities Act of 1933, as amended (the "Securities Act"), (A) to institutional purchasers in reliance upon the exemption provided by Section 4(2) of the Securities Act and Regulation D and Rule 144A promulgated thereunder and (B) outside the United States to certain persons in reliance upon Regulation S under the Securities Act ("Regulation S"). Each Issuer reserves the right to withdraw, cancel or modify the offer made hereby without notice. Each Issuer or the Agents may reject any offer to purchase Notes, in whole or in part. See "Plan of Distribution".

EACH PURCHASER OF THE NOTES OFFERED HEREBY IN MAKING ITS PURCHASE WILL BE DEEMED TO HAVE MADE CERTAIN ACKNOWLEDGMENTS, REPRESENTATIONS AND AGREEMENTS AS SET FORTH ON THE INSIDE FRONT COVER OF THIS OFFERING MEMORANDUM.

MORGAN STANLEY**CREDIT SUISSE FIRST BOSTON****JPMORGAN****LEHMAN BROTHERS****MERRILL LYNCH & CO.***April 30, 2003*

NOTICE TO PURCHASERS

NONE OF THE ISSUERS HAS REGISTERED THE NOTES OFFERED HEREBY NOR DOES ANY ISSUER INTEND TO, OR HAVE ANY OBLIGATION TO, REGISTER THE NOTES PURSUANT TO THE SECURITIES ACT OR UNDER THE SECURITIES LAWS OF ANY STATE AND THE NOTES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION (THE “COMMISSION”) OR ANY STATE SECURITIES AUTHORITY. NEITHER THE COMMISSION NOR ANY STATE SECURITIES AUTHORITY HAS PASSED UPON THE ACCURACY OR ADEQUACY OF THIS OFFERING MEMORANDUM. THE NOTES ARE BEING OFFERED AND SOLD TO INSTITUTIONAL PURCHASERS IN RELIANCE UPON THE EXEMPTION PROVIDED BY SECTION 4(2) OF THE SECURITIES ACT AND REGULATION D AND RULE 144A AND OUTSIDE THE UNITED STATES TO CERTAIN PERSONS IN RELIANCE ON REGULATION S PROMULGATED UNDER THE SECURITIES ACT.

Each purchaser of a Note or Notes offered hereby in making its purchase will be deemed to have acknowledged, represented and agreed as follows:

(1) The Notes have not been and will not be registered under the Securities Act or any other applicable securities law and, accordingly, none of the Notes may be offered, sold, transferred, pledged, encumbered or otherwise disposed of unless either registered pursuant to, or in a transaction exempt from registration under, the Securities Act and any other applicable securities law.

(2) (A) It is (i) an institutional investor that is an “accredited investor” within the meaning of Rule 501(a)(1), (2), (3) or (7) under the Securities Act (an “Accredited Investor”) that is purchasing for its own account or that is a bank (as defined in Section 3(a)(2) under the Securities Act) or a savings and loan association or other institution (as described in Section 3(a)(5)(A) under the Securities Act) that is purchasing as a fiduciary for the account of one or more institutional investors (individually, an “Institutional Account”) or (ii) an Accredited Investor other than a bank (as so defined) or a savings and loan association or other institution (as so described) that is purchasing for one or more Institutional Accounts, each of which is an Accredited Investor; it has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of purchasing the Notes; it is aware that it (or any Institutional Account) may be required to bear the economic risk of an investment in each Note for an indefinite period, and it (or such Institutional Account) is able to bear such risk for an indefinite period; it is purchasing the Notes for its own account, or for one or more Institutional Accounts for which it is acting as a fiduciary or agent, in a minimum principal amount of \$250,000 (or the equivalent thereof in another currency or composite currency) for each such Institutional Account, in each case for investment and not with a view to, or for offer or sale in connection with, any distribution thereof, subject to the disposition of its property or the property of such Institutional Account or Accounts being at all times within its or their control and subject to its or their ability to resell such Notes pursuant to Rule 144A, Regulation S or other exemption from registration available under the Securities Act; (B) if such purchaser is acquiring the Notes from a person other than the Issuer thereof and the seller is relying on Rule 144A under the Securities Act, such purchaser is a “qualified institutional buyer”, as defined in Rule 144A under the Act (a “QIB”), and is purchasing for its own account or solely for the account of one or more accounts for which it acts as a fiduciary or agent, each of which accounts is a QIB and such purchaser acknowledges that it is aware that the seller may rely upon the exemption from the provisions of Section 5 of the Securities Act provided by Rule 144A thereunder or (C) it is a purchaser acquiring such Notes in an offshore transaction occurring outside the United States within the meaning of Regulation S that is not a “U.S. Person” (and is not acquiring such Notes for the account or benefit of a U.S. Person) within the meaning of Regulation S.

(3) It agrees on its own behalf and on behalf of any Institutional Account for which it is purchasing Notes, to offer, sell or otherwise transfer such Notes (A) only in minimum principal amounts of \$1,000 (or \$250,000 in the case of any offer, sale or transfer to an Accredited Investor) (or, in each case, the equivalent thereof in another currency or composite currency) and (B) prior to the date that is two years after the later of (i) the Original Issue Date of such Notes and (ii) the last date on which the Issuer

thereof or the Company or any affiliate of the Issuer or the Company was the beneficial owner of such Notes (or any predecessor of such Notes) only (a) pursuant to the exemption from the registration requirements of the Securities Act provided by either Rule 144A or Regulation S thereunder, (b) to such Issuer, the Company or any of their respective subsidiaries or an Agent that is a party to the Amended and Restated Private Placement Agreement dated April 30, 2003, as amended, referred to in this Offering Memorandum, (c) through an Agent to an institutional investor that is an Accredited Investor approved in advance by such Agent, (d) directly to an institutional investor that is an Accredited Investor or (e) pursuant to an exemption from such registration requirements as confirmed in an opinion of counsel satisfactory to such Issuer and the Company (subject in each of the foregoing cases to any requirement of law that the disposition of its property or the property of such Institutional Account or Accounts remain within its or their control). It acknowledges that each Note will contain a legend substantially to the effect of the foregoing paragraph (1) and this paragraph (3).

(4) It acknowledges that the Trustee referred to herein will register the transfer of any Note resold or otherwise transferred by such purchaser pursuant to clauses (a), (c), (d) or (e) of the foregoing paragraph (3) only: (A) in the case of a sale or other transfer pursuant to such clause (a), upon receipt from the transferor of a certificate to the effect set forth in the relevant paragraph of Exhibit A hereto; (B) in the case of a sale or other transfer pursuant to such clause (c), upon receipt from the relevant Agent of a certificate to the effect set forth in the relevant paragraph of Exhibit A hereto; (C) in the case of a sale or other transfer pursuant to such clause (d), upon receipt in writing from such purchaser's transferee of a statement to the effect set forth in Exhibit B hereto; or (D) in the case of a sale or other transfer pursuant to such clause (e), upon receipt of an opinion of counsel satisfactory to the Issuer and the Company.

(5) It acknowledges that the Issuers, the Company, the Agents and others will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements and it agrees that, if any of the acknowledgments, representations or warranties deemed to have been made by it in connection with its purchase of Notes are no longer accurate, it shall promptly notify the Issuer of such Notes, the Company and the Agent through which it purchased any Notes. If it is acquiring any Notes as a fiduciary or agent for one or more Institutional Accounts, it represents that it has sole investment discretion with respect to each such Institutional Account and that it has full power to make the foregoing acknowledgments, representations and agreements on behalf of each such Institutional Account.

Each person receiving this Offering Memorandum acknowledges that (i) such person has been afforded an opportunity to request from the Issuers and the Company and to review, and has received, all additional information considered by it to be necessary to verify the accuracy and completeness of the information contained herein, (ii) it has not relied on any Agent or any person affiliated with any Agent in connection with its investigation of the accuracy and completeness of such information or its investment decision and (iii) no person has been authorized to give any information or to make any representation concerning any Issuer, the Company or the Notes offered hereby other than those contained herein and, if given or made, such other information or representation should not be relied upon as having been authorized by such Issuer, the Company or any Agent.

This Offering Memorandum does not constitute, and may not be used for the purposes of, an offer or solicitation by anyone in any jurisdiction in which such offer or solicitation is not authorized or to any person to whom it is unlawful to make such offer or solicitation, and no action is being taken to permit an offering of the Notes or the distribution of this Offering Memorandum in any jurisdiction where such action is required.

In connection with the issue and distribution of any tranche of Notes, the Agent (if any) disclosed as the stabilizing manager in the applicable Pricing Supplement or any person acting for such Agent may over-allot or effect transactions with a view to supporting the market price of the Notes of a series of which such tranche forms part at a level higher than that which might otherwise prevail for a limited period after the issue date. However, there may be no obligation on the stabilizing manager or any agent of the stabilizing manager to do this. Such stabilizing, if commenced, may be discontinued at any time and must be brought to an end after a limited period.

NOTICE TO NEW HAMPSHIRE RESIDENTS

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER CHAPTER 421-B OF THE NEW HAMPSHIRE REVISED STATUTES WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE THAT ANY DOCUMENT FILED UNDER RSA 421-B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE SECRETARY OF STATE HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY, OR TRANSACTION. IT IS UNLAWFUL TO MAKE, OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER, OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

Each prospective purchaser of the Notes is hereby offered the opportunity to ask questions of the Issuers, the Company and the Agents concerning the terms and conditions of the offering and to request any additional information such prospective purchaser may consider necessary in making an informed investment decision or in order to verify the information set forth herein. Inquiries concerning such additional information should be directed to:

Manager, Continuously Offered Products, Morgan Stanley & Co. Incorporated, 1585 Broadway, New York, NY 10036, (212) 761-2000; or

Manager, Credit Department, Morgan Stanley & Co. Incorporated, 1221 Avenue of the Americas, 35th Floor, New York, New York 10020, (212) 762-5852; or

MTN Department, Credit Suisse First Boston Corporation, 11 Madison Avenue, 5th Floor, New York, NY 10010, (212) 325-3326; or

Medium-Term Note Desk, J.P. Morgan Securities Inc., 270 Park Avenue, New York, New York 10017, (212) 834-6081.

Medium-Term Note Desk, Lehman Brothers Inc., 745 Seventh Avenue, New York, New York 10019, (212) 526-9664; or

Medium-Term Note Product Management, Merrill Lynch & Co., 4 World Financial Center, North Tower, 15th Floor, New York, New York 10080, (212) 449-7476; or

AVAILABLE INFORMATION

Upon written request to the Company at the address set forth below, the Company will deliver its Report and Accounts for the last audited financial period to holders of the Notes (individually, a “Holder” or a “Noteholder” and, collectively, the “Holders” or the “Noteholders”). Any such request will be subject to the confidentiality provisions referred to below. The financial statements contained in such Report and Accounts will be prepared in accordance with accounting principles generally accepted in the United Kingdom of Great Britain and Northern Ireland (“Great Britain”, the “U.K.” or the “United Kingdom”) and will not contain a reconciliation to accounting principles generally accepted in the United States of America (the “U.S.” or the “United States”). Written requests for the Report and Accounts of the Company should be addressed to the Company’s Head Office, the Mound, Edinburgh EH1 1YZ.

While any Notes remain outstanding, the relevant Issuer shall, during any period in which the Company is not subject to Section 13 or 15(d) of the Exchange Act or exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, make available to any qualified institutional buyer (as defined in Rule 144A under the Securities Act) who holds any Note and any prospective purchaser of a Note who is a qualified institutional buyer (as so defined) designated by such holder of such Note, upon the request of such holder or prospective purchaser, the information concerning the Company required to be provided to such holder or prospective purchaser by Rule 144A(d)(4) under the Securities Act.

By requesting copies of any of the documents referred to herein, each potential purchaser agrees to keep confidential the various documents and all written information clearly labelled “Confidential” which from time to time have been or will be disclosed to it concerning the Company or any other Issuer or any of their affiliates, and agrees not to disclose any portion of the same to any person.

Notwithstanding anything herein to the contrary, except as reasonably necessary to comply with applicable securities laws, investors (and each employee, representative or other agent of the investors) may disclose to any and all persons, without limitation of any kind, the U.S. federal income tax treatment and tax structure of the offering and all materials of any kind (including opinions or other tax analyses) that are provided to the investors relating to such tax treatment and tax structure. For this purpose, “tax structure” is limited to facts relevant to the U.S. federal income tax treatment of the offering and does not include information relating to the identity of the issuer, its affiliates, agents or advisors.

FORWARD-LOOKING STATEMENTS

This Offering Memorandum contains various forward-looking statements regarding events and trends that are subject to risks and uncertainties that could cause the actual results and financial position of the Company or the Company and its consolidated subsidiaries and subsidiary undertakings (collectively, the “HBOS Group” or the “Group”) to differ materially from the information presented herein. When used in this Offering Memorandum, the words “estimate”, “project”, “intend”, “anticipate”, “believe”, “expect”, “should” and similar expressions, as they relate to the Group and its management, are intended to identify such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Group does not undertake any obligation to publicly release the result of any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

ENFORCEMENT OF LIABILITIES; SERVICE OF PROCESS

The Company is a public limited company incorporated on May 3, 2001 and registered in Scotland with its headquarters in Edinburgh. As a consequence of the merger of Bank of Scotland and Halifax Group plc (“Halifax”), the Company became the holding company of the Group. Bank of Scotland is a U.K. clearing

bank established by an Act of the Parliament of Scotland in 1695 with its headquarters in Edinburgh. Treasury Services is a company registered in England and Wales. SIF No. 2 is a finance company incorporated in The Netherlands. Substantially all the directors and executive officers of the Company, Bank of Scotland, Treasury Services and SIF No. 2 are non-residents of the United States. All or a substantial portion of the assets of such non-resident persons and of the Company, Bank of Scotland, Treasury Services and SIF No. 2 are located outside the United States. As a result, it may not be possible for investors to effect service of process within the United States upon such persons, the Company, Bank of Scotland, Treasury Services or SIF No. 2 or to enforce against them in U.S. courts judgments obtained in such courts predicated upon civil liability provisions of the federal securities laws of the United States. The Company, Bank of Scotland and Treasury Services have been advised by their solicitors, Shepherd+ Wedderburn, and SIF No. 2 has been advised by its Dutch counsel, De Brauw Blackstone Westbroek, London, that there is doubt as to the enforceability in the United Kingdom and The Netherlands, respectively, in original actions or in actions for the enforcement of judgments of U.S. courts, of civil liabilities predicated upon the federal securities laws of the United States.

PRESENTATION OF FINANCIAL INFORMATION

The Financial Statements are prepared in accordance with generally accepted accounting principles in the United Kingdom (“U.K. GAAP”). U.K. GAAP relevant to the Group differ from generally accepted accounting principles in the United States (“U.S. GAAP”) in certain material aspects. For a discussion of material differences between U.K. GAAP and U.S. GAAP relevant to the Financial Statements, see “Annex A to the Consolidated Financial Statements”. In addition, the audited financial information contained herein is subject to auditing and auditor independence standards applicable in the United Kingdom, which differ from those applicable in the United States.

In this Offering Memorandum, references to “£”, “sterling”, “pounds sterling” and “pence” are to the lawful currency of the United Kingdom; references to “U.S.\$”, “\$”, “U.S. dollars” and “cents” are to the lawful currency of the United States; references to “€” or “euro” are to the currency established for participating members of the European Union as of the beginning of stage three of European Monetary Union on January 1, 1999; references to “¥” or “Yen” are to the lawful currency of Japan. Merely for convenience, this Offering Memorandum contains translations of certain sterling amounts into U.S. dollars at specified rates. These translations should not be construed as representations that the sterling amounts actually represent such U.S. dollar amounts or could be converted into U.S. dollars at the rate indicated. See “Exchange Rate and Currency Information”.

Unless otherwise indicated, any reference in this Offering Memorandum to the “Financial Statements” is to the audited Consolidated Financial Statements (including the notes thereto) of the Group included in this Offering Memorandum.

For the purposes of the presentation of financial information in the sections entitled “Summary of Terms — Selected Consolidated Financial Information”, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Description of Business”, the term “Group” refers to HBOS plc together with its consolidated subsidiaries and subsidiary undertakings (including, among others, Bank of Scotland and Halifax).

In this Offering Memorandum, all references to “billions” are references to one thousand millions. Due to rounding, the numbers presented throughout this Offering Memorandum may not add up precisely, and percentages may not precisely reflect absolute figures.

Certain financial and statistical information in this Offering Memorandum is presented separately for domestic and foreign activities. Foreign activities include transactions in which the debtor or customer is domiciled outside the United Kingdom. For the purposes of such financial and statistical information, the United Kingdom includes the Channel Islands and the Isle of Man.

EXCHANGE RATES

The following table shows, for the dates indicated, the Applicable Exchange Rate used in the preparation of the Group's Consolidated Financial Statements, expressed in U.S. dollars per £1.00.

<u>Date</u>	<u>Applicable Exchange Rate</u>
December 31, 2002	\$1.6120
December 31, 2001	1.4517
February 28, 2001	1.4428
February 29, 2000	1.5807
February 28, 1999	1.5992

A significant portion of the assets and liabilities of the Group are denominated in currencies other than sterling. However, in the opinion of the Company, fluctuations in the value of sterling relative to other currencies have not constituted a significant change in the context of the total value of Group assets, liabilities, interest income and interest expense.

Fluctuations in exchange rates that have occurred in the past are not necessarily indicative of fluctuations in rates that may occur at any time in the future. No representations are made herein that the pound sterling amounts referred to herein could have been or could be converted into U.S. dollars at any particular rate.

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SUMMARY OF TERMS

This summary does not purport to be complete and is qualified in its entirety by reference to the detailed information appearing elsewhere in this Offering Memorandum. Terms not defined in this summary are defined elsewhere herein.

The Issuers HBOS plc, The Governor and Company of the Bank Scotland, HBOS Treasury Services plc, Scotland International Finance No. 2 B.V. and other designated subsidiaries of the Company from time to time.

Terms of the Notes and

the Guarantees The Notes, which may be issued at their principal amount or at a premium to or discount from their principal amount, on a subordinated or unsubordinated basis, may bear interest at a fixed or floating rate or be issued on a fully discounted basis and not bear interest. The interest rate or interest rate formulae, if any, issue price, currency, terms of redemption or repayment, if any, maturity and other terms not otherwise provided in this Offering Memorandum will be established for each Note by the Issuer thereof at the issuance of such Note and will be indicated in a Pricing Supplement. Senior Notes issued by any Issuer (other than the Company) will be guaranteed by the Company as described in “Description of the Notes and the Guarantees”. Senior Notes issued by Treasury Services or any other designated subsidiary of the Company (other than Bank of Scotland) will also be guaranteed by Bank of Scotland as described in “Description of the Notes and the Guarantees”. Subordinated Notes issued by any Issuer (other than the Company) will be guaranteed on a subordinated basis by the Company as described in “Description of the Notes and the Guarantees”. Subordinated Notes issued by SIF No. 2 and any other designated subsidiary of the Company (other than Bank of Scotland) will also be guaranteed on a subordinated basis by Bank of Scotland as described in “Description of the Notes and the Guarantees”.

Method of Distribution The Notes are being offered on a continuous basis by the Issuers through the Agents. The Issuers may also sell Notes to the Agents acting as principals for resale to investors or other purchasers and may sell Notes directly on their own behalf. See “Plan of Distribution”.

Program Amount The aggregate principal amount (or, in the case of Notes issued at a discount from the principal amount or Indexed Notes, the aggregate initial offering price) of Notes outstanding at any time shall not exceed (together with securities then outstanding under the Issuers’ and BOS International (Australia) Limited’s Program for the Issuance of Debt Instruments described in their Information Memorandum dated April 30, 2003) \$65,000,000,000 or the approximate equivalent thereof in another currency calculated as at the issue date of the relevant Notes. BOS International (Australia) Limited is a direct, wholly-owned, guaranteed, subsidiary of Bank of Scotland.

Status The Senior Notes and the Senior Guarantee, if any, will be direct, unsecured and unsubordinated obligations of the respective Issuer (other than SIF No. 2), Bank of Scotland and the Company, as the case may be, and rank pari passu among themselves and with all other unsecured and unsubordinated obligations of such Issuer, Bank of Scotland and the Company, as the case may be, other than any obligations preferred by statute or by operation of law.

The Subordinated Notes (other than Undated Notes) and the Subordinated Guarantee (other than a Subordinated Guarantee in respect of Undated Notes), if any, will be unsecured subordinated obligations of the respective Issuer (other than Treasury Services), Bank of Scotland and the Company, as the case may be, and rank pari passu among themselves all as described in “Description of the Notes and the Guarantees”. The Undated Notes, and the Subordinated Guarantee issued in respect of Undated Notes, if any, will be unsecured subordinated obligations of the respective Issuer (other than SIF No. 2 and Treasury Services), Bank of Scotland and the Company, as the case may be, and rank pari passu among themselves all as described in “Description of the Notes and the Guarantees”. SIF No. 2 may not issue Undated Notes and Treasury Services may not issue Subordinated Notes.

Unless otherwise stated in the applicable Pricing Supplement, Subordinated Notes are intended to constitute Tier 2 Capital in accordance with the requirements of the U.K. Financial Services Authority.

Maturities The Notes will mature on a date nine months or more from their Original Issue Dates, as selected by the initial purchaser and agreed to by the Issuer thereof in the applicable Pricing Supplement. Unless otherwise provided in the applicable Pricing Supplement, Subordinated Notes, under the requirements of the U.K. Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, must have a minimum maturity of at least five years and one day.

Currency The Notes will be denominated in U.S. dollars unless otherwise specified in the applicable Pricing Supplement. The Issuer may also issue Notes denominated in another currency, as set forth in the applicable Pricing Supplement. See “Description of the Notes and the Guarantees”.

Form and Denomination The Notes will be issued in fully registered form in minimum denominations of \$1,000 (or, in the case of Notes not denominated in U.S. dollars, the equivalent thereof in such foreign currency, rounded down to the nearest 1,000 units of such foreign currency) and integral multiples of \$1,000 (or, in the case of Notes not denominated in U.S. dollars, 1,000 units of such foreign currency) in excess thereof.

Notes sold to QIBs in reliance on Rule 144A will be represented by one or more global Notes (each, a “Rule 144A Global Note”), registered in the name of a nominee of DTC. Notes sold outside of the United States to non-U.S. Persons (as defined in Regulation S) in offshore transactions in reliance on Regulation S will be represented by one or more global Notes (each, a “Regulation S Global Note” and, together with the Rule 144A Global Notes, the “Global Notes”), registered in the name of a nominee of DTC. All other Notes will be represented by definitive Notes. See “Description of the Notes and the Guarantees — Book Entry, Delivery and Form”.

Interest Rates Interest bearing Notes may be issued either as Fixed Rate Notes or Floating Rate Notes. Interest on Floating Rate Notes will be determined with reference to one or more of the Commercial Paper Rate, the Prime Rate, the CD Rate, the Federal Funds Rate, EURIBOR, LIBOR, the Treasury Rate, the CMT Rate or another interest rate basis, each as

adjusted by the Spread and/or Spread Multiplier, if any, as set forth in the applicable Pricing Supplement. Any Floating Rate Note may also have a maximum and/or minimum interest rate limitation. See “Description of the Notes and the Guarantees”.

Interest Payment Dates	Unless otherwise indicated in the applicable Pricing Supplement, interest on Fixed Rate Notes will be payable annually on June 1 or semiannually on June 1 and December 1 and at Maturity. Unless otherwise indicated in the applicable Pricing Supplement, interest on Floating Rate Notes will be payable quarterly on the dates set forth in the applicable Pricing Supplement and at Maturity.
Redemption and Repurchase	The applicable Pricing Supplement will indicate either that the Notes cannot be redeemed prior to Maturity other than for taxation reasons, or will indicate the terms on which the Notes will be redeemable at the option of the Issuer thereof or redeemable at the option of the Holder thereof or both. An Issuer of Notes, the Company or Bank of Scotland may at any time purchase such Notes in the open market. Under the requirements of the U.K. Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, Subordinated Notes may not be redeemed prior to their Stated Maturity at the option of the Holder thereof, and may not be redeemed prior to their Stated Maturity or purchased by the Issuer thereof, the Company or Bank of Scotland without the prior consent of the U.K. Financial Services Authority.
Indexed Notes	Notes may be issued with the amount of principal thereof or interest thereon (or both) payable to be determined by reference to the value of one or more currency exchange rates, commodity prices, equity indices or other factors. See “Description of the Notes and the Guarantees”.
Amortizing Notes	Fixed Rate Notes may be issued as Amortizing Notes under which payments combining principal and interest are made in installments over the life of the Note. Payments with respect to Amortizing Notes will be applied first to interest due and payable thereon and then to the reduction of the unpaid principal amount thereof.
Taxation	Payments of principal of and interest on the Notes will be made without deduction for or on account of withholding requirements with respect to income taxes, subject to certain limited exceptions. For a more detailed discussion of U.S., U.K. and Dutch tax considerations, see “Taxes”.
Trustee	The Senior Notes offered hereby will be issued pursuant to an Amended and Restated Indenture dated as of April 30, 2003, as amended and supplemented from time to time, among the Company, Bank of Scotland, Treasury Services and The Bank of New York, as Trustee (the “Trustee”). The Subordinated Notes offered hereby will be issued pursuant to an Amended and Restated Indenture dated as of April 30, 2003, as amended from time to time, among the Company, Bank of Scotland, SIF No. 2 and the Trustee.
Paying Agent	Citibank, N.A., London office, will act as Paying Agent, Authenticating Agent, Registrar and, unless otherwise specified in the applicable Pricing Supplement, as Exchange Rate Agent and Interest Rate Calculation Agent.

SELECTED CONSOLIDATED FINANCIAL INFORMATION

HBOS was incorporated on May 3, 2001. As a consequence of the approval of schemes of arrangement of Bank of Scotland and Halifax, which became effective on September 7 and September 10, 2001, respectively, it became the holding company of the Group. In accordance with merger accounting principles under U.K. GAAP, the Group's results have been presented as if the new group had been established throughout 2000 and 2001.

The financial information set forth on the following pages as at the end of and for each of the three years ended December 31, 2002, 2001 and 2000 has been extracted unless otherwise stated from the consolidated financial statements and notes thereto of the Group for those years, as audited by KPMG Audit Plc, independent auditors (together, the "Consolidated Financial Statements"). The financial information contained in this Offering Memorandum should be read in conjunction with, and is qualified by reference to, the Consolidated Financial Statements and notes thereto, as set out in Annex A to this Offering Memorandum.

The Group's Consolidated Financial Statements are prepared in accordance with U.K. GAAP, which differ in certain significant respects from U.S. GAAP. See "Differences Between U.K. and U.S. Generally Accepted Accounting Principles" at Annex A to the Consolidated Financial Statements for an explanation of the relevant principal differences between U.K. GAAP and U.S. GAAP.

SUMMARY CONSOLIDATED PROFIT AND LOSS ACCOUNT

	Year ended December 31,		
	2002	2001	2000
	(Restated)		
	(in £ millions, except per share)		
Net interest income	4,770	4,155	4,031
Non-interest income	2,776	2,379	2,213
Total income	7,546	6,534	6,244
Operating expenses	(3,762)	(3,505)	(3,070)
General insurance claims	(79)	(68)	(11)
Provisions for bad and doubtful debts	(832)	(608)	(471)
Amounts written off fixed asset investments	(24)	(21)	(9)
Total operating profit	2,849	2,332	2,683
Share of operating profits/(losses) of joint ventures	8	20	(35)
Share of profits of associated undertakings	27	16	20
Profit on disposal of business	25	—	—
Merger costs — exceptional	—	(76)	—
Profit before taxation	2,909	2,292	2,668
Taxation	(835)	(663)	(757)
Attributable to minority interests	(158)	(161)	(133)
Profit attributable to shareholders	1,916	1,468	1,778
<i>Dividends</i>			
Preference	(37)	(37)	(37)
Ordinary	(1,140)	(993)	(789)
Retained profit	739	438	952
Pence per share Underlying earnings per share ⁽¹⁾	56.1p	47.7p	55.6p
Basic earnings per share	50.6p	40.5p	49.9p
Diluted earnings per share	50.2p	40.1p	49.7p

(1) Underlying earnings per share have been calculated excluding exceptional items and amortization of goodwill.

SUMMARY CONSOLIDATED BALANCE SHEET

	Year ended December 31,		
	2002	2001	2000
	(Restated)		
	(in £ millions, except per share)		
<i>Called up share capital</i>			
Ordinary shares	946	892	878
Preference shares	400	400	400
Reserves	12,423	10,121	9,260
Shareholders' funds	13,769	11,413	10,538
Minority interests	2,139	2,095	1,474
Capital and reserves	15,908	13,508	12,012
Subordinated undated loan capital	3,437	2,957	2,131
Subordinated dated loan capital	5,690	4,966	3,854
Deposits by banks, customer accounts and debt securities in issue...	276,629	240,493	206,018
Loans and advances to customers and banks	246,153	210,822	188,005
Cumulative provisions for bad and doubtful debts	2,024	1,769	1,578
Total assets	355,080	312,071	266,143
Net assets per share	353p	309p	289p

OTHER FINANCIAL DATA (unaudited)

	Year ended December 31,		
	2002	2001	2000
	(Restated)		
Post-tax return on mean equity ⁽¹⁾	16.3%	15.1%	19.5%
Net interest margin ⁽²⁾	1.86%	1.87%	1.95%
Cost to total income ratio ⁽³⁾	45.2%	49.2%	43.3%
Basel convergence ratios ⁽⁴⁾ Tier 1 capital	7.9%	7.9%	7.9%
Total capital	10.4%	10.6%	10.7%
<i>Closing provisions as a percentage of year end customer advances</i>			
Specific	0.56%	0.56%	0.57%
General	0.30%	0.34%	0.36%
Total	0.86%	0.90%	0.93%

- (1) Profit attributable to ordinary shareholders before exceptional items expressed as a percentage of the average of opening and closing equity shareholders' funds.
- (2) Net interest income expressed as a percentage of average balances of interest earning assets (excluding trading assets). In 2000 the net interest margin has been calculated as net interest income expressed as a percentage of average balances of interest earning assets (including trading assets).
- (3) Underlying operating expenses excluding exceptional items, goodwill amortization and operating lease depreciation divided by underlying operating income after deducting operating lease depreciation, amounts written off fixed asset investments and general insurance claims.
- (4) Tier 1 and total capital expressed as a percentage of risk weighted assets, including off-balance sheet items calculated in accordance with the Basel Guidelines.

THE COMPANY

On September 10, 2001, Bank of Scotland and Halifax Group plc (“Halifax”) merged under HBOS. HBOS is the ultimate holding company for Halifax plc, Bank of Scotland and a number of other subsidiaries principally carrying on financial services business. HBOS is a public limited company incorporated in Scotland (registered number SC218813) under the Companies Act 1985 with its head office, corporate headquarters and registered office at The Mound, Edinburgh EH1 1YZ, Scotland.

HBOS together with its subsidiaries and subsidiary undertakings (as defined in the Companies Act 1985) are collectively referred to as the “HBOS Group” or the “Group”. At December 31, 2002, HBOS Group had approximately 700 (directly and indirectly held) subsidiaries.

BANK OF SCOTLAND

Bank of Scotland, which was established by an Act of the Parliament of Scotland in 1695, is a U.K. clearing bank with its headquarters in Edinburgh. Bank of Scotland is an “authorised person” under the Financial Services and Markets Act 2000. As at December 31, 2002, Bank of Scotland operated from locations throughout the world including more than 350 branch outlets in Scotland, London and other regional commercial centres in England, as well as from overseas branches in New York City, Hong Kong, Paris, Amsterdam, Singapore, Grand Cayman, Frankfurt and Madrid and representative offices in Chicago, Illinois; Houston, Texas; Los Angeles, California; Seattle, Washington; and Minneapolis, Minnesota. It is a member of the British Bankers’ Association and the Committee of Scottish Clearing Bankers. The Bank Notes (Scotland) Act 1845 confirmed Bank of Scotland’s right to issue bank notes in Scotland. At December 31, 2002 circulation of such notes was approximately £821 million. At December 31, 2002, Bank of Scotland had approximately 360 (directly and indirectly held) subsidiaries. Bank of Scotland together with its subsidiaries and subsidiary undertakings (as defined in the Companies Act 1985) are collectively referred to as the “Bank of Scotland Group”. The head office of Bank of Scotland is located at The Mound, Edinburgh EH1 1YZ, Scotland.

TREASURY SERVICES

Treasury Services, a direct, wholly owned subsidiary of Bank of Scotland, was registered in England and Wales on February 26, 1992 (registered number 2692890) for the purpose of taking over and developing Bank of Scotland’s treasury operations. Following the merger of Halifax and Bank of Scotland in 2001, substantially all of the treasury business of Halifax plc was transferred to Treasury Services with effect from June 1, 2002. On June 14, 2002, Treasury Services changed its name from Bank of Scotland Treasury Services PLC to HBOS Treasury Services plc. Treasury Services is an “authorised person” under the Financial Services and Markets Act 2000.

Bank of Scotland has unconditionally and irrevocably guaranteed due payment of all lawfully incurred present and future indebtedness and other obligations of Treasury Services. Treasury Services has unconditionally guaranteed due payment of all Bank of Scotland’s lawfully incurred present and future indebtedness and other obligations. Payments under the guarantee by Treasury Services in respect of Bank of Scotland’s subordinated obligations are subordinated until after the lawful claims of all Treasury Services’ ordinary or unsubordinated creditors have been satisfied in full.

Treasury Services provides centralised wholesale multi-currency funding, liquidity management and treasury services to HBOS and its subsidiary undertakings in the U.K. and the Republic of Ireland. From April 1, 2003, Treasury Services also has management responsibility for the treasury function in BOS Australia. Treasury Services manages the market risk arising from the HBOS Group’s Retail Banking, Business Banking and Corporate Banking Divisions. It operates in the world’s foreign exchange and money markets and also provides a range of treasury services to certain of the HBOS Group’s customers from offices in London and Glasgow. Treasury Services also trades in foreign exchange and in a limited range of derivative instruments primarily for risk management purposes. It leads the debt capital issuance and asset securitisation

activities of the HBOS Group in the United Kingdom. Treasury Services' registered office is located at 33 Old Broad Street, London EC2N 1HZ, England. Treasury Services has no subsidiaries.

SIF NO. 2

SIF No. 2 was incorporated with limited liability in The Netherlands on December 27, 1991 and is a direct, wholly owned subsidiary of Bank of Scotland. SIF No. 2 was established for the purpose of issuing and selling subordinated debt securities and making the proceeds of such issues available to Bank of Scotland Group. SIF No. 2 now makes the proceeds of such issues available to the HBOS Group. SIF No. 2 has its registered office at Amsterdam and its office at Herengracht 548, 1017 CG Amsterdam. As a Dutch finance company, SIF No. 2 is subject to the provisions of the 1992 Banking Act Exemption Regulation (Vrijstellingsregeling Wtk 1992) setting forth the criteria which Netherlands finance companies should meet in order not to require a licence as a credit institution (kredietinstelling) under Section 6 of the Dutch 1992 Act on the Supervision of the Credit System (Wet toezicht kredietwezen 1992) and other applicable laws and regulations of The Netherlands. On January 27, 1992 and February 6, 1992, SIF No. 2 issued an aggregate of \$300 million of 8.80% Subordinated Guaranteed Notes due January 27, 2004, on November 2, 1994 SIF No. 2 issued \$150 million of 8.85% Subordinated Guaranteed Notes due November 1, 2006, on February 15, 1996 SIF No. 2 issued \$150 million of 6.50% Subordinated Guaranteed Notes due February 15, 2011 and on August 22, 2000 SIF No. 2 issued \$500 million of 7.70% Subordinated Guaranteed Notes due August 15, 2010, all of which are unconditionally and irrevocably guaranteed on a subordinated basis by Bank of Scotland. SIF No. 2 lent the proceeds thereof to Bank of Scotland on a subordinated basis. SIF No. 2 has no subsidiaries.

USE OF PROCEEDS

The net proceeds from the issuance of the Senior Notes will be used for the general funding purposes of the Group. The net proceeds from the issuance of the Subordinated Notes will be used to strengthen the capital base of the Group and to support the continuing growth of its business.

An amount corresponding to at least 95% of the balance sheet total of SIF No. 2 shall be lent or invested in HBOS or any of HBOS' subsidiaries (*dochtermaatschappij*) as defined in Section 2:24a of the Dutch Civil Code (*Burgerlijk Wetboek*).

CAPITALIZATION

The following table shows the audited capitalization of the Group as at December 31, 2002 and has been extracted without material adjustment from the Group's Report and Accounts for the year ended December 31, 2002.

	As at December 31, 2002 (in £ millions)
<i>Shareholders' Funds</i>	
Preference shares (of £1 each, fully paid)	400
Ordinary shares (of 25p each, fully paid)	946
Reserves	12,423
Minority interests	
(equity)	436
(non-equity)	1,703
Subordinated liabilities	
Undated	3,437
Dated	<u>5,690</u>
Total capitalization	<u><u>25,035</u></u>

Since December 31, 2002, there have been no material changes in the HBOS Group's capitalization, indebtedness, contingent liabilities or guarantees save for the issue by HBOS of €1,000,000,000 4.875% Subordinated Notes due 2015 on March 20, 2003, U.S.\$1,000,000,000 6.85% Undated Subordinated Notes on March 21, 2003 and £600,000,000 5.75% Undated Subordinated Step-Up Notes on April 10, 2003 and the provision by HBOS of a subordinated guarantee in respect of the issue of U.S.\$1,000,000,000 6.85% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities by HBOS Capital Funding No. 1 L.P. on March 21, 2003.

The following table shows the audited capitalization of Bank of Scotland as at December 31, 2002 and has been extracted without material adjustment from Bank of Scotland's Report and Accounts for the year ended December 31, 2002.

	As at December 31, 2002 (in £ millions)
<i>Proprietors' Funds</i>	
Preference stocks (of £1 each, fully paid)	400
Ordinary stock (units of 25p each, fully paid)	367
Reserves	5,186
Minority interests	
(equity)	202
(non-equity)	400
Subordinated liabilities	
Undated	1,709
Dated	<u>3,046</u>
Total capitalization	<u><u>11,310</u></u>

Since December 31, 2002, there have been no material changes in Bank of Scotland's capitalization, indebtedness, contingent liabilities or guarantees, save that on April 30, 2003 Bank of Scotland issued 53,846,000 ordinary stock units of 25p each for a consideration of £350,000,000.

The following table shows the audited capitalization of Treasury Services as at December 31, 2002.

	As at December 31, 2002 (in £ millions)
Ordinary shareholders' equity	771
Undated subordinated loan capital	357
Dated subordinated loan capital	<u>397</u>
Total capital resources	<u><u>1,525</u></u>

Treasury Services' total capital resources are owned by the Company and the Company has unconditionally and irrevocably guaranteed due payment of all lawfully incurred present and future indebtedness and other obligations of Treasury Services.

Since December 31, 2002, there have been no material changes in Treasury Services' capitalization, indebtedness, contingent liabilities or guarantees.

The following table shows the audited capitalization of SIF No. 2 as at December 31, 2002.

	As at December 31, 2002 (in U.S.\$ millions)
Ordinary shareholders' equity	0.02
Dated loan capital	<u>1,100.00</u>
Total capital resources	<u><u>1,100.02</u></u>

The dated loan capital of SIF No. 2 consists of \$300 million of 8.80% Subordinated Guaranteed Notes due January 27, 2004, \$150 million of 8.85% Subordinated Guaranteed Notes due November 1, 2006, \$150 million of 6.50% Subordinated Guaranteed Notes due February 15, 2011 and \$500 million of 7.70% Subordinated Guaranteed Notes due August 15, 2010, the proceeds of which were lent by SIF No. 2 to Bank of Scotland on a subordinated basis. SIF No. 2's obligations under such issues of dated loan capital are unconditionally and irrevocably guaranteed on a subordinated basis by Bank of Scotland. None of the dated loan capital is secured.

Since December 31, 2002, there have been no material changes in SIF No. 2's capitalization, indebtedness, contingent liabilities or guarantees.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is based on the Consolidated Financial Statements included elsewhere in this Offering Memorandum. The Consolidated Financial Statements are prepared in accordance with U.K. GAAP, which differ in certain significant respects from U.S. GAAP. For an explanation of the relevant principal differences, see Annex A to the Consolidated Financial Statements.

Accounting Policies

The Group has now adopted the more generally accepted approach of using unsmoothed asset values for the purposes of projecting future cash flows attributable to the shareholder. Previously, these projections were based on smoothed asset values. The cumulative impact of this change of policy relating to previous years has been recognised in the accounts as a prior year adjustment and accordingly, the 2001 results have been restated. The cumulative impact of this change of accounting policy in 2002 was to reduce income from long term assurance business and profit before tax by £203 million (2001 £320 million), partially offset by an increase of £56 million (2001 nil) resulting from a reduction in the risk discount rate from 9%, to 8.5%. This reduced the taxation charge in 2002 by £49 million (2001 £92 million) partially offset by the tax effect on the risk discount rate of £15 million (2001 nil). The value of the Group's reserves at December 31, 2001 has been reduced by £190 million and minority interests (equity) by £10 million (2000 — increase of £28 million to the Group's reserves).

In 2002, the Group implemented FRS19 Deferred Tax. The cumulative impact on the taxation charge relating to previous years has been recognised in the accounts as a prior period adjustment and the 2001 results have been restated. The effect of implementing this new accounting standard in 2002 was to reduce the taxation on profit on ordinary activities by £11 million (2001 £10 million), increase the profit on ordinary activities after taxation by £11 million (2001 £10 million) and increase the value of the Group's reserves at December 31, 2001 by £135 million (2000 £125 million). This is mainly due to the recognition in full of a deferred tax asset on the general provision for bad and doubtful debts.

UITF 33 Obligations in capital instruments' was also implemented in 2002. This required reclassification of certain capital instruments from minority and other interests (non-equity) to undated loan capital. The impact of this in 2002 was to re-classify £297 million (2001 £297 million) of perpetual securities within the consolidated balance sheet from capital and reserves to liabilities. Within the consolidated profit and loss account £22 million (2001 £18 million) of interest on preferred securities was recognised in 2002 as interest payable rather than minority interests (non-equity).

The results for the year to December 31, 2000 have not been restated for the above changes in accounting policy.

The Group

The following table summarizes key indicators of the Group's performance for the years indicated:

	Year ended December 31,		
	2002	2001	2000
	(Restated)		
	(in £ millions, except percentages)		
Operating profit (before provisions for bad and doubtful debts)	3,681	2,940	3,154
Profit before taxation	2,909	2,292	2,668
Total assets	355,080	312,071	266,143
Post tax return on mean equity ⁽¹⁾	16.3%	15.1%	19.5%
Cost:income ratio (operating expenses to total income) ⁽²⁾	45.2%	49.2%	43.3%
Total capital resources	15,908	13,508	12,012
Tier 1 capital ratio	7.9%	7.9%	7.9%
Total capital ratio	10.4%	10.6%	10.7%

- (1) Profit attributable to ordinary shareholders before exceptional items expressed as a percentage of the average of opening and closing equity shareholders' funds.
- (2) The cost:income ratio is calculated excluding exceptional items, and goodwill amortization and after netting operating lease depreciation, amounts written off fixed asset investments and general insurance claims against operating income.

The Group operating profit before provisions for bad and doubtful debts in the year to December 31, 2002 was £3,681 million, compared to £2,940 million for the year ended December 31, 2001. This change represents an increase of 25%. Group pre-tax profit for the year to December 31, 2002 was £3,062 million before exceptional expenses of £153 million, compared to £2,515 million before exceptional expenses of £223 million for the year ended December 31, 2001. This change represents an increase of 22%.

Total assets increased in the year to December 31, 2002 by 14%, to £355 billion from £312 billion at December 31, 2001, due to strong lending growth.

The Group's post-tax return on mean equity before exceptional items for the year ended December 31, 2002 was 16.3%, compared to 15.1% for the year ended December 31, 2001.

The Group's cost to income ratio before exceptional items for the year ended December 31, 2002 was 45.2%, compared to 49.2% for the year ended December 31, 2001.

The Group's Tier 1 and total capital increased to £14,788 million and £19,527 million at December 31, 2002, respectively, from £12,415 million and £16,758 million, respectively, at December 31, 2001. The Tier 1 and total capital ratios were 7.9% and 10.4% respectively, compared with 7.9% and 10.6% at December 31, 2001. The minimum total capital ratios of 8% established by the Basel Committee serve as the base standard from which the Financial Services Authority sets individual bank ratios. The Group's ratios exceed the minimum requirements of the Basel Committee.

European economic and monetary union

The U.K. government has confirmed that it will make a decision on U.K. entry into the single European currency within 2 years of commencement of the current parliament, i.e. by June 2003.

The Group continues to monitor developments and remains actively involved in discussions within the banking industry and other sectors of the economy to help assess the implications of U.K. entry into the single European currency for the Group and its customers. The Group has further undertaken an assessment, under the direction of the Group's Euro Preparations Task Force (comprising senior representatives of the Group's U.K. business areas and support functions), of the potential impact arising from the U.K.'s entry to the single currency and what such a programme of work would entail.

The uncertainty that exists around the U.K. government's intentions and timing with respect to U.K. entry into the single European currency is such that it is not possible to make an accurate assessment of the total costs that would be involved in the euro changeover programme.

Interest rate developments

Faced with conflicting signals about the pace of global economic recovery, the US Federal Reserve, the European Central Bank (the "ECB") and the U.K. Monetary Policy Committee (the "MPC") kept interest rates unchanged for most of last year. Towards the end of 2002, however, a renewed downturn in global economic growth, together with falling equity prices and heightened geopolitical uncertainty prompted the US Federal Reserve and the ECB to cut interest rates by 0.50%, to 1.25% and 2.75%, respectively. The relative resilience of the U.K. economy enabled the MPC to keep rates unchanged throughout 2002. Faced with a sharp fall in equity prices and a renewed downturn in economic activity in early 2003, however, the MPC also decided a further rate cut was warranted. In February 2003, the U.K. 2-week repo rate was lowered from 4.0%, to 3.75%, bringing to an end fifteen months of policy stability and leaving rates at their lowest level in 48 years.

Sale of discontinued operations

The Merchants Services business within Bank of Scotland, a part of its credit card business, was sold during 2002, the profit on disposal was £25 million.

Results of operations

The contribution of Divisions towards Group profit on ordinary activities before taxation and exceptional items is summarized below:

Profit before taxation and exceptional items by Division

	Year ended December 31,		
	2002	2001 (Restated) (in £ millions)	2000
Retail Banking	1,426	1,205	1,567
Insurance & Investment	589	472	593
Business Banking	307	306	290
Corporate Banking	681	523	376
Treasury	231	169	210
BankWest	75	80	73
Group items ⁽¹⁾	(247)	(240)	(184)
Profit before taxation	<u>3,062</u>	<u>2,515</u>	<u>2,925</u>

(1) Group items comprise costs incurred in the management of the Group as a whole and the amortization of goodwill.

Years ended December 31, 2002 and December 31, 2001. The Group's profit before taxation was £3,062 million before exceptional costs of £153 million for the year ended December 31, 2002, compared to £2,515 million before exceptional costs of £223 million for the year ended December 31, 2001. This change represents an increase of 22%.

Profit before taxation and exceptional items for Retail Banking for the year ended December 31, 2002 was £1,426 million, compared to £1,205 million for the year ended December 31, 2001, an 18% increase, which represented 47% of Group profits. The increase was due to a year of volume growth, coupled with stable or improving asset quality and tight cost control.

Profit before taxation and exceptional items of the Insurance & Investment Division for the year ended December 31, 2002 was £589 million, compared to £472 million for the year ended December 31, 2001, a 25% increase, which represented 19% of Group profits. This increase was due to the benefits of the HBOS multi-channel/multi-brand strategy in 2002 which increased sales, with general insurance sales up by 25% and total investment sales (such as the sale of life products, unit trusts and open-ended investment companies) up by 11%.

Profit before taxation and exceptional items, including £25 million profit from the disposal of the Merchant Services business, for Business Banking was £307 million for the year ended December 31, 2002, compared to £306 million for the prior year, which represented 10% of Group profits. This result was achieved in a year in which there was significant investment and the introduction of credit interest on all business current accounts. The Division's investments are discussed in more detail under "Operating Expenses" below.

For Corporate Banking, profit before taxation was £681 million for the year ended December 31, 2002, compared to £523 million for the prior year, an increase of 30%, which represented 22% of Group profits. During the year net interest income grew by 35%, to £737 million and non-interest income grew by 34%, to £445 million while operating expenses grew by 24%, to £194 million.

Profit before taxation for Treasury was £231 million in the year ended December 31, 2002, compared to £169 million in the year ended December 31, 2001, an increase of 37%, which represented 8% of Group profits. This increase was due to volume growth in providing funding to the Group's businesses through money market activities, with margins enhanced through successful positioning in the favourable interest rate environment also contributing to the underlying year on year growth.

Profit before taxation for BankWest was £75 million for the year ended December 31, 2002, compared to £80 million for the prior year, a decrease of 6%, which represented 2% of Group profits. This decrease reflects a year of restructuring and investment in expansion into new markets in order to sustain future growth.

Years ended December 31, 2001 and December 31, 2000. The Group's profit before taxation fell by 14%, to £2,515 million before exceptional items of £223 million in 2001, from £2,925 million before exceptional items of £169 million in 2000.

Profit before taxation for Retail Banking decreased 23%, to £1,205 million in 2001, compared to pre-tax profit for Retail Banking of £1,567 million in 2000. This decrease resulted from the strategic decision to reduce product spreads to improve customer retention and compete aggressively for new business.

Profit before taxation of the Insurance & Investment Division in 2001 was £472 million, compared to £593 million for 2000, a 20% decrease. This decrease was due to the restatement of the 2001 figures as detailed in the Accounting Policies section of this document.

Business Banking's profit before taxation increased 6%, to £306 million in 2001 from £290 million in 2000.

Corporate Banking's profit before taxation increased 39%, to £523 million in 2001 from £376 million in 2000. This increase was largely attributable to a 33% growth in lending.

Profit before taxation for Treasury decreased 20%, to £169 million in 2001 from £210 million in 2000. This decrease was due to a reduction in profit on the sale of fixed income securities.

Profit before taxation for BankWest increased 10%, to £80 million in 2001 from £73 million in 2000.

Net interest income

The following tables show the net interest income and net interest margin of the Group for the years stated.

Net Interest Income

	Year ended December 31,		
	2002	2001	2000
		(Restated) (in £ millions)	
Retail Banking	3,007	2,697	2,776
Insurance & Investment	50	18	16
Business Banking	628	550	494
Corporate Banking	737	544	375
Treasury	200	206	238
BankWest	148	140	132
Net interest income	<u>4,770</u>	<u>4,155</u>	<u>4,031</u>

Net Interest Margin*

	Year ended December 31,		
	2002	2001	2000
		(Restated)	
Retail Banking	2.04%	2.15%	2.44%
Business Banking	3.04%	3.04%	3.16%
Corporate Banking	1.83%	1.69%	1.64%
Treasury	0.17%	0.21%	0.27%
BankWest	2.13%	2.20%	n/a
Group total†	<u>1.86%</u>	<u>1.87%</u>	<u>1.95%</u>

* Net interest income as a percentage of average interest earning assets.

† Group figure is calculated excluding trading assets in 2001 and 2002.

Years ended December 31, 2002 and December 31, 2001. The Group's net interest income increased 15%, to £4,770 million for the year ended December 31, 2002 from £4,155 million for the year ended December 31, 2001, due to strong asset led net interest earnings and broadly stable net interest margins. The Group net interest margin, based on average interest earning assets, decreased to 1.86% for the year ended December 31, 2002 from 1.87% during the previous year.

Net interest income for Retail Banking rose by 11%, to £3,007 million for the year ended December 31, 2002 from £2,697 million during the prior year. The key driver behind this increase was the 17% growth in lending balances to £157.9 billion. Net interest margins decreased to 2.04% in 2002 from 2.15% in 2001. This decline was in part attributable to the exceptional absence of base rate changes which caused a 4 basis points decline in the savings spread. Increased wholesale funding reduced the margin by 6 basis points.

Net interest income for Insurance & Investment increased to £50 million for the year ended December 31, 2002, from £18 million during the prior year.

Business Banking's net interest income rose by 14%, to £628 million during the year ended December 31, 2002 from £550 million during the prior year, due to lending growth of 23%. Net interest margins remained stable at 3.04% in 2002, unchanged from the margin reported for the year ended December 31, 2001.

Net interest income for Corporate Banking rose by 35%, to £737 million for the year to December 31, 2002 from £544 million during the prior year, compared to a 25% growth in lending reflecting a further improvement in net interest margins. Net interest margins increased to 1.83% in 2002 from 1.69% in 2001.

For Treasury, net interest income fell 3%, to £200 million in the year ended December 31, 2002 from £206 million during the prior year. After adjusting for non-recurring profits from the sale of fixed income securities earned in the prior year, underlying growth was 8%. Net interest margins decreased to 0.17% in 2002 from 0.21% in 2001.

Net interest income for BankWest rose by 6%, to £148 million for the year to December 31, 2002 from £140 million during the prior year. Net interest margins decreased to 2.13% in 2002 from 2.20% in 2001.

Years ended December 31, 2001 and December 31, 2000. The Group's net interest income increased 3%, to £4,155 million in 2001 compared to £4,031 million in 2000.

For Retail Banking, net interest income decreased 3%, to £2,697 million in 2001 from £2,776 million in 2000. The net interest margin of 2.15% for 2001 was lower than the net interest margin of 2.44% for 2000, due to the deliberate reduction of product spreads to improve customer retention and to compete aggressively for new business.

Net interest income for Insurance & Investment increased to £18 million for the year ended December 31, 2001, from £16 million during the prior year.

Business Banking net interest income increased 11%, to £550 million in 2001 from £494 million in 2000, lending growth was also 11%. Net interest margins decreased to 3.04% in 2001 from 3.16% in 2000.

Net interest income for Corporate Banking increased 45%, to £544 million in 2001 from £375 million in 2000, which was faster than the recorded lending growth of 33% reflecting an improvement in the overall net interest margin to 1.69% in 2001 from 1.64% in 2000.

For Treasury, net interest income fell 13%, to £206 million in 2001 from £238 million in 2000. The net interest margin declined to 0.21% in 2001 from 0.27% in 2000.

BankWest's net interest income increased 6% in 2001 to £140 million from £132 million in 2000.

Non-interest income

The Group's non-interest income consists of net fees and commissions, dealing profits, profit on sales of investments, dividend income from equity shares and other operating income. The Company classifies its fee and commission income as income related to branch-based services, banking direct, international, central support services, foreign exchange and other (which includes the profit on sale of equity-related investment securities negotiated alongside senior debt facilities in the corporate banking business). In addition, the income of the Insurance & Investment Division is reflected as non-interest income for the Group.

The following table shows non-interest income of the Group for the years stated.

Non-interest income

	Year ended December 31,		
	2002	2001 (Restated) (in £ millions)	2000
Net fees and commissions	1,485	1,404	1,304
Fees and commissions receivable	2,157	1,921	1,711
Fees and commissions payable	(672)	(517)	(407)
Dealing profits	154	82	66
Income from long-term assurance business	233	150	288
Other operating income	904	743	555
Total non-interest income	<u>2,776</u>	<u>2,379</u>	<u>2,213</u>

Years ended December 31, 2002 and December 31, 2001. The Group's non-interest income increased 17%, to £2,776 million for the year ended December 31, 2002 from £2,379 million for the year ended December 31, 2001.

Non-interest income was £721 million for Retail Banking in 2002, compared with £677 in 2001, an increase of 6%. Fees and commissions receivable were £162 million higher at £1,080 million, reflecting volume led growth in fee income across all product lines. This was partly offset by a £105 million increase in fees and commissions payable, mainly reflecting a volume led increase in mortgage intermediary fees.

For Insurance & Investment, non-interest income rose by 13%, to £831 million for the year ended December 31, 2002, from £733 million in the prior year, excluding exceptional income in 2001 of £27 million within St. James's Place Capital. In the Insurance business non-interest income benefited from mortgage, loan and credit card growth in the Retail Division. In the Investment business strong sales growth helped non-interest income increase to £285 million in the year to December 31, 2002 from £240 million in the prior year.

For Business Banking, non-interest income rose 21%, to £576 million in the year ended December 31, 2002, compared to £476 million in the prior year.

Non-interest income for Corporate Banking rose by 34%, to £445 million for the year ended December 31, 2002 from £333 million in the prior year, as a result of significant increases in fees and commissions.

Treasury's non-interest income increased 127%, to £125 million for the year ended December 31, 2002, from £55 million during the prior year. This increase was due to customer sales remaining strong and continuing to grow throughout the year, with some 62% of the dealing profits arising from activity related to customer sales.

Non-interest income for BankWest remained unchanged from the prior year at £78 million for the year ended December 31, 2002.

Years ended December 31, 2001 and December 31, 2000. The Group's non-interest income increased 8%, to £2,379 million in 2001 from £2,213 million in 2000.

Non-interest income was £677 million for Retail Banking in 2001, compared with £670 in 2000, an increase of 1%.

For Insurance & Investment, non-interest income fell by 1%, to £733 million in 2001, excluding exceptional income in 2001 of £27 million within St. James's Place Capital, from £737 million in the prior year.

Non-interest income for Business Banking was £476 million in 2001, up from £429 million in 2000, an increase of 11%, reflecting growth in the Australian and Irish businesses, particularly following the ICC Bank acquisition in February 2001.

Corporate Banking's non-interest income rose 42%, to £333 million in 2001 from £234 million in 2000, reflecting increases in fees and commissions and investment gains.

Treasury's non-interest income increased 10%, to £55 million in 2001 from £50 million in 2000 as a result of continuing growth in revenues from Treasury product sales to the Group's corporate and SME customers and an increase in trading profits helped by the favourable interest rate environment experienced through most of the year.

BankWest's non-interest income increased 7%, to £78 million in 2001 from £73 million in 2000.

Operating expenses

The Group's operating expenses consist of staff costs, expenditures on premises and equipment, depreciation and amortization, professional services (including auditors' remuneration, legal and professional and consultancy services fees), and other costs (including advertising and marketing, computer software and services, telephone, postage and stationery, irrecoverable VAT and other miscellaneous expenditures). The following table shows operating expenses of the Group for the years stated.

	Year ended December 31,		
	2002	2001	2000
	(Restated) (in £ millions)		
Staff costs	1,552	1,425	1,311
Expenditure on premises and equipment	153	159	143
Depreciation and amortization	634	538	490
Other	1,423	1,383	1,126
Total	<u>3,762</u>	<u>3,505</u>	<u>3,070</u>

Years ended December 31, 2002 and December 31, 2001. The Group's operating expenses increased by 7% in the year ended December 31, 2002 to £3,762 million from £3,505 million for the year ended December 31, 2001.

The analysis of operating expenses by Division which follows excludes exceptional costs of £153 million in 2002, £174 million in 2001 and £124 million in 2000. Also excluded from the analysis are expenses classified as Group Items, which comprise costs incurred in the management of the Group as a whole and the amortization of goodwill.

Operating expenses for Retail Banking rose 2%, to £1,956 million in 2002 from £1,912 million during the previous year. Increased investment and volume driven growth in Intelligent Finance, our telephone and internet bank, accounted for a £30 million increase in expenses. Exceptional sales performance also resulted in performance related bonuses £38 million higher.

Operating expenses for Insurance & Investment rose 1%, to £196 million in 2002 from £194 million during the previous year.

Operating expenses for Business Banking rose by 29%, to £789 million in 2002 from £614 million during the previous year. The rise mainly relates to the increase in staff and IT expansion costs. Staff numbers increased 26%, to over 7,000.

For Corporate Banking, expenses rose by 24%, to £194 million in 2002 from £156 million during the previous year. This increase relates to the fact that Corporate Banking have invested heavily over the last two

years to establish the necessary skills and infrastructure to take advantage of increased opportunities, £24 million of this increase relates to staff costs.

For Treasury, costs increased 7%, to £89 million in 2002 from £83 million during the previous year. Increased expenditure principally arose from higher performance related bonus accruals resulting from strong trading performance.

Operating expenses for BankWest rose by 5%, to £138 million in 2002 from £132 million during the previous year. The rise reflects increased staff costs as a result of inflationary pressures and the creation of a bigger sales network to support the Bank's small business initiative, which was launched during the year.

Years ended December 31, 2001 and December 31, 2000. The Group's operating expenses increased by 14%, to £3,505 million in 2001 from £3,070 million in 2000. This increase reflects higher staff numbers and technology costs to support higher business levels.

Operating expenses for Retail Banking rose 11%, to £1,912 million in 2001 from £1,728 million during the previous year. Technology spending in particular increased as new investments were made in core branch banking systems.

Operating expenses for Insurance & Investment rose 28%, to £194 million in 2001 from £152 million during the previous year. This increase was due entirely to the additional running costs of the operations acquired from Equitable Life Assurance Society and the establishment of the Halifax repayment insurance business.

Operating expenses for Business Banking rose by 9%, to £614 million in 2001 from £563 million during the previous year. The rise reflected the strong asset growth and was in line with the Group's expansion plans involving significant investments in human resources and technology spending.

For Corporate Banking, expenses rose by 31%, to £156 million in 2001 from £119 million during the previous year, reflecting higher staff expenditures. This rise was less than the Division's income growth, leading to an improved cost to income ratio of 17.1%.

For Treasury, costs increased by 6%, to £83 million in 2001 from £78 million during the previous year. The increase reflects significant spending on upgrading risk management systems and recruiting additional skilled personnel.

Operating expenses for BankWest rose by 8%, to £132 million in 2001 from £122 million during the previous year.

Income taxes

The following table shows income taxes of the Group for the years stated.

	Income taxes		
	Year ended December 31,		
	2002	2001 (Restated) (in £ millions)	2000
U.K. corporation tax ⁽¹⁾	519	429	589
Relief for overseas taxation	(17)	(12)	(11)
Exceptional credit — U.K. corporation tax	—	—	(40)
	502	417	538
Tax relating to change in value of long-term assurance business	51	23	67
	553	440	605
Overseas taxation	107	97	59
Share of joint ventures' taxation	12	11	(6)
Share of associated undertakings' taxation	5	4	7
	677	552	665
Deferred taxation	158	111	92
	<u>835</u>	<u>663</u>	<u>757</u>

(1) Based on effective statutory tax rates of 30% in each of the above years.

Years ended December 31, 2002 and December 31, 2001. The Group charge for tax increased 26%, to £835 million in the year ended December 31, 2002, compared to £663 million in the year ended December 31, 2001. The taxation charge in the years ended December 31, 2002 and December 31, 2001 represented 29% of profit before taxation.

Years ended December 31, 2001 and December 31, 2000. The Group charge for tax decreased by 12%, to £663 million in 2001 from £757 million in 2000. The taxation charge in 2001 represented 29% of profit before taxation, compared with 28% in 2000. The decrease in the tax charge follows the restatement of the 2001 figures for the introduction of FRS 19 Deferred Tax. The restatement is discussed in more detail in "Management's Discussion and Analysis of Financial Condition and Results of Operations — Accounting Policies".

Exceptional expenses

The following table shows exceptional expenses of the Group for the years indicated.

	Exceptional expenses		
	Year ended December 31,		
	2002	2001 (in £ millions)	2000
Exceptional expenses	(153)	(147)	(124)
Merger costs	—	(76)	—
Total exceptional items	<u>(153)</u>	<u>(223)</u>	<u>(124)</u>

Exceptional costs in 2002 were merger integration costs covering the costs of integrating and reorganising Bank of Scotland and its subsidiaries and Halifax and its subsidiaries following the merger.

Exceptional items in 2001 were merger integration costs of £132 million covering the costs of integrating and reorganising Bank of Scotland and its subsidiaries and Halifax and its subsidiaries following the merger and £42 million relating to expenses incurred during the integration of the Equitable Life Assurance Society sales force, acquired on March 1, 2001 into the new Halifax Equitable structure, together with ancillary integration costs associated with the transaction. In addition merger costs of £76 million in 2001 comprise the deal costs incurred in connection with the merger of Bank of Scotland and Halifax. Included within income from long-term assurance business in 2001 is an exceptional credit of £27 million arising from St. James's Place Capital plc's share of profits from an arrangement to transfer Life Assurance Holding Corporation Ltd's ("LAHC") investment management business to Aberdeen Asset Management plc. LAHC is an associated undertaking of St. James's Place Capital plc.

In 2000, Bank of Scotland charged £80 million relating to the restructuring of Bank of Scotland and its subsidiaries; costs of £31 million were incurred to cover Halifax's (and its subsidiaries') rationalisation programmes instigated across central sites, regional offices and Birmingham Midshires. Halifax charged a further £13 million during 2000 for the rationalisation of the Halifax retail branch network. In addition, during 2000 the Group's share of operating losses of joint ventures included an exceptional charge of £45 million reflecting a provision against Lex Vehicle Leasing Ltd's impairment of the residual value of leased vehicles. And finally at a hearing in March 2000, the Special Commissioners decided in favour of Halifax that the costs of conversion to listed company status were a deductible expense for tax purposes and an exceptional tax credit of £40 million was recognised and included within the Group's 2000 tax on profit on ordinary activities.

Provisions for bad and doubtful debts

The provisions for bad and doubtful debts consist of specific loan loss provisions for individual risks on loans and advances and a general risk provision that is intended to cover losses on advances which are latently doubtful but not yet identified as such. Specific risk provisions are increased where exposures may be considered at risk as a result of adverse influences in a particular market sector. Additions to the general provision are based on formulae applied to risk weighted assets. The general provision may also be adjusted at the discretion of the Group to reflect special circumstances such as changes in the economy or geographic or sector risks.

While ultimate responsibility for approving the provisioning policy rests with the Group's Board of Directors, based on recommendations from the Group Management Board, day to day responsibility and monitoring is delegated to the Divisional Boards and the Divisional Chief Executive, and down to Management and Account Officers within the individual lending areas.

The following table shows the charge to the Group's consolidated profit and loss account relating to provisions for bad and doubtful debts.

Provisions for bad and doubtful debts

	Year ended December 31,		
	2002	2001 (Restated) (in £ millions)	2000
<i>Credit risk provisions less releases charged to profit and loss account⁽¹⁾⁽²⁾</i>			
Specific risk	833	595	n/a
General risk	37	52	n/a
Recoveries	(38)	(39)	n/a
Total provisions	<u>832</u>	<u>608</u>	<u>n/a</u>
<i>Credit risk provisions less releases charged to profit and loss account⁽¹⁾⁽²⁾</i>			
Retail Banking	373	281	259
Business Banking	147	125	75
Corporate Banking	295	196	127
Treasury	4	—	—
BankWest	<u>13</u>	<u>6</u>	<u>10</u>
Total provisions	<u>832</u>	<u>608</u>	<u>471</u>

(1) Provisions calculated on basis of end-of-period exchange rate.

(2) Net of reversals of provisions and recoveries from loans written-off in prior years.

Years ended December 31, 2002 and December 31, 2001. The Group combined specific and general provisions for bad and doubtful debts charge against profits totalled £832 million in the year ended December 31, 2002 compared to £608 million in the year ended December 31, 2001, representing an increase of 37%. The charge for specific provisions net of recoveries increased 43%, to £795 million in the year ended December 31, 2002 compared to £556 million in the year ended December 31, 2001. This charge represented 0.37% of average customer lending compared with 0.30% in the year ended December 31, 2001.

Within Business Banking the overall charge for provisions increased by 18%, to £147 million for 2002 from £125 million in 2001. However, there was little change in the total provision charge as a percentage of average customer lending which was 0.70% compared to 0.69% for 2001.

The combined charge for provisions for Retail Banking increased 33%, to £373 million for 2002 from £281 million in 2001, reflecting the significant growth in unsecured balances delivered in the past two years. The charge represents 0.25% of average customer lending compared with 0.22% in 2001.

The overall charge for provisions for Corporate Banking increased by 51%, to £295 million for 2002 from £196 million in 2001, owing to the continued economic slowdown. The charge represents 0.74% of average customer lending compared with 0.65% in 2001.

Years ended December 31, 2001 and December 31, 2000. The combined specific and general provisions for bad and doubtful debts charged against Group profits totalled £608 million in the year ended December 31, 2001 compared to £471 million in the year ended December 31, 2000. This was an increase of 29%.

The combined charge for provisions for Retail Banking increased 8%, to £281 million for 2001 from £259 million in 2000, reflecting the high-quality asset growth and performance in the year.

Within Business Banking the overall charge for provisions increased by 67%, to £125 million for 2001 from £75 million in 2000, this increase is against a backdrop of less benign economic conditions during the year and a number of one-off recoveries made in the previous year. In the year to December 31, 2000 there was a general provision release of £18 million against a charge of £6 million in the year to December 21, 2001.

The overall charge for provisions for Corporate Banking increased by 54%, to £196 million for 2001 from £127 million in 2000, as slowing economies in the U.K. and overseas inevitably resulted in a decrease in asset quality and as a consequence an increase in provisions.

Loan loss ratios

The following table sets forth the Group's specific bad debt charge as a percentage of average loans and advances to customers net of provisions for the periods stated.

	Year ended December 31,		
	2002	2001	2000
	(in percent)		
Retail Banking	0.25	0.21	n/a
Business Banking	0.64	0.66	n/a
Corporate Banking	0.72	0.54	n/a
Treasury	0.24	n/a	n/a
BankWest	0.16	n/a	n/a
Total loans	0.37	0.30	n/a

Description of assets and liabilities

Assets

As at December 31, 2002 and December 31, 2001. As at December 31, 2002, the Group's total assets were £355,080 million, an increase of £43,009 million, or 14%, from £312,071 million as at December 31, 2001. Advances to customers increased to £234,315 million from £197,893 at December 31, 2001, an increase of 18% reflecting growth across all business Divisions.

As at December 31, 2001 and December 31, 2000. As at December 31, 2001, the Group's total assets were £312,071 million, an increase of 17% from £266,143 million as at December 31, 2000. This increase was due mainly to the increase in advances to customers to £197,893 million at December 31, 2001, an increase of 17% from £169,888 million at December 31, 2000, reflecting the high growth in commercial lending.

Loan portfolio

The Group's loans and advances portfolio consists of loans and advances to customers and banks. Gross loans and advances to customers are classified as advances to customers (including banking advances, installment credit and other financial agreements and assets leased to customers), advances to joint ventures and advances to associated undertakings. Cumulative provisions for bad and doubtful debts and interest in suspense are deducted from gross loans and advances to determine net loans and advances to customers.

Loans and advances to customers and banks

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
<i>Loans and advances to customers</i>			
Gross advances to customers	236,480	199,785	171,562
Cumulative provisions for bad and doubtful debts	(2,024)	(1,769)	(1,578)
Interest in suspense	(141)	(123)	(96)
Net advances to customers	<u>234,315</u>	<u>197,893</u>	<u>169,888</u>
<i>Loans and advances to banks</i>			
Loans and advances to banks	<u>11,838</u>	<u>12,929</u>	<u>18,117</u>
Total loans and advances to customers and banks	<u>246,153</u>	<u>210,822</u>	<u>188,005</u>

As at December 31, 2002 and December 31, 2001. The Group's loan and advances to customers and banks (after taking into account provisions for bad and doubtful debts and interest in suspense) totalled £246,153 million at December 31, 2002, an increase of £35,331 million, or 17%, from £210,822 million as at December 31, 2001. The increase was primarily due to an 18% increase in loans and advances to customers to £234,315 million as at December 31, 2002 from £197,893 million at December 31, 2001. Loans and advances to banks were £11,838 million as at December 31, 2002, a decrease of £1,091 million, or 8%, from £12,929 million as at December 31, 2001.

As at December 31, 2001 and December 31, 2000. The Group's loans and advances to customers and banks (after taking into account provisions for bad and doubtful debts and interest in suspense) totalled £210,822 million at December 31, 2001, an increase of £22,817 million, or 12%, from £188,005 million as at December 31, 2000. The increase was primarily due to a 16% increase in loans and advances to customers to £197,893 million at December 31, 2001 from £169,888 million at December 31, 2000. Loans and advances to banks decreased to £12,929 million at December 31, 2001, a drop of £5,188 million, or 29%, from £18,117 million at December 31, 2000.

Loans and advances to customers

The following table analyzes the Group's classification of loans and advances to customers in accordance with Financial Services Authority reporting requirements:

Loans and advances to customers by classification

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
Agriculture, forestry and fishing	1,096	1,038	974
Energy	1,591	1,598	1,610
Manufacturing industry	5,836	5,654	5,426
Construction and property	20,591	15,053	10,051
Hotels, restaurants and wholesale and retail trade	8,410	5,930	5,126
Transport, storage and communication	5,107	4,736	2,925
Financial	6,867	6,716	7,225
Other services	12,788	9,850	9,900
Individuals:			
Home mortgages	147,470	127,636	110,412
Other personal lending	16,560	13,874	11,421
Overseas residents	10,164	7,700	6,492
Gross advances	<u>236,480</u>	<u>199,785</u>	<u>171,562</u>

Lending concentrations

One of the principal factors influencing the quality of the Group's earnings is the diversification of its loan portfolio by geographical area within the U.K., by industry classification and by individual customer. The spread of the Group's assets is intended to reduce concentration of risk. The following table analyzes the Group's loans and advances to customers by maturity as at the dates indicated.

Analysis of loans and advances to customers by maturity

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
Repayable on demand	18,469	16,679	11,468
Other loans and advances repayable:			
in 3 months or less	24,008	18,296	17,260
between 3 months and 1 year	11,514	10,057	8,961
between 1 year and 5 years	34,613	27,582	24,810
after 5 years	147,876	127,171	109,063
Gross loans and advances to customers	<u>236,480</u>	<u>199,785</u>	<u>171,562</u>

Loans and advances to banks

The Group places funds with other banks for a number of reasons, including liquidity management, facilitation of international money transfers and documentary credit business with correspondent banks. Limits on the aggregate amount of placings that may be made with individual institutions are established in accordance with Group credit policy.

The following table analyzes the Group's loans and advances to banks by maturity as at the dates indicated.

Analysis of loans and advances to banks by maturity

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
Repayable on demand	3,159	1,625	2,400
Other loans and advances repayable:			
in 3 months or less	6,551	9,191	10,099
between 3 months and 1 year	1,776	1,741	4,826
between 1 year and 5 years	282	185	642
after 5 years	<u>70</u>	<u>187</u>	<u>150</u>
Gross loans and advances to banks	<u>11,838</u>	<u>12,929</u>	<u>18,117</u>

Country exposure

The authority to set country limits for credit exposure throughout the Group has been delegated by the Board to the Group Credit Risk Committee. The Committee meets monthly or more regularly if necessary. See "Management of market risk and currency exposure" below for further details.

Country risk can arise from transfer risk, political risk and economic risk. In assessing the overall limits for individual countries, various factors are taken into consideration, including the rating agencies' view of the country concerned, the economic situation and the political climate. The Group country limit is then allocated to Divisions according to levels of business and approved strategies.

It is the policy of the Group for all countries (excluding the U.K.) to have a country limit, even if they carry the highest credit ratings. Individual country limits are reviewed at least on an annual basis by the Group Credit Risk Committee.

The following table sets forth the Group's country exposure as at December 31, 2002.

Country exposure

<u>As at December 31, 2002</u>	<u>Risk Exposure</u> <u>(in £ millions)</u>
<i>Geographic area</i> ⁽¹⁾	
Western Europe (other than U.K.)	38,259
U.S./Canada	21,060
Australasia	13,010
Asia (including Hong Kong and Singapore)	298
Eastern Europe	23
Other	134

(1) Based on the location of the customer.

Securities portfolio

The Group's securities portfolio consists of investment securities and trading securities (classified as "other securities" for U.K. bank regulatory purposes). Investment securities consist of both listed (including British government and other) and unlisted securities (including joint ventures, certificates of deposit issued by banks and building societies and others). Trading securities consist of both listed and unlisted securities, which are predominantly held by Treasury Services. Unlisted securities are securities that on or after May 1, 2000 were not listed on the Official List of the Financial Services Authority or on a "recognised investment exchange" as defined in the Financial Services and Markets Act 2000. The Group carries all investment securities at book value. Listed trading securities are valued on a marked-to-market basis. Unlisted trading securities are valued by the Board. The following table shows the value of the Group's investment and trading securities portfolios as at the dates indicated.

Securities portfolio

	<u>As at December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	<u>(in £ millions)</u>		
<i>Investment securities</i>			
Listed			
British Government	521	378	2,313
Others ⁽¹⁾	15,404	13,088	11,132
Unlisted ⁽²⁾			
Certificates of deposit issued by banks and building societies	1,962	5,138	8,902
Others ⁽¹⁾	7,281	10,616	6,669
Total investment securities	25,168	29,220	29,016
<i>Trading securities</i>			
Listed	2,312	1,851	3
Unlisted ⁽²⁾	16,844	11,378	524
Total trading securities	19,156	13,229	527
Total securities	44,324	42,449	29,543

(1) Securities classified as "other securities" in accordance with Financial Services Authority requirements.

(2) Securities which as at the dates indicated were not listed on the London Stock Exchange or another "recognised investment exchange" (as defined in the U.K. Financial Services and Markets Act 2000).

As at December 31, 2002 and December 31, 2001. The book value of the Group's securities portfolio as at December 31, 2002 was £44,324 million, an increase of £1,875 million, or 4%, compared to £42,449 million at December 31, 2001.

As at December 31, 2001 and December 31, 2000. The book value of the Group's securities portfolio as at December 31, 2001 was £42,449 million, an increase of £12,906 million, or 44%, compared to £29,543 million as at December 31, 2000.

Provisions for bad and doubtful debts

The Group regularly reviews the quality of its advances and other extensions of credit. Specific provisions are made against loans and other extensions of credit when, as a matter of banking judgment, it is considered that recovery is doubtful, which depends in each case on the individual circumstances of the loan or extension of credit, including, among other things, the adequacy of any collateral security. In addition, a general provision to cover advances which are latently bad or doubtful but not yet identified as such, is also maintained for use in appropriate circumstances. The general provision is augmented regularly based upon a formula applied to risk weighted assets. Provisions made during a year (less amounts released and recoveries of amounts written off in previous years) are charged to revenue.

The following table sets forth the cumulative balances of the Group's provisions for bad and doubtful debts by type of provision and by Division as at the dates indicated:

Cumulative provisions for bad and doubtful debts

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
<i>Cumulative balances by type of provision</i>			
General provision	703	667	607
Specific provisions	1,321	1,102	971
Total	<u>2,024</u>	<u>1,769</u>	<u>1,578</u>
<i>Cumulative balances by Division</i>			
Retail Banking	1,167	1,079	992
Business Banking	343	335	285
Corporate Banking	460	311	260
Treasury	4	—	—
BankWest	50	44	41
Total	<u>2,024</u>	<u>1,769</u>	<u>1,578</u>

The following table sets forth the Group's risk provisioning rates (total provisions as a percentage of total loans and advances to customers) broken down by Division as at the dates indicated.

Risk provisioning rates

	As at December 31,		
	2002	2001	2000
	(in percent)		
Retail Banking	0.74	0.80	0.85
Business Banking	1.48	1.77	1.67
Corporate Banking	1.04	0.88	0.99
BankWest	0.70	0.67	0.68
Treasury	0.18	—	—
Total	<u>0.86</u>	<u>0.90</u>	<u>0.93</u>

The following table provides an analysis of the movement in the Group's provisions for bad and doubtful debts over the years indicated.

Movements in provisions for bad and doubtful debts

	As at December 31,					
	2002		2001		2000	
	Specific	General	Specific	General	Specific	General
	(in £ millions)					
Opening provisions	1,102	667	971	607	n/a	n/a
Amounts written off	(618)	—	(478)	—	n/a	n/a
Exchange movements	4	(1)	(2)	(3)	n/a	n/a
Adjustments for acquisitions and disposals of subsidiaries	—	—	16	11	n/a	n/a
New provisions less releases	833	37	595	52	n/a	n/a
Closing provisions	<u>1,321</u>	<u>703</u>	<u>1,102</u>	<u>667</u>	<u>n/a</u>	<u>n/a</u>

The following table presents the ratio of cumulative provisions for bad and doubtful debts to average loans and advances as at the dates indicated:

Ratio of cumulative provisions to average loans and advances

	As at December 31,		
	2002	2001	2000
	(in percent)		
Cumulative provisions as a percentage of average loans and advances (net of provisions):			
Specific	0.61	0.60	n/a
General	<u>0.33</u>	<u>0.36</u>	n/a
Total	<u>0.94</u>	<u>0.96</u>	<u>n/a</u>

Non-performing assets

The following table sets forth the Group's non-performing assets, cumulative provisions and interest in suspense (which are deducted from advances in the balance sheet) together with their cover as a percentage of non-performing assets.

Non-performing assets

	As at December 31,		
	2002	2001	2000
	(in £ millions, except ratios)		
Non-performing assets	<u>4,206</u>	<u>4,072</u>	<u>3,666</u>
Specific provisions	1,321	1,102	971
General provisions	703	667	607
Interest in suspense	<u>141</u>	<u>123</u>	<u>96</u>
Total	<u>2,165</u>	<u>1,892</u>	<u>1,674</u>
NPA's/Total loans	1.80%	2.06%	2.16%
Cumulative provisions/NPA's	51%	46%	46%

As at December 31, 2002 and December 31, 2001. The Group's non-performing assets increased by 3%, to £4,206 million at December 31, 2002 from £4,072 million at December 31, 2001. As a percentage of customer advances, non-performing assets decreased to 1.80% from 2.06% at December 31, 2001.

As at December 31, 2001 and December 31, 2000. The Group's non-performing assets increased by 11%, to £4,072 million at December 31, 2001 from £3,666 million at December 31, 2000. As a percentage of customer advances, non-performing assets decreased to 2.06% in 2001 from 2.16% in 2000.

Liabilities

Deposits

The Group's assets are funded by the taking of both retail and wholesale deposits. Retail deposits are collected primarily through Bank of Scotland's and Halifax's U.K. branch networks or placed directly with Treasury Services or other companies in the Group.

The following table analyzes the maturities of the Group's deposits by customers and banks as at the dates stated below.

Maturity analysis of deposits

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
<i>Customer accounts</i>			
Repayable on demand	123,262	116,715	103,603
Repayable:			
in 3 months or less	19,022	18,961	18,679
between 3 months and 1 year	6,326	3,917	3,345
between 1 year and 5 years	1,371	876	1,282
after 5 years	240	47	103
Total customer accounts	150,221	140,516	127,012
<i>Bank deposits</i>			
Repayable on demand	14,704	8,440	6,653
Repayable:			
in 3 months or less	22,066	16,267	15,793
between 3 months and 1 year	8,725	5,632	2,877
between 1 year and 5 years	63	44	5
after 5 years	79	66	—
Total bank deposits	45,637	30,449	25,328
Total deposits	195,858	170,965	152,340

Capital resources

The following table shows the Group's capital resources as at the dates stated below.

Capital resources

	As at December 31,		
	2002	2001	2000
	(Restated) (in £ millions)		
Ordinary shareholders' equity	946	892	878
Preference stock	400	400	400
Shareholders' funds	12,423	10,121	9,260
Minority interests (equity)	436	405	377
Minority interests (non-equity)	1,703	1,690	1,097
Total capital resources	<u>15,908</u>	<u>13,508</u>	<u>12,012</u>

Capital adequacy

The following table sets forth the development of the Group's total capital and capital adequacy ratios as a percentage of risk-weighted assets based on Bank for International Settlements guidelines as of the stated dates.

Capital adequacy

	As at December 31,		
	2002	2001	2000
	(Restated) (in £ millions, except ratios)		
Tier 1 capital	14,788	12,415	10,621
Total capital	19,527	16,758	14,412
Risk-weighted assets	187,142	157,532	135,196
Tier 1 capital ratio	7.9%	7.9%	7.9%
Total capital ratio	10.4%	10.6%	10.7%

The minimum total capital ratio of 8%, established by the Basel Committee serves as the base standard from which the Financial Services Authority sets individual bank's ratios, reflecting each institution's particular circumstances. As shown, the Group's capital ratios exceed the minimum requirements of the Basel Committee. Tier 1 capital increases year to year through retained profits and both Tier 1 and Tier 2 capital are periodically supplemented by new capital being raised. Retained earnings, which increase Tier 1 capital, amounted to £739 million in the year to December 31, 2002, £438 million (restated) in 2001 and £952 million in 2000. Tier 2 capital increased by £1,103 million in the year to December 31, 2002 and £1,396 million in the year to December 31, 2001.

Contingent liabilities and commitments

The Group's contingent liabilities consist of acceptances and endorsements, guarantees and assets pledged as collateral security and guarantees and irrevocable letters of credit. The Group's commitments consist of short-term trade related transactions, undrawn formal standby facilities, credit lines and other irrevocable commitments to lend (classified as up to and including one year and over one year). The following table sets forth the Group's contingent liabilities and commitments for the dates indicated.

Contingent liabilities and commitments

	As at December 31,		
	2002	2001	2000
	Contract	Contract	Contract
	amount	amount	amount
	(in £ millions)		
<i>Contingent Liabilities</i>			
Acceptances and endorsements	157	202	160
Guarantees and irrevocable letters of credit	<u>2,672</u>	<u>2,133</u>	<u>1,713</u>
	<u>2,829</u>	<u>2,335</u>	<u>1,873</u>
<i>Commitments</i>			
Short-term trade related transactions.....	129	202	104
Undrawn formal standby facilities, credit lines and other irrevocable commitments to lend:			
up to and including 1 year	35,634	26,298	19,229
over 1 year	<u>13,261</u>	<u>10,772</u>	<u>8,199</u>
	<u>49,024</u>	<u>37,272</u>	<u>27,532</u>

Geographical regions

The primary geographical split in the Group's business is between income and assets booked in the U.K. on the one hand, and outside the U.K. on the other. The following table sets forth segment information by geographical region, as determined by the domicile of the Group subsidiary or branch providing the credit, for the periods indicated and as at the dates specified.

Geographic segment analysis

	As at or for the year ended December 31,		
	2002	2001	2000
		Restated (in £ millions)	
<i>Interest receivable</i>	16,691	16,115	15,111
U.K.	15,444	14,961	14,154
Non-U.K.	1,247	1,154	957
<i>Fees and commissions receivable</i>	2,157	1,921	1,711
U.K.	1,988	1,789	1,575
Non-U.K.	169	132	136
<i>Dealing profits</i>	154	82	66
U.K.	146	77	61
Non-U.K.	8	5	5
<i>Income from long-term assurance business</i>	233	150	n/a
U.K.	131	89	n/a
Non-U.K.	102	61	n/a
<i>Other operating income</i>	904	743	843
U.K.	700	720	815
Non-U.K.	204	23	28
<i>Gross income</i>	20,139	19,011	17,731
U.K.	18,409	17,636	16,605
Non-U.K.	1,730	1,375	1,126
<i>Operating profit before exceptional items</i>	3,002	2,479	2,895
U.K.	2,552	2,195	2,720
Non-U.K.	450	284	175
<i>Total assets</i>	354,627	311,725	265,836
U.K.	326,949	289,233	248,932
Non-U.K.	27,678	22,492	16,904
<i>Net assets (excluding minority interests)</i>	13,769	11,413	10,538
U.K.	12,226	10,306	9,871
Non-U.K.	1,543	1,107	667

Management of market risk and currency exposure

Mapping and Managing Risk

The Group is subject to risks inherent in financial services activity. The Group's principal activities are the provision of retail, business and corporate banking services, investment management and insurance. It consequently makes loans to and takes deposits from customers and wholesale counterparties while the activities of Insurance & Investment Division carry investment management and insurance underwriting risks.

Credit Risk

This is the risk of financial loss from a customer's failure to settle financial obligations as they fall due. The Group Credit Risk Committee (the "GCRC"), which is chaired by the Group Finance Director and includes the Chief Executives (or their named alternates) of the Retail, Business, and Corporate Banking Divisions, the Chief Executive of Treasury Services and the Chief Financial Risk Officer, reviews the Group's lending portfolio to ensure a Group-wide understanding and control of credit risk.

Day to day management of credit risk is undertaken by specialist credit teams working within each business area in compliance with policies approved by the Board. A specialist support function within Group Financial Risk ("GFR") provides centralised expertise in the area of credit risk measurement and management techniques. Performance of each portfolio is reported to GCRC.

In Retail Banking use is made, where it is practical to do so, of software technology in credit scoring new applications and current account overdraft extensions. In addition, behavioural scoring is used. Collections activity for credit card and current accounts, and for personal loans, is centralised for the various products, and software systems are used to prioritise action. Mortgage collection is conducted through a number of payment collection departments.

Within Business Banking, small business customers may be rated using scorecards in a similar manner to retail customers. Larger SME (small to medium enterprises) customers are typically rated in the same way as corporate customers. Corporate Banking conducts a full credit assessment of the financial strength of each potential transaction and/or customer, awarding an internal risk rating. Internal ratings are reviewed regularly.

For Treasury Services, policies are established and reviewed by the Group Wholesale Credit Committee, a sub-committee of GCRC.

The controls applied to lending assessment processes consider environmental risk and the potential impact this may have on the value of the underlying security.

Insurance and Investment Risk

Insurance risk is the potential for loss arising from poor experience in relation to insurance contract pricing parameters (for both life and general insurance products). Investment risk is the potential for financial loss arising from the risks associated with the fund management activities of the Group. This includes both the assets where the Group retains the primary risk and those assets where it is retained by third parties, including policyholders.

Day to day management of such risk is undertaken both by line management and by specialist teams within the Insurance and Investment Division. Full use is made of the statutory Appointed Actuary and (Pension) Scheme Actuary roles, both to ensure regulatory compliance (in respect of the authorised insurance companies in the Group) and to meet HBOS control standards.

The Group Insurance and Investment Risk Committee (the "GIIRC") receives regular reports on specified aggregate risks across the Division.

Regulatory Risk

This is the risk that the Group, or any part of it, fails to meet the requirements or expectations of regulatory authorities or supervisors responsible for enforcing legislation, codes, or regulations governing the way that the Group's business activities are conducted within the U.K. or elsewhere. Regulatory risk can also arise where the Group fails to anticipate and manage regulatory change adequately.

Day to day management of regulatory risk is undertaken both by line management and specialist teams of compliance experts working within business areas. Reports on regulatory risk management are made by business areas and Divisions to their Risk Control Committee and individual company Audit Committee. Group Regulatory Risk provides a high level assessment to the Audit Committee.

Operational Risk

HBOS has adopted the industry standard Basel Committee on Banking Supervision definition of operational risk: “The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events”.

The management of operational risk is an intrinsic part of every business manager’s role. HBOS’s approach is to ensure business managers identify, assess, prioritise and manage all substantial risks in a cost effective and consistent manner.

To this end HBOS uses a combination of risk self assessment, risk event and key risk indicator analysis, appropriate insurance cover and contingency arrangements, together with sound control procedures and systems. This approach is entirely consistent with the current requirements under the new Basel Capital Accord.

Each Division and Group function is required half yearly to compile an operational risk profile which sets out the internal assessment of risk controls against consistent categories as a form of self certification. These profiles are presented to the Risk Control Committees, the Audit Committee and the Board and are subject to independent review by the relevant risk teams. They are also validated by Group Internal Audit during the course of their work.

In addition a number of specialist support functions provide centralised expertise in operational risk areas such as information security, fraud, corporate insurance and business continuity planning.

Liquidity Risk

Liquidity risk is the risk that the Group will be unable to meet financial commitments arising from the cashflows generated by its business activities. This risk can arise from mismatches in the timing of cashflows relating to assets, liabilities and off-balance sheet instruments.

The Group’s U.K. liquidity is managed by Treasury Services. It operates within a framework and policies determined by the Group Asset and Liability Committee (the “GALCO”) which ensures that the Group’s funding requirements can be met at all times and that a stock of high quality liquid assets is maintained in a form and at a level which reflect prudent banking practice.

A further objective is to raise funding as cost effectively as possible whilst ensuring that no significant unintended mismatches arise between loans and deposits. Close control is exercised over both volume and quality of short-term deposits, with the sources and maturities being managed to avoid a concentration of funding requirements at any one time from any one source. The framework ensures that the Group meets regulatory authority requirements.

Market Risk

This is the risk of financial loss from changes in market prices of financial instruments — typically resulting from movements in interest rates (interest rate risk), equity or other indices, and foreign exchange rates (foreign exchange risk). Overall accountability for the management of market risk and responsibility for allocating limits for banking activities within parameters set by the Board, lies with GALCO.

Interest Rate Risk

The primary market risk faced by the Group is interest rate risk. Interest rate risk exists where the Group’s financial assets and liabilities have interest rates set under different bases or reset at different times.

The Group assumes interest rate risk from dealings with customers, through fixed term lending, deposit taking or derivative contracts. This risk is monitored by Group and divisional Asset and Liability Management within a framework determined by GALCO. Trading activity is undertaken by Treasury Services.

The effect of interest rate movements is assessed using sensitivity analysis and other modelling techniques.

Foreign Exchange Risk

Structural foreign exchange exposures arise from the Group's investments in overseas subsidiaries, branches and other investments.

Foreign exchange exposures in Treasury Services, which arise in the normal course of business, are transferred to the trading book where they are managed within GALCO approved limits.

Trading

The Group's market risk trading activities are principally conducted by Treasury Services in the U.K.. The regulatory capital charge for market risk trading exposures represents less than 1.58% of the Group's capital base.

The Group employs several complementary techniques to measure and control trading activities including: Value at Risk ("VaR"), sensitivity analysis, stress testing and position limits. The VaR model used forecasts the Group's exposure to market risk within an estimated level of confidence over a defined time period.

The average VaR value in 2002 was £11.1 million. The calculation is based upon a confidence interval of 99% with a one day holding period. The principal areas of market risk taken are interest rate (outright positioning, basis, spread and volatility risk), and foreign exchange risk. There is no material commodity or equity exposure.

The current methodology for providing an aggregated VaR for the business uses very conservative assumptions. In order to assess the effectiveness of VaR the Group uses a technique known as backtesting which compares the daily profit and loss from trading activities to the VaR estimate for that day. Backtesting results show that the VaR measure calculated for each day was never exceeded by profit and loss volatility during 2002. Daily standard deviation of trading profit and loss was £1.7 million.

The Group recognises that the VaR methodology cannot guarantee the maximum loss that may be suffered in any trading period, particularly in the event of market turmoil. Therefore, stress testing is used to simulate the effect of selected adverse market movements.

Derivatives

In the normal course of banking business, the Group uses a limited range of derivative instruments for both trading and non-trading purposes. The principal derivative instruments used are interest rate swaps, interest rate options, cross currency swaps, forward rate agreements, forward foreign exchange contracts and futures. The Group uses derivatives primarily as a risk management tool for hedging interest rate and foreign exchange rate risk.

The Group's activity in derivatives is controlled within risk management limits set by GALCO. This framework recognises the principal risks including credit, operational, liquidity and market risk associated with derivatives.

The Group has entered into derivative contracts as noted below.

Analysis of derivatives contracts by maturity and replacement cost

	<u>As at December 31, 2002</u>		<u>As at December 31, 2001</u>		<u>As at December 31, 2000</u>	
	<u>Notional Principal Amount</u>	<u>Replacement Cost</u>	<u>Notional Principal Amount</u>	<u>Replacement Cost</u>	<u>Notional Principal Amount</u>	<u>Replacement Cost</u>
	(in £ millions)					
Contracts maturing: in 1 year or less	198,933	1,239	223,122	1,724	150,419	1,243
In more than 1 but not more than 5 years	128,890	1,727	91,187	782	83,988	1,028
In more than 5 years	<u>67,771</u>	<u>2,624</u>	<u>37,075</u>	<u>920</u>	<u>19,276</u>	<u>668</u>
	<u>395,594</u>	<u>5,590</u>	<u>351,384</u>	<u>3,426</u>	<u>253,683</u>	<u>2,939</u>

The notional principal amounts of these derivatives are analyzed below between non-trading and trading activity. Details of the “fair value” of trading derivatives are also shown. “Fair value” is the amount at which instruments could be exchanged in an arms length transaction.

Analysis of derivatives contracts by type and fair values

	As at December 31, 2002		
	Notional Principal Amount	Fair Values	
		Asset	Liability
	(in £ millions)		
Non-Trading			
<i>Exchange rate related contracts</i>			
Forward foreign exchange	411	8	11
Cross currency swaps	32,414	556	843
	<u>32,825</u>	<u>564</u>	<u>854</u>
<i>Interest rate related contracts</i>			
Interest rate swaps	28,980	979	598
Forward rate agreements Options	558	4	1
Futures	2,678	1	1
	<u>32,216</u>	<u>984</u>	<u>600</u>
<i>Equity and commodity related contracts</i>			
Options and swaps	535	10	31
Total non-trading derivatives	<u>65,576</u>	<u>1,558</u>	<u>1,485</u>
Trading			
<i>Exchange rate related contracts</i>			
Forward foreign exchange	49,471	682	1,674
Cross currency swaps	142	5	7
Options	12,728	9	9
	<u>62,341</u>	<u>696</u>	<u>1,690</u>
<i>Interest rate related contracts</i>			
Interest rate swaps	214,096	3,168	3,390
Forward rate agreements	9,856	2	2
Options	45,840	130	185
Futures	190,017	49	74
	<u>459,809</u>	<u>3,349</u>	<u>3,651</u>
<i>Equity and commodity related contracts</i>			
Options and swaps	563	37	28
Total trading derivatives	<u>522,713</u>	<u>4,082</u>	<u>5,369</u>
Total Group Derivatives	<u>588,289</u>	<u>5,640</u>	<u>6,854</u>

	As at December 31, 2001			As at December 31, 2000		
	Notional Principal Amount	Fair Values		Notional Principal Amount	Fair Values	
		Asset	Liability		Asset	Liability
		(in £ millions)				
Non-Trading						
<i>Exchange rate related contracts</i>						
Forward foreign exchange	1,653	24	12	16,888	114	503
Cross currency swaps	13,264	450	513	10,723	430	538
	<u>14,917</u>	<u>474</u>	<u>525</u>	<u>27,611</u>	<u>544</u>	<u>1,041</u>
<i>Interest rate related contracts</i>						
Interest rate swaps	62,447	1,076	987	77,148	1,263	834
Forward rate agreements	734		1	3,119	10	7
Options	183	6	3	2		
Futures	2,838		4	13,017		
	<u>66,202</u>	<u>1,082</u>	<u>995</u>	<u>93,286</u>	<u>1,273</u>	<u>841</u>
<i>Equity and commodity related contracts</i>						
Options and Swaps	520	21	14	614	88	66
Total Non-Trading Derivatives	<u>81,639</u>	<u>1,577</u>	<u>1,534</u>	<u>121,511</u>	<u>1,905</u>	<u>1,948</u>
Trading						
<i>Exchange rate related contracts</i>						
Forward foreign exchange	49,887	327	441	14,393	247	278
Cross currency swaps	78	1	1	49		2
Options	483	3	3	285	7	4
	<u>50,448</u>	<u>331</u>	<u>445</u>	<u>14,727</u>	<u>254</u>	<u>284</u>
<i>Interest rate related contracts</i>						
Interest rate swaps	184,125	1,415	1,508	110,950	675	607
Forward rate agreements	6,323	3	3	4,911	6	5
Options	31,364	89	61	14,252	88	5
Futures	80,591	22	60	32,019	5	2
	<u>302,403</u>	<u>1,529</u>	<u>1,632</u>	<u>162,132</u>	<u>774</u>	<u>619</u>
<i>Equity and commodity related contracts</i>						
Options and Swaps	323	11	5	349	11	12
Total Trading Derivatives	<u>353,174</u>	<u>1,871</u>	<u>2,082</u>	<u>177,208</u>	<u>1,039</u>	<u>915</u>
Total Group Derivatives	<u>434,813</u>	<u>3,448</u>	<u>3,616</u>	<u>298,719</u>	<u>2,944</u>	<u>2,863</u>

Credit Risk Analysis

Counterparties of the Group's derivative transactions are primarily financial institutions. An institutional and geographical analysis of replacement cost, based on the location of the office writing the business, is shown below:

Breakdown of replacement costs of derivative transactions by counterparty

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
<i>Institutional</i>			
Financial institutions	4,516	3,094	2,598
Non-financial institutions	1,074	332	341
	<u>5,590</u>	<u>3,426</u>	<u>2,939</u>
<i>Geographical</i>			
U.K.	5,411	3,190	2,698
Non-U.K.	179	236	241
	<u>5,590</u>	<u>3,426</u>	<u>2,939</u>

Assets and Liabilities in Foreign Currencies

The following table shows the aggregate amounts of assets and liabilities as at the dates indicated denominated in currencies other than pounds sterling.

Assets and liabilities in foreign currencies

	As at December 31,		
	2002	2001	2000
	(in £ millions)		
Assets	73,420	59,932	49,361
Liabilities	115,484	82,912	59,388

The above figures do not reflect the Group's exposure to foreign exchange, which is significantly lower as it is hedged by off-balance sheet instruments.

DESCRIPTION OF BUSINESS

Introduction

The HBOS Group is a diversified financial services group engaged in a range of banking, insurance broking, financial services and finance-related activities throughout the U.K. and internationally.

On September 10, 2001, Bank of Scotland and Halifax Group plc (“Halifax”) merged under HBOS. HBOS is the ultimate holding company for Halifax plc, Bank of Scotland and a number of other subsidiary undertakings principally carrying on financial services business. HBOS is a public limited company incorporated in Scotland (registered number SC218813) under the Companies Act 1985 with its head office, corporate headquarters and registered office at The Mound, Edinburgh EH1 1YZ. Subsequent to the merger, all of Halifax’s innovative Tier 1 and Tier 2 capital and any guarantee obligations thereunder were transferred to HBOS on July 1, 2002.

The HBOS Group’s products and services can be categorised into the following business sectors:

- Retail Banking
- Business Banking
- Corporate Banking
- Insurance & Investment
- Treasury

Retail Banking

The retail operations and consumer credit businesses of Halifax were combined with the personal banking Division of Bank of Scotland to form the Retail Banking Division of the HBOS Group employing over 40,000 people in over 1,000 branches and 10 call centres throughout the United Kingdom, as at December 31, 2002.

The HBOS Group had over 19 million customers, as at December 31, 2002, and offers an extensive range of personal finance products and services including mortgages, savings, current accounts, credit cards, online services, share dealing and estate agency. In addition to Halifax and Bank of Scotland, other brands within the Retail Banking Division include Intelligent Finance, Birmingham Midshires and The Mortgage Business.

As at December 31, 2002, the HBOS Group was the largest retail mortgage provider in the United Kingdom, with residential mortgages of approximately £150 billion, and held savings and banking balances of over £100 billion.

Business Banking

The Business Banking Division provides a range of finance products and services principally to small and medium-sized enterprises (“SMEs”) through a network of branches and business centres in the United Kingdom and Ireland as well as through internet banking, mail and telephone. The HBOS Group provides a full banking service to SMEs including deposits and investments, business finance, commercial mortgages, free internet banking, merchant services and business insurance. The Business Banking Division also provides specialist services such as asset finance, cashflow finance, motor finance, vehicle management and contract hire. The Business Banking Division employed over 7,000 employees in the United Kingdom, Ireland and Australia as at December 31, 2002.

The HBOS Group provided finance products and services to approximately 33%, as at December 2002, of the SME market in Scotland and is aiming to capture a significant amount of SME business in England and Wales.

Corporate Banking

The Corporate Banking Division focuses on larger businesses (typically those with an annual turnover in excess of £10 million) and comprises a number of relationship banking and specialist lending teams with responsibilities including working capital finance, term loans, asset finance, multi-currency loans and deposits, project and specialist finance, acquisition finance and syndicated lending. The key objective of these teams is to expand and strengthen the HBOS Group's corporate market share by pursuing a relationship and partnership driven approach and delivering specialist services to existing and new customers.

The HBOS Group employed over 1,400 staff in the Corporate Banking Division in over 20 locations in Scotland and England, with international operations in New York City, Chicago, Houston, Los Angeles, Boston, Seattle, Minneapolis, Paris, Frankfurt, Amsterdam, Singapore, Madrid and Sydney as at December 31, 2002.

The HBOS Group was the leader, of deals by volume, in the provision of acquisition finance to the United Kingdom management buy-out sector for the year ended December 31, 2002.

Insurance & Investment

The Insurance & Investment Division ("IID") comprises a number of different brands including Halifax Financial Services, Bank of Scotland Investment Services, Clerical Medical Investment Group, St James's Place Capital, St Andrew's and esure.

Products offered by the companies within IID include savings, investments and pensions, life and repayment insurance and household, travel and motor insurance distributed through a number of different channels, branches, independent financial advisers, company agents and by telephone.

Treasury

HBOS Treasury Services plc comprises the Treasury Division and its activities are described under the heading "Selected and Consolidated Financial Information — Treasury Services".

Principal Group Subsidiaries

Certain details of the principal subsidiary undertakings of the Company are set out below:

<u>Company Name</u>	<u>Activity</u>	<u>Country of Incorporation or Registration</u>	<u>Registered Office/Head Office</u>
The Governor and Company of the Bank of Scotland	Banking, financial and related services	Scotland	The Mound Edinburgh EH1 1YZ
Halifax plc	Banking Services	England and Wales	Trinity Road Halifax HX1 2RG
Halifax Share Dealing Limited	Execution only Stockbroking	England and Wales	Trinity Road Halifax HX1 2RG
HBOS Insurance & Investment Group Limited	Investment holding	England and Wales	Trinity Road Halifax HX1 2RG

Certain details of the principal subsidiary undertakings of HBOS Insurance & Investment Group Limited are set out below:

<u>Company Name</u>	<u>Activity</u>	<u>Country of Incorporation or Registration</u>	<u>Registered Office</u>	<u>Total % Held by HBOS Insurance & Investment Group Limited</u>
Clerical Medical Investment Group (Holdings) Limited and its subsidiaries	Life assurance	England and Wales	33 Old Broad Street London EC2N 1HZ	100%
Halifax Financial Services (Holdings) Limited and its subsidiaries	Financial services	England and Wales	Trinity Road Halifax HX1 2RG	100%
St James's Place Capital PLC and its subsidiaries	Financial services	England and Wales	J Rothschild House Dollar Street Cirenscester GL7 2AQ	60%*

* as at December 31, 2002

Certain details of the principal subsidiary undertakings of Bank of Scotland are set out below:

<u>Company Name</u>	<u>Activity</u>	<u>Country of Incorporation or Registration</u>	<u>Registered Office</u>	<u>Total % held by Bank of Scotland</u>
HBOS Treasury Services plc	Banking	England and Wales	33 Old Broad Street London EC2N 1HZ	100%
Capital Bank plc	Banking and personal finance	England and Wales	Queens Park Road Handbridge Chester CH88 3AN	100%
Bank of Western Australia Limited	Retail and commercial banking	Australia	Bankwest Tower 108 St. Georges Terrace, Perth Australia WA6000	56.8%*

* as at December 31, 2002

Employees

The HBOS Group employed on average 48,180 people on a full-time basis and 15,802 people on a part-time basis during the year ended December 31, 2002. Certain of the HBOS Group's employees in the U.K. are members of the union UNIFI (formerly the Banking, Insurance & Finance Union), which is recognised by the HBOS Group as representing the interests of such employees. The HBOS Group considers its relations with its employees to be satisfactory.

Properties

As at December 31, 2002, HBOS Group operated throughout the world, principally in the U.K., from both freehold and leasehold properties.

Legal Proceedings

There are no legal proceedings pending or, so far as the Company is aware, threatened against the Company or any of its subsidiaries, the result of which is likely to have a material effect on the Company or any of its subsidiaries.

Competition

U.K.

The banking market in the U.K. is characterized by continuing structural change which has increased competition in recent years from a variety of sources, including merged banks, demutualized life insurers and building societies and diversified consumer services companies. The impact of these changes is still being felt, particularly in the form of more aggressive competition and drives to greater productivity through reductions in branch networks and employees with greater use of technology.

In addition, the U.K. financial services industry has continued to attract new entrants, often well-established non-financial companies with large customer bases or insurance companies. Technology has lowered many traditional barriers to such new entrants. For example, several supermarkets have started banks, generally as joint ventures with existing banks and life insurance companies, that provide certain banking products and services using new technology and their established brand names to reach existing customer bases. Sainsbury's Bank plc, in which the Company has a 45% shareholding, is an example of such a "supermarket" bank.

As at December 31, 2002, the Company had 1,121 branch outlets in the U.K. In the U.K., the Company competes with U.K. clearing banks, the major international banks represented there and the U.K. building societies.

The U.K. markets for the Company's activities are characterized by intense competition. These are generally over-supplied markets, putting pressure on new business lending margins. The Company has pursued a strategy of asset and industry specialization, which, together with distribution power and efficiency gains, has achieved asset growth and increased net income.

Australia

BankWest is a public company listed on the Australian Stock Exchange. In its home state, BankWest is a market leader with about one quarter of all bank advances and deposits. In interstate markets, which have increased to 45.8% of the bank's total lending, BankWest promotes a selected range of products using cost-effective third party distribution channels, including mortgage brokers and partnerships.

International

The Company's other overseas operations are conducted through its branches in New York City, Hong Kong, Paris, Amsterdam, Singapore and Frankfurt and representative offices in Boston, Chicago, Houston, Los Angeles, Minneapolis and Seattle. In these locations, the Group competes with a wide variety of large domestic and international banks.

Regulation and Supervision

Regulation and Supervision in the U.K.

Responsibility for banking supervision was transferred from the Bank of England to the Financial Services Authority ("FSA") on June 1, 1998, pursuant to the Bank of England Act 1998. The FSA subsequently acquired direct supervision powers over deposit takers under the U.K. Financial Services and Markets Act 2000 ("FSMA") which came into force on December 1, 2001.

Following the transfer of banking supervision, the Bank of England and the FSA maintain a close working relationship. The Bank of England retains a role in ensuring financial stability. The agreed framework for

cooperation in the field of financial stability is set out in detail in the Memorandum of Understanding published jointly by H.M. Treasury, the FSA and the Bank of England at the end of October 1997. The Memorandum of Understanding explains how the three authorities work together towards the common objective of financial stability and sets out how their respective responsibilities are to be discharged. The division of responsibilities is based on four guiding principles:

- (i) clear accountability;
- (ii) “transparency” (i.e., the U.K. Parliament, the markets and the public must know who is responsible for what);
- (iii) no duplication; and
- (iv) regular information exchange.

The respective responsibilities of the Bank of England, the FSA and H.M. Treasury may be summarized as follows:

(i) **Bank of England**

The Bank of England is responsible for the overall stability of the financial system as a whole which involves:

- (a) monitoring the stability of the monetary system;
- (b) the financial system infrastructure, in particular payments systems at home and abroad;
- (c) maintaining a broad overview of the financial system through its monetary stability role and the Deputy Governor’s membership of the FSA’s Board;
- (d) the undertaking of official financial operations; and
- (e) the efficiency and effectiveness of the financial sector, with particular regard to international competitiveness.

(ii) **The Financial Services Authority**

The FSA’s powers and responsibilities are derived from the FSMA.

The FSA has responsibility for:

- (a) regulating and authorizing all businesses carrying on regulated activities in the U.K. (which currently includes all forms of deposit taking and investment activity, and is expected to incorporate long term care insurance by 2004 and general insurance regulation by 2005);
- (b) regulating and authorizing unit trusts and open-ended investment companies;
- (c) recognizing and supervising markets and investment exchanges;
- (d) recognizing and supervising clearing houses;
- (e) recognizing and supervising credit unions.

Under the FSMA the FSA is required to observe and pursue four statutory objectives:

- (a) to maintain confidence in the U.K. financial system;
- (b) to promote public understanding of the financial system;
- (c) to secure the right degree of protection for consumers; and
- (d) to reduce financial crime.

The securities listing function previously undertaken by the London Stock Exchange was transferred to the FSA with effect from May 1, 2000 under the Official Listing of Securities (Change of Competent Authority) Regulations 2000.

(iii) H.M. Treasury

H.M. Treasury is responsible for the overall institutional structure of regulation and the legislation which governs it. It has no operational responsibility for the activities of the FSA or the Bank of England and will not be involved in them. However, there is a variety of circumstances where the FSA and the Bank of England will need to alert H.M. Treasury about possible problems e.g., where there may be a need for a support operation or a problem arises which could cause wider economic disruption.

Banking Supervision

Deposit taking business is a regulated activity under the FSMA. The FSA has published the Interim Prudential Sourcebook: Banks, that forms part of its Handbook of rules and guidance with which such authorized persons must comply.

The FSA is broadly empowered to request information from and give directions to banks and also sets standards that serve as guidelines for banks under its supervision. Each bank is obliged to submit regular reports to the FSA which provide material for supervisory assessment. The approach adopted by the FSA in supervising banks is risk-based with the objectives of (i) systematic assessment of whether a bank meets the FSMA authorization criteria, (ii) understanding the quality of the management and the risks banks face, (iii) using appropriate supervisory tools to identify risks such as skilled persons' reports on internal controls and (iv) allocating resources proportionate to risk by focusing on banks with a high risk profile.

Banks must report, and in some cases obtain consent for, large single exposures (consent being required for any single exposure exceeding 25% of a bank's capital) and large exposures to related borrowers. The FSA may also obtain independent confirmation from skilled persons as to the accuracy of accounting records and prudential returns and the adequacy of internal controls.

Financial Services Supervision

The Group's business activities such as advising on, dealing in or managing investments such as bonds, money market derivative products and equities and also the sale of personal financial services in investment fields, which the Group undertakes through its bank branches and other business channels (e.g., telephone and on-line banking), are regulated by the FSA.

The U.K. Government has announced that certain types of mortgages, mortgage advisers and general insurance intermediaries will be added to the list of regulated activities under the FSMA. Accordingly, Group companies carrying on these businesses will become subject to the regulation of the FSA, probably on October 31, 2004.

The FSA has proposed the removal of the strict "polarisation" rules (under which firms are required to decide whether to market the investment products of only one company or, alternatively, to become an independent intermediary to provide its customers with impartial advice) and is currently consulting on proposed changes to these "polarised" marketing arrangements. This may allow the Group greater flexibility in its marketing arrangements, particularly with regard to marketing personal financial products across the Group.

With the advent of on-line banking facilities, the rules on financial promotion (that is, the communication in the course of business of an invitation or inducement to engage in investment activity) made under the FSMA, which are media neutral, apply to the internet as they would to other media such as letter, fax or phone call. On-line banking facilities may, however, be further regulated in the future following the introduction of the Electronic Communications Act 2000.

Financial Services Compensation Scheme

The FSMA has introduced the Financial Services Compensation Scheme that combines the functions of the previous compensation schemes. Under the Scheme, deposit claimants will receive the first £2,000 of any claim in full, and 90% of the next £33,000, up to a maximum compensation figure of £31,700.

Data Protection

The Group is also subject to the regulations of the Information Commissioner and is required to abide by the requirements of the Data Protection Act 1998.

Capital Adequacy

As at December 31, 2002, the banks within the Group met and exceeded the minimum capital requirements of the Basel Guidelines and the FSA relating to capital adequacy. It is anticipated that continued compliance with the Basel Guidelines and the FSA minimum capital requirements will not impede the development of the Group's activities.

It should be noted that the Basel Committee on Banking Supervision has issued a proposal for a new capital adequacy framework to replace the 1988 Basel Capital Accord. The new capital framework proposed consists of three "pillars"; (i) minimum capital requirements, (ii) supervisory review of an institution's internal assessment process and capital adequacy and (iii) effective use of disclosure to strengthen market discipline. The FSA believes that the new capital framework will help produce more efficient use of capital, better risk management by financial institutions and improved disclosure which should lead to a safer, more efficient financial system.

In a parallel development, on November 23, 1999, the European Commission published a consultation document containing proposals to review the capital adequacy framework for European Union credit institutions and investment firms. While the scope of the Basel Committee's proposal on capital adequacy is confined to banks, the European Commission's consultation exercise is broader in that it affects investment firms and building societies too.

In the European Union, the existing capital framework (which includes the Own Funds Directive (the "OFD"), the Solvency Ratio Directive (the "SRD") and the Capital Adequacy Directive (the "CAD") which are reflected in the FSA's capital adequacy requirements) is closely modeled on and reflects the 1988 Basel Accord. The OFD and CAD establish the quality and composition of capital for credit institutions and investment firms while the SRD establishes capital charges in respect of credit risk.

The papers produced by the European Commission and the Basel Committee on Banking Supervision are broadly consistent. Initial consultative periods on the papers expired on March 31, 2000 and there have been further consultations. The Basel Committee started a further review of the new proposals in late 2001 which means that the next consultation paper is not expected to be issued until later this year. The European Commission has said that it will reschedule its proposals to accord with the Basel Committee. The implementation of the new capital adequacy framework following both consultations is not expected until 2007.

European Commission Proposals on Consumer Credit

In September 2002, the European Commission published a proposal for a directive of the European Parliament and of the Council on the harmonisation of the laws, regulations and administrative provisions of the member states concerning credit for consumers. If the proposed directive is finalised, member states will have two years in which to bring national implementing legislation into force. The proposal includes (among other things) specific documentation and procedural requirements in respect of mortgage loan origination and administration. For example, a key requirement under the proposed directive is that each drawing under a flexible mortgage loan, and each further advance, must be subject to new underwriting and a new contract. Penalties for non-compliance with these requirements will be determined by the member states, and may provide that credit agreements that do not comply will be unenforceable against the borrower.

In its current form, the proposed directive will not apply to residential mortgage loans for home purchases or home improvements, other than loans where part of the mortgage credit is for equity release, such as a further drawing under a flexible mortgage loan or a further advance. Additionally, the proposed directive will not apply to residential mortgage loans originated before national implementing legislation comes into force, with exceptions. For example, the requirement for new underwriting will apply to any further drawing or further advance made after national implementing legislation comes into force. Accordingly, if implemented in its current form, the proposed directive will apply to each mortgage loan for home purchases or home improvements that includes an equity release component, if the loan is originated, or a further drawing or further advance is made within that loan, after the implementation date.

Until the final text of the directive is decided and the details of United Kingdom implementing legislation are published, it is not certain what effect the adoption and implementation of the directive would have on the respective businesses and operations of entities in the Group.

Regulation and Supervision in the United States

The Company owns two principal bank subsidiaries: Bank of Scotland and Halifax plc. Because Bank of Scotland maintains a federally-licensed branch located in New York City (the “New York Branch”), the Company and Bank of Scotland are subject to the International Banking Act of 1978, as amended (the “IBA”) and thus to various federal statutes, including the Bank Holding Company Act of 1956, as amended (the “BHCA”) and certain provisions of the Federal Reserve Act, as amended. As a general rule, the IBA regulates the U.S. banking activities, and the BHCA regulates the U.S. non-banking activities, of the Company, Bank of Scotland and their affiliates.

Halifax plc has no U.S. operations and therefore is not itself subject to U.S. regulation. However, if Halifax plc at any point were to expand its business into the United States, by, for example, opening a U.S. branch, Halifax plc would become subject to U.S. regulation.

The Company’s insurance and investment subsidiary is HBOS Insurance & Investment Group Limited (“HBOS I&I”), which it acquired as a result of its acquisition of Halifax plc. Among the subsidiaries of HBOS I&I is Rothschild International Asset Management Limited, a non-U.S. investment adviser that is registered with the Securities and Exchange Commission (the “Commission”) and HBOS Investment Advisor Inc., a U.S. investment adviser that is also registered with the Commission and provides investment advice to the Company’s Clerical Medical Investment Group Limited insurance company. The investment advisers are subject to the Investment Advisers Act of 1940 (the “Advisers Act”) and the rules promulgated thereunder by the Commission. HBOS I&I has no other U.S. operations. If, however, it were further to expand its operations in the United States, these operations would also become subject to the U.S. regulations discussed below governing the non-banking activities of the Company.

Regulation of Banking Activities.

The New York Branch, which is licensed by the Comptroller of the Currency (the “Comptroller”), is subject to regulations issued under the IBA by the Comptroller that are similar in most respects to regulations imposed by the Comptroller on national banks, and by the Board of Governors of the Federal Reserve System (the “FRB”). The New York Branch is subject to the FRB’s reserve requirements on deposits and to restrictions on the payments of interest on demand deposits and to restrictions on engaging in tying arrangements involving certain products and services. Deposits with the New York Branch are not insured or eligible to be insured with the Federal Deposit Insurance Corporation. Bank of Scotland’s U.S. representative offices located in Chicago, Illinois; Houston, Texas; Seattle, Washington; Los Angeles, California and Minneapolis, Minnesota are state-licensed and regulated by state banking authorities in the states in which they are located. In addition, these offices, and a subsidiary of Bank of Scotland in Boston, Massachusetts that performs a representative office function, are subject to regulations issued under the IBA by the FRB.

The Company and Bank of Scotland may not open any branch, agency or representative office in the United States, or acquire more than 5% of any class of the voting stock of a U.S. bank or bank holding company, without the prior approval of the FRB. Furthermore, the IBA and related interstate banking and

branching laws impose restrictions on the establishment by Bank of Scotland of banking operations outside its home state (which is New York). In particular, there may be some states in which Bank of Scotland may not be able to establish a full service branch if it should decide to do so. Bank of Scotland generally may acquire a U.S. bank or establish an agency or representative office in any state.

The Gramm-Leach-Bliley Act of 1999 (the “GLBA”), an act which amended various bank and securities laws, includes so-called “push-out” provisions that eliminated the exclusion of banks (including U.S. branches of foreign banks) from the definitions of “broker” and “dealer” under the Securities Exchange Act of 1934 while providing limited exemptions to facilitate certain activities in which banks have traditionally engaged. This change will effectively require most securities activities in which the New York Branch had been authorized to engage to be conducted, if they are to be conducted, in a U.S.-registered broker-dealer affiliate of Bank of Scotland. The final rules relating to the “push-out” provisions were adopted by the Commission with an effective date of March 26, 2003, however, the effective date of these rules have been extended several times by the Commission. Banks now have until May 12, 2003 to comply with the “broker” provisions of the “push-out” rules and until September 30, 2003 to comply with the “dealer” provisions of those rules. The Company does not currently expect these requirements to have a material effect on its U.S. operations.

The GLBA and other laws impose additional requirements on the New York Branch, including certain obligations with respect to the sharing of customer information with third parties in order to maintain the privacy of such information. In addition, the USA Patriot Act of 2001 (the “Patriot Act”) imposes on covered financial institutions, including the New York Branch, certain record-keeping and disclosure obligations. For example, the New York Branch is required to establish a compliance program to detect and report money laundering activities through correspondent and private banking accounts.

Regulation of Non-Banking Activities

In August 2000, Bank of Scotland’s election to become a financial holding company was declared effective by the FRB under amendments to the BHCA that were added by the GLBA. As of September 10, 2001, the date of the creation of HBOS as a holding company for Bank of Scotland, the election of the Company to be a financial holding company was also declared effective. As financial holding companies, the Company and Bank of Scotland may engage in the United States in a wider range of financial activities than those in which they had previously been authorized to engage. In particular, the Company and Bank of Scotland may now engage in a full range of securities, insurance and merchant banking activities, all of which to varying degrees had been restricted or prohibited under prior law. Moreover, they generally may do so without the prior approval of the FRB which in most cases would have been required under prior law.

Except to the extent permitted through merchant banking authority, the Company and Bank of Scotland continue as a general rule to be subject to the requirement under prior law that any investment in a company engaged in the United States in non-financial activities may not exceed 5% of any class of voting shares of that company. In order for the Company and Bank of Scotland to qualify and to maintain their status as financial holding companies, the Company and Bank of Scotland must satisfy certain criteria established in regulations issued by the FRB, including that Bank of Scotland be “well capitalized” and “well managed.” These standards are generally comparable to the standards required to be satisfied by U.S. bank subsidiaries of domestic bank holding companies seeking to qualify as financial holding companies. Under the FRB’s regulations, Bank of Scotland will be regarded as well capitalized if (1) its home country supervisor has adopted risk-based capital standards that are consistent with the Basel Capital Accord; (2) its Tier 1 and total risk-based capital ratios, as calculated under its home country standards, are at least 6% and 10%, respectively; and (3) the FRB determines that its capital is “comparable to the capital required for a U.S. bank owned by a financial holding company”. It will be regarded as well-managed if: (1) each U.S. branch and agency of Bank of Scotland has received at least a “satisfactory” composite rating at its most recent examination; (2) Bank of Scotland’s home country supervisor has consented to the bank’s expanding its activities in the United States to include activities permissible for a financial holding company and (3) the FRB has determined that Bank of Scotland’s management “meets standards comparable to those required of a U.S. bank owned by a financial holding company”.

If the Company or Bank of Scotland were to cease to qualify as a financial holding company, the Company and Bank of Scotland could be required to cease engaging in activities that are permitted only for financial holding companies. A non-U.S. bank that maintains a branch or an agency in the United States or its parent that is not a financial holding company may continue to engage in activities in the United States subject to the BHCA requirements that apply to companies that choose not to be designated as a financial holding company.

Bank of Scotland owns a U.S. non-banking subsidiary, BoS (USA) Inc., a financial lending company, which in turn has an investment in Drive Financial Services L.P., an auto lending company. Both of these lending companies are subject to various federal and state laws regarding lending and consumer protection, as well as the federal laws described above that govern non-banking activities of financial holding companies.

Regulation and Supervision in Australia

Australian Authorized Deposit-taking Institutions (“ADIs”), including banks, operate under the prudential guidelines of the Australian Prudential Regulation Authority (“APRA”). The prudential guidelines have been developed to reflect the important role of ADIs within the Australian economy, to ensure that the financial system remains stable and to protect Australian depositors. ADIs, other than state owned banks, are required by the Banking Act 1959 (Commonwealth) to hold an authority under that Act. BankWest was granted such an authority from December 1, 1995.

APRA’s Prudential Statement on Liquidity Management places the emphasis on ADIs internal management practices and requires ADIs to have systems in place to manage liquidity under different scenarios, including normal day-to-day operations and a bank-specific (“name”) crisis. In particular, ADIs must be able to demonstrate that they would have sufficient liquidity to keep operating for at least five business days under a “name” crisis. ADIs can use a range of strategies to manage liquidity, including holding liquid assets, setting limits on maturity mismatches, diversifying liability sources and developing asset sale strategies. The liquidity management strategy of an ADI is agreed between the ADI and APRA and the ADI must provide APRA with liquidity reports as agreed, usually every quarter.

In addition to liquidity management, ADIs must report large loan exposures to APRA. Each ADI is required to provide a large exposure policy statement, report quarterly all large exposures of more than 10% of its consolidated capital base, review and limit the size of large exposures, and notify any intention to enter into an exceptionally large exposure (defined as an exposure in excess of 30% of its capital base), to ensure this would not result in excessive risk. APRA regularly meets senior management of each ADI to discuss a wide range of issues, including the ADI’s strategic plan, recent performance, prudential compliance and management.

APRA has also released prudential statements relating to capital adequacy and market risk, which apply to all ADIs.

New legislation came into effect in Australia on March 11, 2002 which introduced a new licensing and disclosure regime for financial services providers. The licensing requirements will apply to ADIs in addition to the Banking Act. There are detailed transitional provisions under the new legislation. Broadly, existing financial services providers have two years from the commencement date to obtain an Australian financial services license.

MANAGEMENT

Board of Directors of the Company

<u>Name</u>	<u>Position in the Company</u>	<u>Principal outside activity (if any) of significance to the Company</u>
Lord Stevenson of Coddendam	Chairman — Non-executive Director	Pearson plc
Sir Ronald Garrick	Deputy Chairman — Non-executive Director	—
James Crosby	Chief Executive	—
Mike Ellis	Group Finance Director	—
Philip Hodkinson	Chief Executive — Insurance & Investment	—
Andrew Hornby	Chief Executive — Retail Banking	—
Gordon McQueen	Chief Executive — Treasury	—
Colin Matthew	Chief Executive — Business Banking	—
George Mitchell	Chief Executive — Corporate Banking	—
Charles Dunstone	Non-executive Director	Carphone Warehouse Group plc
Anthony Hobson	Non-executive Director	—
Brian Ivory	Non-executive Director	—
John Maclean	Non-executive Director	—
Coline McConville	Non-executive Director	Clear Channel International Limited
Sir Bob Reid	Non-executive Director	—
Louis Sherwood	Non-executive Director	—
Philip Yea	Non-executive Director	Investcorp International Limited

Meetings of the Board of Directors

The Board of Directors meets regularly (normally ten times per year) to determine the strategic direction of the Group and review its operating and financial performance. The Board has a formal schedule of matters specifically reserved to it, which can only be amended by the Board itself.

Terms of Office of Directors

At every Annual General Meeting of the Company one-third of the current Directors must retire as Directors. All Directors are required to submit themselves for re-election every three years in accordance with the Company's Articles of Association.

Remuneration of Directors

The aggregate remuneration paid to the Directors by members of the Group for the period ended December 31, 2002 was £7.1 million including bonuses and taxable benefits in kind.

Advances to Directors, Officers and Connected Persons

As at December 31, 2002, there were loans (including credit card accounts) by the Group outstanding to 12 Directors, officers and connected persons in the aggregate principal amount of £2.926 million.

DESCRIPTION OF THE NOTES AND THE GUARANTEES

General

The particular terms of any Notes sold will be described in an accompanying supplement to this Offering Memorandum (a “Pricing Supplement”). The terms and conditions set forth in “Description of the Notes and the Guarantees” below will apply to each Note unless otherwise specified in the applicable Pricing Supplement and in such Note.

The senior Notes (the “Senior Notes”) will be issued as separate series under an Amended and Restated Indenture dated as of April 30, 2003 (as amended, supplemented or otherwise modified and in effect from time to time, the “Senior Indenture”) among the Company, Bank of Scotland, Treasury Services and The Bank of New York, as Trustee. The subordinated Notes (the “Subordinated Notes”) will be issued as separate series under an Amended and Restated Indenture dated as of April 30, 2003 (as amended, supplemented or otherwise modified and in effect from time to time, the “Subordinated Indenture” and, together with the Senior Indenture, collectively, the “Indentures”) among the Company, Bank of Scotland, SIF No. 2 and The Bank of New York, as Trustee. The following summaries of certain provisions of the Indentures do not purport to be complete and are subject to, and are qualified in their entirety by reference to, all the provisions of the Indentures, including the definitions therein of certain terms. Wherever particular Sections or defined terms of an Indenture are referred to, such Sections or defined terms shall be deemed to be incorporated herein by reference.

Each Indenture provides that, in addition to the Notes, securities of other series may be issued thereunder without limitation as to aggregate principal amount. (Senior Indenture § 301, Subordinated Indenture § 301). All Notes of one issuance need not be issued at the same time and, unless otherwise provided, an issuance may be reopened under the applicable Indenture, without the consent of any holder, for issuances of additional Notes which will be consolidated and form one series with the notes of the previous issuance. (Senior Indenture § 301, Subordinated Indenture § 301) The securities of other series are to mature on such dates and to bear interest at such rates and to have such other terms and provisions not inconsistent with the Indentures as the respective Issuers and, if applicable, the Company may determine.

The Notes offered hereby are limited to an aggregate principal amount (or, in the case of Notes issued at a discount from their principal amount or Indexed Notes, the aggregate initial offering price) at any time outstanding of (together with securities then outstanding under the Issuers’ and BOS International (Australia) Limited’s Program for the Issuance of Debt Instruments described in their Information Memorandum dated April 30, 2003) up to \$65,000,000,000 or, in the case of Notes denominated in foreign currencies (“Foreign Currency Notes”), the approximate equivalent thereof at the Program Exchange Rate of such foreign currencies or on the date an Issuer agreed to issue such Notes.

Unless otherwise specified in the applicable Pricing Supplement, each Note will mature on a date nine months or more from its date of original issuance (the “Original Issue Date”), as selected by the initial purchaser and agreed to by the Issuer of such Note.

The Notes will be issuable only in fully registered form and in minimum denominations of \$1,000 (or, in the case of Notes not denominated in U.S. dollars, the equivalent thereof in such foreign currency, rounded down to the nearest 1,000 units of such foreign currency) and integral multiples of \$1,000 (or, in the case of Notes not denominated in U.S. dollars, 1,000 units of such foreign currency) in excess thereof. See “Special Provisions Relating to Foreign Currency Notes” for additional information regarding Foreign Currency Notes.

Unless otherwise indicated in the applicable Pricing Supplement, the Notes will be denominated in U.S. dollars and payments of the principal of and any premium or interest on the Notes will be made in U.S. dollars. If any of the Notes are to be denominated in a currency other than U.S. dollars, additional information pertaining to the terms of such Notes and other matters relevant to the holders thereof will be described in the applicable Pricing Supplement. See “Special Provisions Relating to Foreign Currency Notes”.

The Notes may be issued as Original Issue Discount Notes. An Original Issue Discount Note is a Note, including any Note that does not provide for the payment of interest prior to Maturity, which is issued at a price lower than the principal amount thereof and which provides that upon redemption or acceleration of the Stated Maturity thereof an amount less than the principal amount thereof shall become due and payable. In the event of redemption or acceleration of the Stated Maturity of an Original Issue Discount Note, the amount payable to the holder of such Note upon such redemption or acceleration will be determined in accordance with the terms of the Note, but will be an amount less than the amount payable at the Stated Maturity of such Note. Original Issue Discount Notes (and certain other Notes) may be treated as issued with original issue discount for U.S. federal income tax purposes.

The Notes will be redeemable, at the option of the relevant Issuer, prior to their Stated Maturity in the event that such Issuer is obliged to pay any of the additional amounts described in “Payments of Additional Amounts”. See “Optional Tax Redemption.” In addition, the applicable Pricing Supplement will indicate either that a Note cannot otherwise be redeemed prior to its Stated Maturity or that a Note will be redeemable at the option of the relevant Issuer on or after a specified date prior to its Stated Maturity at a specified price or prices (which may include a premium), together with accrued interest to the date of redemption. The applicable Pricing Supplement will also indicate either that an Issuer will not be obligated to redeem a Note at the option of the holder thereof or that an Issuer will be so obligated. If the Issuer will be so obligated, the applicable Pricing Supplement will indicate the period or periods within which (or, if applicable, the event or events upon the occurrence of which) and the price or prices at which the applicable Notes will be redeemed, in whole or in part, pursuant to such obligation and the other detailed terms and provisions of such obligation.

Unless otherwise specified in the applicable Pricing Supplement, the Notes will not be subject to any sinking fund or analogous provisions.

Payment of Principal and Interest

Payment of the principal of and any premium or interest on Notes, other than Foreign Currency Notes with respect to which a Specified Currency payment election has been made, will be made to the registered holders thereof at the office of the Paying Agent, or such other office or agency of the relevant Issuer or the Company maintained by it for that purpose in the Borough of Manhattan, The City of New York, in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts; *provided, however*, that payment of the principal of and any premium and interest on such Notes due at Maturity will be made to the registered holders thereof in immediately available funds at such office or such other offices or agencies if such Notes are presented to the Paying Agent or any other paying agent in time for the Paying Agent or such other paying agent to make such payments in accordance with its normal procedures; and, *provided, further*, that at the option of the relevant Issuer, payment of interest, other than interest payable at Maturity, may be made by check mailed to the address of the person entitled thereto as such address shall appear in the Security Register unless that address is in the Issuer’s country of incorporation or, if different, country of tax residence; and, *provided, further*, that notwithstanding the foregoing a registered holder of \$10,000,000 or more in aggregate principal amount of such Notes having the same Interest Payment Date will be entitled to receive payments of interest, other than interest due at Maturity, by wire transfer of immediately available funds to an account at a bank located in The City of New York (or other location consented to by such Issuer) if appropriate wire transfer instructions have been received by the Paying Agent or any other paying agent in writing not less than 15 calendar days prior to the applicable Interest Payment Date. With respect to payments on Foreign Currency Notes with respect to which a Specified Currency payment election has been made, see “Special Provisions Relating to Foreign Currency Notes.”

Subject to the restrictions on resale set forth on pages 2 and 3 of this Offering Memorandum, the Notes may be presented for registration of transfer or exchange at the office of the Paying Agent. No service charge will be made for any transfer or exchange of such Notes, but an Issuer may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith. (Senior Indenture §§ 301, 302 and 305, Subordinated Indenture §§ 301, 302 and 305).

The Issuers have appointed Citibank N.A., London office as their agent for the payment, transfer and exchange of the Notes, for certain foreign exchange transactions and for the calculation of certain interest rates (the “Paying Agent”, “Authenticating Agent”, “Registrar”, “Exchange Rate Agent” and “Interest Rate Calculation Agent”, respectively).

Senior Notes — General

The Senior Notes are direct, unsecured and unsubordinated obligations of the Company, Bank of Scotland or Treasury Services (or such other designated subsidiary of the Company from time to time), which, in the case of Bank of Scotland will be unconditionally and irrevocably guaranteed by the Company and, in the case of Treasury Services or such other subsidiary, will be unconditionally and irrevocably guaranteed by the Company and Bank of Scotland, jointly and severally. The Senior Notes will rank *pari passu* among themselves and at least *pari passu* with all other unsecured and unsubordinated obligations of the Company, Bank of Scotland, Treasury Services or such other subsidiary, as the case may be, other than with respect to obligations preferred by statute or operation of law.

Senior Notes — Senior Guarantee

Pursuant to the Senior Indenture and the applicable Pricing Supplement, the Company will unconditionally and irrevocably guarantee the due and punctual payment of the principal of and premium and interest, if any, on and any sinking fund payments provided for by the terms of the Senior Notes issued by Bank of Scotland, and the Company and Bank of Scotland will, jointly and severally, unconditionally and irrevocably guarantee the due and punctual payment of the principal of and premium and interest, if any, on and any sinking fund payments provided for by the terms of the Senior Notes issued by Treasury Services and such other designated subsidiaries of the Company from time to time, as the case may be, when and as the same shall become due and payable, whether at Stated Maturity, upon acceleration or by call for redemption. The Company and Bank of Scotland will agree that any amounts to be paid by the Company or Bank of Scotland under their respective guarantees contained in the Senior Indenture (each such guarantee, a “Senior Guarantee”) will be paid without deduction or withholding for any and all present and future taxes, levies, imposts or other governmental charges whatsoever imposed, assessed, levied or collected by or for the account of the United Kingdom or, if different, the country of tax residence of either Guarantor or any political subdivision or taxing authority thereof or therein (the “Company Taxing Jurisdiction”), or if deduction or withholding of any such taxes, levies, imposts or other governmental charges shall at any time be required by the Company Taxing Jurisdiction, the Company or Bank of Scotland, as applicable, will pay such additional amounts in respect of any such principal, premium, interest or sinking fund payment as may be necessary in order that the net amounts paid to the Holders of Senior Notes or to the Trustee, as the case may be, pursuant to the Senior Guarantee after such deduction or withholding shall equal the respective amounts of principal, premium, interest or sinking fund payment, as specified in such Senior Notes, to which the Holders thereof or the Trustee would be entitled if no such deduction or withholding had been made; *provided, however*, that the foregoing shall not apply to any such tax, levy, impost or other governmental charge (i) which would not be payable or due but for the fact that the beneficial owner or the Holder of such Senior Notes is a domiciliary, national or resident of, or engaging in business (whether through a branch, agency or otherwise) or maintaining a permanent establishment or being physically present in, the Company Taxing Jurisdiction or otherwise having some connection with the Company Taxing Jurisdiction other than the holding or ownership of a Senior Note, or receiving income therefrom, or the enforcement of a Senior Note or a Senior Guarantee, (ii) which would not be payable or due but for the failure to comply with any certification, identification or other reporting requirements concerning the nationality, residence, identity or connection with the Company Taxing Jurisdiction of the Holder or beneficial owner of such Senior Notes, if compliance is possible pursuant to the provisions of any statute or regulation or by practice of the Company Taxing Jurisdiction as a condition to or requirement of relief or exemption from such tax, levy, impost or other governmental charge, (iii) which would not be payable or due but for the fact that such Senior Note was presented (if presentation is required) more than 30 days after the date such payment became due or was provided for, whichever is later, except to the extent that the Holder thereof would have been entitled to additional amounts on presenting the same for payment on or before the expiry of such period of 30 days, or (iv) which would not have been so imposed if

the beneficial owner of such Senior Note had been the Holder of such Senior Note or which, if the beneficial owner of such Senior Note had been the Holder of such Senior Note, would have been excluded pursuant to clauses (i) through (iii) inclusive above. (Senior Indenture §§ 205 and 1301).

Senior Notes — Events of Default

The Senior Indenture provides that, if any Event of Default (other than an Event of Default specified in paragraphs (e) and (f) below) with respect to Senior Notes of any series at the time Outstanding occurs and is continuing, either the Trustee or the Holders of not less than 25% in principal amount of the outstanding Senior Notes of that series may, by notice as provided in the Senior Indenture, declare the principal amount (or, if the Senior Notes of that series are Original Issue Discount Notes, such portion of the principal amount as may be specified in the applicable Pricing Supplement) of all of the Senior Notes of that series to be due and payable immediately and upon such declaration such principal amount (or specified amount) shall become immediately due and payable. (Senior Indenture § 502). If an Event of Default specified in paragraphs (e) and (f) below with respect to Senior Notes of any series at the time Outstanding occurs, then the principal amount (or, if the Senior Notes of that series are Original Issue Discount Notes, such portion of the principal amount as may be specified in the applicable Pricing Supplement) of all of the Senior Notes of that series shall, without any act by the Trustee or the Holders of such Senior Notes, become immediately due and payable without presentment, demand, protest or other notice of any kind. Upon certain conditions such acceleration or declaration may be annulled and past defaults may be waived by the Holders of a majority in principal amount of the outstanding Senior Notes of that series on behalf of the Holders of all Senior Notes of that series as described in “Events of Default — General.” Unless otherwise provided in the applicable Pricing Supplement, the following shall be an Event of Default with respect to the Senior Notes of any series (Senior Indenture § 501):

(a) failure by the Issuer of such Senior Notes to pay any interest on any Senior Note when due, continued for 30 days;

(b) failure by the Issuer of such Senior Notes to pay principal of (and premium, if any, on) or the Redemption Price of any Senior Note when due;

(c) failure by the Issuer of such Senior Notes to make any sinking fund payment in respect of any Senior Note when due or beyond any period of grace provided with respect thereto;

(d) failure by the Issuer of such Senior Notes or, if such Senior Notes are guaranteed, the applicable Guarantors to perform any other covenant or warranty of such Issuer (other than a covenant expressly included in the Senior Indenture solely for the benefit of one or more series of Senior Notes other than such series of Senior Notes), continued for 30 days after written notice by the Trustee or the Holders of at least 25% in principal amount of the outstanding Senior Notes of that series;

(e)(i) the entry by a court having jurisdiction in the premises of a decree or order for relief in respect of the Company, Bank of Scotland, the Issuer of such Senior Notes or any Principal Subsidiary in any voluntary case or proceeding under any applicable bankruptcy, insolvency, reorganization, winding up (other than a winding up under or in connection with a scheme of amalgamation or reconstruction not involving bankruptcy or insolvency), sequestration or other similar law or (ii) the entry by a court having jurisdiction in the premises of a decree or order adjudging the Company, Bank of Scotland, such Issuer or any Principal Subsidiary a bankrupt or insolvent, or approving as properly filed a petition seeking reorganization, arrangement, adjustment or composition of or in respect of the Company, such Issuer or any Principal Subsidiary under any applicable law (other than any reorganization, arrangement, adjustment or composition for the purposes of amalgamation or reconstruction while solvent) or appointing a custodian, receiver, liquidator, assignee, trustee, sequestrator or other similar official of the Company, Bank of Scotland, such Issuer or any Principal Subsidiary or any substantial part of the property of the Company, Bank of Scotland, such Issuer or such Principal Subsidiary (having an aggregate book value in excess of £50,000,000) or ordering the winding up or liquidation of the affairs of the Company, Bank of Scotland, such Issuer or any Principal Subsidiary, and any such decree or order for

relief or any such other decree or order shall continue unstayed and in effect for a period of 60 consecutive days; or

(f) commencement by the Company, Bank of Scotland, the Issuer of such Senior Notes or any Principal Subsidiary of a voluntary case or proceeding under any applicable bankruptcy, insolvency, reorganization or other similar law or any other case or proceeding to be adjudicated a bankrupt or insolvent, or the consent by the Company, Bank of Scotland, such Issuer or any Principal Subsidiary to the entry of a decree or order for relief in respect of the Company, Bank of Scotland, such Issuer or such Principal Subsidiary in an involuntary case or proceeding under any applicable bankruptcy, insolvency, reorganization or other similar law or to the commencement of any bankruptcy or insolvency case or proceeding against the Company, Bank of Scotland, such Issuer or such Principal Subsidiary or the filing by the Company, Bank of Scotland, such Issuer or such Principal Subsidiary of a petition or answer or consent seeking reorganization or relief under any such applicable law, or the consent by the Company, Bank of Scotland, such Issuer or any Principal Subsidiary to the filing of such petition or to the appointment or the taking possession by a custodian, receiver, liquidator, assignee, trustee, sequestrator or other similar official of the Company, Bank of Scotland, such Issuer or any Principal Subsidiary or of any substantial part of its respective property (having an aggregate book value in excess of £50,000,000), or the making by the Company, Bank of Scotland, such Issuer or any Principal Subsidiary of an assignment for the benefit of creditors, or the taking of action by the Company, Bank of Scotland, such Issuer or any Principal Subsidiary in furtherance of any such action.

Subordinated Notes — General

The Subordinated Notes (other than Undated Notes) are unsecured subordinated obligations of the Company, Bank of Scotland or SIF No. 2 (or such other designated subsidiary of the Company from time to time), which, in the case of Bank of Scotland will be unconditionally and irrevocably guaranteed on a subordinated basis by the Company and, in the case of SIF No. 2 or such other subsidiary, will be unconditionally and irrevocably guaranteed on a subordinated basis by the Company and Bank of Scotland, jointly and severally. The Subordinated Notes (other than the Undated Notes) will rank *pari passu* among themselves.

Unless otherwise stated in the applicable Pricing Supplement, Subordinated Notes issued under the Program by any Issuer are intended to constitute Tier 2 Capital in accordance with the requirements of the Financial Services Authority. Under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, such Subordinated Notes may not be redeemed prior to their Stated Maturity or purchased by the Issuer thereof, the Company or Bank of Scotland without the prior consent of the Financial Services Authority.

Subordinated Notes intended to constitute Tier 2 Capital shall, under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, have a minimum maturity of five years and one day.

Optional redemption of Subordinated Notes by the Issuer thereof, the Company or Bank of Scotland under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, shall not be permitted prior to five years and one day after the Original Issue Date of such Subordinated Notes. Unless otherwise stated in the applicable Pricing Supplement, Subordinated Notes may not at any time be repaid at the option of the Holder thereof. Subordinated Notes intended to constitute Tier 2 Capital in accordance with the requirements of the Financial Services Authority may not be issued on terms that they are redeemable at the option of the Holder thereof.

Under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, any optional tax redemption of Subordinated Notes would require the prior consent of the Financial Services Authority.

References in this Offering Memorandum to Subordinated Notes include Undated Notes (as hereinafter defined) except as otherwise specified herein.

SIF No. 2 may not issue Undated Notes.

Subordinated Notes (other than Undated Notes) issued by Issuers other than Bank of Scotland — Subordination

The rights and claims of the Trustee and the Holders of Subordinated Notes (other than Undated Notes and Subordinated Notes issued by Bank of Scotland) against the Issuer thereof are subordinated, in the event of the bankruptcy, winding up or liquidation of such Issuer, to the claims of Senior Creditors of the Issuer (as defined below), so that amounts due and payable under the Subordinated Indenture and any such Subordinated Note issued by such Issuer shall be due and payable by such Issuer in such bankruptcy, winding up or liquidation only if and to the extent that such Issuer could make payment thereof rateably with the claims of other Subordinated Creditors of the Issuer (as defined below) and still be solvent immediately thereafter. For this purpose, an Issuer of Subordinated Notes (other than Undated Notes and Subordinated Notes issued by Bank of Scotland) shall be considered to be solvent if it is able to pay its debts to Senior Creditors of the Issuer in full. (Subordinated Indenture § 1006(a)).

A report in writing as to the solvency of the Issuer by its receiver in bankruptcy or liquidator in winding up or liquidation shall, unless the contrary is proved, be treated and accepted by such Issuer, the Company and Bank of Scotland, as guarantors (where applicable), the Trustee and the Holders of such Subordinated Notes as correct and sufficient evidence thereof. (Subordinated Indenture § 1006(a)).

For purposes of the foregoing description of Subordinated Notes (other than Undated Notes and Subordinated Notes issued by Bank of Scotland): (a) “Senior Creditors of the Issuer” means all creditors of an Issuer of Subordinated Notes (other than Bank of Scotland) who are unsubordinated creditors of such Issuer; and (b) “Subordinated Creditors of the Issuer” means creditors of an Issuer of Subordinated Notes (other than Bank of Scotland) (including, without limitation, Holders of such Subordinated Notes) whose claims against such Issuer are subordinated in the event of the bankruptcy, winding up or liquidation of such Issuer in any manner to the claims of any unsecured and unsubordinated creditors of such Issuer but excluding those subordinated creditors of such Issuer (if any) whose claims rank or are expressed to rank junior to (i) the claims of the Trustee and Holders of such Subordinated Notes and/or (ii) the claims of any other creditors of such Issuer whose claims rank or are expressed to rank *pari passu* with the claims of the Trustee and Holders of such Subordinated Notes. (Subordinated Indenture § 1006(a)).

Subordinated Notes (other than Undated Notes) issued by Bank of Scotland — Subordination

The rights and claims of the Trustee and the Holders of Subordinated Notes (other than Undated Notes) issued by Bank of Scotland against Bank of Scotland are subordinated, in the event of the winding up or sequestration of Bank of Scotland, to the claims of Senior Creditors (as defined below) of Bank of Scotland, so that amounts due and payable under the Subordinated Indenture and any such Subordinated Note issued by Bank of Scotland shall be due and payable by Bank of Scotland in such winding up or sequestration only if and to the extent that Bank of Scotland could make payment thereof rateably with the claims of other Subordinated Creditors (as defined below) of Bank of Scotland and still be solvent immediately thereafter. For this purpose, Bank of Scotland shall be considered to be solvent if it is able to pay its debts to Senior Creditors of Bank of Scotland in full. (Subordinated Indenture § 1006(b)).

A report in writing as to the solvency of Bank of Scotland by its liquidator or trustee shall, unless the contrary is proved, be treated and accepted by the Company, as guarantor, Bank of Scotland, the Trustee and the Holders of such Subordinated Notes as correct and sufficient evidence thereof. (Subordinated Indenture § 1006(b)).

For purposes of the foregoing description of Subordinated Notes (other than Undated Notes) issued by Bank of Scotland: (a) “Senior Creditors” of Bank of Scotland means creditors of Bank of Scotland whose claims are lodged or admitted to proof in the winding up or sequestration of Bank of Scotland and who are unsubordinated creditors of Bank of Scotland and (b) “Subordinated Creditors” of Bank of Scotland means creditors of Bank of Scotland (including, without limitation, Holders of such Subordinated Notes issued by Bank of Scotland) whose claims against Bank of Scotland are subordinated in the event of the winding up or

sequestration of Bank of Scotland in any manner to the claims of any unsecured and unsubordinated creditors of Bank of Scotland but excluding those subordinated creditors of Bank of Scotland (if any) whose claims rank or are expressed to rank junior to (i) the claims of the Trustee and Holders of such Subordinated Notes and/or (ii) the claims of any other creditors of Bank of Scotland whose claims rank or are expressed to rank *pari passu* with the claims of the Trustee and Holders of such Subordinated Notes. (Subordinated Indenture § 1006(b)).

Undated Subordinated Notes — Subordination

The rights and claims of the Trustee and the Holders of Subordinated Notes which are specified in the relevant Pricing Supplement as having no fixed Stated Maturity and no fixed date for redemption and are issued by an Issuer other than SIF No. 2 (the “Undated Notes”) against the Issuer of such Undated Notes are subordinated to the claims of Senior Creditors (as defined below) of the Issuer in that payments of principal, Redemption Price, interest or other amounts payable in respect of any such Undated Note will be conditional (such condition is referred to as the “Solvency Condition”) upon such Issuer and, in relation to Undated Notes which are guaranteed by the Company, the Company being solvent at the time of and immediately after payment and in that no principal, Redemption Price, interest or other amounts shall be payable in respect of any such Undated Note except to the extent that such Issuer and, in relation to Undated Notes which are guaranteed (assuming that a payment was then due by the Company), the Company could make such payment and still be solvent (whether or not it is bankrupt, being sequestrated or liquidated or is in winding up) immediately thereafter. In such circumstances, no principal, Redemption Price, interest or other amounts payable in respect of such Undated Notes which would otherwise fall due for payment shall fall so due (subject always to the provisions of the second sentence of the second paragraph under “Subordinated Notes — Events of Default; Defaults; Limited Right of Acceleration”), and, instead, such payment shall become due for payment only if and when and to the extent that both the Issuer of such Undated Notes and, in relation to Undated Notes which are guaranteed, the Company (assuming that a payment was then due by the Company) could make such payment in whole or in part and still be solvent (whether or not it is bankrupt or being liquidated or sequestrated or in winding up) immediately thereafter. Interest will continue to accrue on any such Undated Notes payment of which is suspended pursuant to the provisions described above in accordance with the provisions of such Undated Notes and the Subordinated Indenture. For this purpose, each of such Issuer and the Company, as the case may be, shall be considered to be solvent if it is able to pay its debts to its Senior Creditors (as defined below) as they fall due and its Assets (as defined below) exceed its Liabilities (as defined below) to such Senior Creditors. (Subordinated Indenture § 1006(c)). Amounts representing interest on Undated Notes which are not paid when due as a result of the Solvency Condition not being satisfied shall, so long as the same remain unpaid, constitute “Arrears of Interest” otherwise than for the purposes of the third paragraph below. Arrears of Interest in respect of Undated Notes shall not bear interest. (Subordinated Indenture § 1006(c)).

In addition, Undated Notes issued by Bank of Scotland shall rank *pari passu* with the obligations of Bank of Scotland in respect of its \$250,000,000 Undated Floating Rate Primary Capital Notes, its £200,000,000 Perpetual Subordinated Notes, its £100,000,000 Instruments, its Yen 17,000,000,000 Instruments, its £150,000,000 Instruments and its £150,000,000 Instruments. Undated Notes issued by the Company shall rank *pari passu* with the obligations of the Company in respect of its €415,000,000 Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048, £245,000,000 7.881 per cent. Subordinated Extendable Maturity Notes 2048, £300,000,000 7.50 per cent. Undated Subordinated Step-up Notes, €300,000,000 Floating Rate Undated Subordinated Step-up Notes, ¥42,500,000,000 3.50 per cent. Undated Subordinated Step-up Notes, £600,000,000 Undated Subordinated Notes, €500,000,000 Fixed to Floating Rate Undated Subordinated Notes, £500,000,000 5.75 per cent. Undated Subordinated Step-up Notes, \$1,000,000,000 6.85 per cent. Undated Subordinated Notes and £600,000,000 5.75 per cent. Undated Subordinated Step-up Notes.

A report in writing as to the solvency of an Issuer of Undated Notes or the Company by two Executive Officers (as such term is defined in the Subordinated Indenture) of such Issuer or the Company, as the case may be, or the independent public accountants or auditors of such Issuer or the Company, as the case may be,

or, if the Issuer or the Company, as the case may be, is bankrupt, has been sequestrated or is being liquidated or wound up, its receiver in bankruptcy, its trustee or its liquidator, as the case may be, shall, unless the contrary is proved, be treated and accepted by such Issuer, the Company, the Trustee and the Holders of such Undated Notes as correct and sufficient evidence thereof. (Subordinated Indenture § 1006(c)).

Without prejudice to the Solvency Condition, an Issuer of Undated Notes shall not be obliged to make payment of the interest accrued in respect of any period (an “Accrual Period”) on the due date for the payment thereof (the “Payment Date”), if during the period of twelve months ending on such Payment Date no dividend or other Distribution (as defined below) shall have been declared, paid or made on any class of stock or share capital of, where the Issuer is the Company, the Company or, where the Issuer is Bank of Scotland, Bank of Scotland; and all interest not so paid shall, so long as the same remains unpaid, constitute “Arrears of Interest”. Such Issuer may, subject to the provisions of the immediately succeeding sentence, at its option (upon the expiry of not less than seven days’ notice to the Holders of Undated Notes given in accordance with the relevant provisions of such Undated Notes) at any time pay all or part of the Arrears of Interest (being, if part only, the whole of the interest accrued on all of such Undated Notes during any one or more Accrual Periods) but so that, in the case of any such partial payment, the interest accrued during any Accrual Period shall not be paid prior to that accrued during any earlier Accrual Period. If an Issuer shall have outstanding more than one series of Undated Notes, such Issuer may not pay all or part of the Arrears of Interest in respect of any such series unless it pays all or (as near as practicable) an equivalent proportion of the Arrears of Interest in respect of each other series of its Undated Notes then outstanding. All Arrears of Interest shall (subject to satisfaction of the Solvency Condition and subject to the provisions of the immediately succeeding paragraph) become due in full on the date on which any dividend or other Distribution is next declared, paid or made on any class of stock or share capital of, where the Issuer is the Company, the Company or, where the Issuer is Bank of Scotland, Bank of Scotland, or, if earlier, the date set for any redemption permitted under the Subordinated Indenture, any early redemption exercised at the option of such Issuer (other than a partial redemption) in accordance with the terms of any Undated Note, any early redemption exercised at the option of the Holder in accordance with the terms of any Undated Note or, where the Issuer is Bank of Scotland, the commencement of the sequestration or winding up of Bank of Scotland or, where the Issuer is the Company, the commencement of liquidation or winding up of the Company. If notice is given by such Issuer of its intention to pay the whole or part of Arrears of Interest, such Issuer shall be obliged (subject to satisfaction of the Solvency Condition and subject to the provisions of the immediately succeeding paragraph) to do so upon the expiry of such notice. Arrears of Interest in respect of Undated Notes shall not bear interest. (Subordinated Indenture § 1006(c)).

If, at any time, where the Issuer is Bank of Scotland, an order is made for the sequestration or winding up of Bank of Scotland or an effective resolution is passed for the winding up of Bank of Scotland or, where the Issuer is the Company, an order is made for the liquidation or winding up of the Company or an effective resolution is passed for the winding up of the Company, the Undated Notes shall become due and payable in accordance with the provisions of this paragraph and the Issuer of Undated Notes shall, in lieu of any other payment on Undated Notes representing principal, Redemption Price, accrued interest, Arrears of Interest and/or interest due but unpaid, but subject to satisfying the Solvency Condition, be obliged to pay, in respect of such Undated Notes, such amounts as would have been payable if the Holders of such Undated Notes had, on the day preceding the commencement of such sequestration, liquidation or winding up, become holders of preference stock or shares in the capital of the Company or Bank of Scotland, as the case may be, forming or being part of a class having a preferential right in the sequestration, liquidation or winding up over the holders of all other classes of stock and shares in the capital of the Company or Bank of Scotland, as the case may be, and entitled to receive in such sequestration, liquidation or winding up an amount equal to the Redemption Price and interest (if any) accrued since the Payment Date immediately preceding or coinciding with the commencement of such sequestration, liquidation or winding up to the date of such repayment and all Arrears of Interest and/or, as the case may be, all such interest due but unpaid. (Subordinated Indenture § 1006(c)).

The payment obligations of the Issuer in respect of Undated Notes are conditional upon the Issuer and, in relation to Undated Notes which are guaranteed, the Company being solvent immediately before and after payment by the Issuer and, in relation to Undated Notes which are guaranteed, (assuming that a payment was

then due by the Company) the Company. If this condition is not satisfied, any amounts which might otherwise have been allocated in or towards payment of principal, Redemption Price, interest or other amounts in respect of the Undated Notes may be used to absorb losses. This paragraph is for information only and does not form part of these terms and conditions.

For purposes of the foregoing description of Undated Notes: (a) “Assets” means the non-consolidated gross assets of an Issuer of Undated Notes or, as the case may be, the Company; (b) “Distribution” means (1) any dividend paid by an Issuer of Undated Notes, or the Company, including a capital dividend, (2) any other distribution out of assets of an Issuer of Undated Notes or the Company (whether in cash or otherwise) in respect of stock or shares in such Issuer or the Company, except so much of the distribution, if any, as represents a repayment of capital on the stock or shares or is, when it is made, equal in amount or value to any new consideration received by such Issuer or the Company for the distribution, (3) any redeemable capital stock or any security, issued by an Issuer of Undated Notes or the Company in respect of stock or shares in such Issuer or the Company otherwise than wholly for new consideration, or such part of any redeemable capital stock or share capital or any security so issued as is not properly referable to new consideration, and (4) a distribution within section 209 or 418 of the United Kingdom Income and Corporation Taxes Act 1988 as in force on August 21, 1992; (c) “Liabilities” means the non-consolidated gross liabilities of an Issuer of Undated Notes or, as the case may be, the Company, in each case, as shown by the latest published audited balance sheet of such Issuer or, as the case may be, the Company, but adjusted for contingencies and for subsequent events in such manner and to such extent as such Executive Officers, independent public accountants or auditors or, as the case may be, receiver in bankruptcy, trustee or liquidator may determine to be appropriate; and (d) “Senior Creditors” means in relation to an Issuer of Undated Notes or the Company, creditors of such Issuer or, as the case may be, the Company, (i) who are unsubordinated creditors of such Issuer or, as the case may be, the Company or (ii) whose claims are, or are expressed to be, subordinated to the claims of depositors and/or other creditors, whether subordinated or unsubordinated, of such Issuer or, as the case may be, the Company, other than those whose claims rank, or are expressed to rank, *paripassu* with or junior to the claims of the Trustee and Holders of such Undated Notes. (Subordinated Indenture § 1006(c)).

Subordinated Notes — Certain Additional Limitations

In the event of the bankruptcy, liquidation, sequestration or winding up, as the case may be, of an Issuer, if any payment or distribution of assets of such Issuer of any kind or character, whether in cash, property or securities, including any such payment or distribution which may be payable or deliverable by reason of the payment of any other indebtedness of such Issuer being subordinated to the payment of the Subordinated Notes issued by such Issuer, shall be received by the Trustee or the Holders of such Subordinated Notes, before the claims of all Senior Creditors (as such term is defined, in the case of Subordinated Notes, other than Undated Notes and Subordinated Notes issued by Bank of Scotland, in “Subordinated Notes (other than Undated Notes) issued by Issuers other than Bank of Scotland — Subordination”, in the case of Subordinated Notes, other than Undated Notes, issued by Bank of Scotland, in “Subordinated Notes (other than Undated Notes) Issued by Bank of Scotland — Subordination”, and, in the case of Undated Notes, in “Undated Subordinated Notes — Subordination”) of such Issuer have been paid in full, such payment or distribution shall be held in trust by the Trustee or such Holders, as applicable, and shall be immediately returned by it or them to the liquidator or trustee or receiver in bankruptcy of such Issuer. Thereupon, such payment or distribution will be deemed not to have been made or received. If any of the said rights and claims of any Holder of such Subordinated Notes against such Issuer is discharged by set-off, such Holder will immediately pay an amount equal to the amount of such discharge to the liquidator or trustee or receiver in bankruptcy of such Issuer and until such time as payment is made will hold a sum equal to such amount in trust for the liquidator or trustee or receiver in bankruptcy of such Issuer. Accordingly, such discharge will be deemed not to have taken place. (Subordinated Indenture § 1006(d)).

Subordinated Notes — Other Provisions

The subordination provisions of the Subordinated Indenture apply only to amounts payable under the Subordinated Notes and nothing contained therein shall affect or prejudice any claim by the Trustee against an Issuer of Subordinated Notes in respect of the costs, charges, expenses, liabilities, indemnification or remuneration of the Trustee. (Subordinated Indenture § 1006(e)).

Nothing contained in the subordination provisions of the Subordinated Indenture in any way restricts the right of an Issuer to issue debt obligations, or to give any guarantee or indemnity of any nature, ranking in priority to or *pari passu* with or junior to the obligations of such Issuer in respect of the Subordinated Notes and, if in the opinion of the Trustee, any modification to the subordination provisions to permit such ranking is necessary or expedient, the Trustee is authorized without the consent of the Holders of Subordinated Notes to concur with such Issuer in executing a supplemental indenture effecting such modification. (Subordinated Indenture § 1006(g)). The Articles of Association of SIF No. 2 prohibit SIF No. 2 from incurring any unsubordinated indebtedness for money borrowed. Bank of Scotland has agreed not to permit any amendment or repeal of such prohibition. (Subordinated Indenture § 1305).

Subordinated Notes — Subordinated Guarantee

Pursuant to the Subordinated Indenture, the Company will unconditionally and irrevocably guarantee on a subordinated basis the due and punctual payment of the principal of and premium and interest, if any, on and any sinking fund payments provided for by the terms of the Subordinated Notes issued by Bank of Scotland, and the Company and Bank of Scotland will jointly and severally, unconditionally and irrevocably guarantee on a subordinated basis the due and punctual payment of the principal of and premium and interest, if any, on and any sinking fund payments provided for by the terms of the Subordinated Notes issued by any Issuer other than the Company and Bank of Scotland when and as the same shall become due and payable, whether at Stated Maturity, upon acceleration or by call for redemption. The Company and Bank of Scotland will agree that any amounts to be paid by the Company and/or Bank of Scotland under their respective guarantees contained in the Subordinated Indenture (the “Subordinated Guarantee”) will be paid without deduction or withholding for any and all present and future taxes, levies, imposts or other governmental charges whatsoever imposed, assessed, levied or collected by or for the account of the Company Taxing Jurisdiction, or if deduction or withholding of any such taxes, levies, imposts or other governmental charges shall at any time be required by the Company Taxing Jurisdiction, the Company and/or Bank of Scotland, as the case may be, will pay such additional amounts in respect of any such principal, premium, interest or sinking fund payment as may be necessary in order that the net amounts paid to the Holders of such Subordinated Notes or to the Trustee, as the case may be, pursuant to the Subordinated Guarantee after such deduction or withholding shall equal the respective amounts of principal, premium, interest or sinking fund payment, as specified in such Subordinated Notes, to which the Holders thereof or the Trustee would be entitled if no such deduction or withholding had been made; *provided, however*, that the foregoing shall not apply to any such tax, levy, impost or other governmental charge (i) which would not be payable or due but for the fact that the beneficial owner or the Holder of such Subordinated Notes is a domiciliary, national or resident of, or engaging in business (whether through a branch, agency or otherwise) or maintaining a permanent establishment or being physically present in, the Company Taxing Jurisdiction or otherwise having some connection with the Company Taxing Jurisdiction other than the holding or ownership of a Subordinated Note, or receiving income therefrom, or the enforcement of a Subordinated Note or the Subordinated Guarantee, (ii) which would not be payable or due but for the failure to comply with any certification, identification or other reporting requirements concerning the nationality, residence, identity or connection with the Company Taxing Jurisdiction of the Holder or beneficial owner of such Subordinated Notes, if compliance is possible pursuant to the provisions of any statute or regulation or by practice of the Company Taxing Jurisdiction as a condition to or requirement of relief or exemption from such tax, levy, impost or other governmental charge, (iii) which would not be payable or due but for the fact that such Subordinated Note was presented (if presentation is required) more than 30 days after the date such payment became due or was provided for, whichever is later, except to the extent that the Holder thereof would have been entitled to additional amounts on presenting the same for payment on or before the expiry of such period

of 30 days, or (iv) which would not have been so imposed if the beneficial owner of such Subordinated Note had been the Holder of such Subordinated Note or which, if the beneficial owner of such Subordinated Note had been the Holder of such Subordinated Note, would have been excluded pursuant to clauses (i) through (iii) inclusive above. (Subordinated Indenture §§ 205 and 1301).

Subordinated Notes — Subordinated Guarantee — Certain Additional Limitations

In the event of the sequestration, liquidation or winding up of the Company, in the case of any Subordinated Note guaranteed by the Company, or in the event of the sequestration or winding up of Bank of Scotland, in the case of any Subordinated Note guaranteed by Bank of Scotland, if any payment or distribution of assets of the Company or Bank of Scotland, as the case may be, of any kind or character, whether in cash, property or securities, including any such payment or distribution which may be payable or deliverable by reason of the payment of any other indebtedness of the Company or Bank of Scotland, as the case may be, being subordinated to the payment under the Subordinated Guarantee, shall be received by the Trustee or the Holders of Subordinated Notes guaranteed by the Company or Bank of Scotland, as the case may be, before the claims of all Senior Creditors (as such term is defined, in the case of Subordinated Notes, other than Undated Notes, in “Subordinated Notes (other than Undated Notes) Issued by Issuers other than Bank of Scotland — Subordination” or in “Subordinated Notes (other than Undated Notes) issued by Bank of Scotland — Subordination”, as appropriate, and, in the case of Undated Notes, in “Undated Subordinated Notes — Subordination”) of the Company or Bank of Scotland, as the case may be, have been paid in full, such payment or distribution shall be held in trust by the Trustee or such Holders for the benefit of, and shall be immediately returned by it or them to, the liquidator or trustee of the Company or Bank of Scotland, as the case may be. Thereupon, such payment or distribution will be deemed not to have been made or received. If any of the said rights and claims of any Holder against the Company or Bank of Scotland, as the case may be, is discharged by set-off, such Holder will immediately pay an amount equal to the amount of such discharge to the liquidator or trustee of the Company or Bank of Scotland, as the case may be, and until such time as payment is made will hold a sum equal to such amount in trust for the liquidator or trustee of the Company or Bank of Scotland, as the case may be. Accordingly, such discharge will be deemed not to have taken place. (Subordinated Indenture § 1304(c)).

Subordination of the Subordinated Guarantee — in respect of Subordinated Notes other than Undated Notes

The rights and claims of the Trustee and the Holders of Subordinated Notes (other than Undated Notes) against the Company or Bank of Scotland under a Subordinated Guarantee will be subordinated, in the event of the sequestration, liquidation or winding up of the Company or in the event of the sequestration or winding up of Bank of Scotland, as the case may be, to the claims of Senior Creditors (as defined below) of the Company or Bank of Scotland, respectively, so that amounts guaranteed under such Subordinated Guarantee shall be due and payable by the Company or Bank of Scotland, respectively, in such liquidation, sequestration or winding up only if, and to the extent that, the Company or Bank of Scotland, as the case may be, could make payment thereof rateably with the claims of other Subordinated Creditors (as defined below) of the Company or Bank of Scotland, respectively, and still be solvent immediately thereafter. For this purpose, each of the Company and Bank of Scotland, as the case may be, shall be considered to be solvent if it is able to pay its debts to its Senior Creditors in full. At March 31, 2003, the amount of outstanding claims of Senior Creditors of the Company was approximately £10.3 billion and the amount of outstanding claims of Senior Creditors of Bank of Scotland was approximately £85.9 billion (including approximately £80.7 billion of deposits). As at April 30, 2003, there is no limitation on the issuance of senior indebtedness by either the Company or Bank of Scotland. (Subordinated Indenture §§ 205 and 1304(a)).

A report in writing as to the solvency of the Company or Bank of Scotland, as the case may be, by its liquidator or trustee shall, unless the contrary is proved, be treated and accepted by the Company, Bank of Scotland, the Issuer of such Subordinated Notes, the Trustee and the Holders of Subordinated Notes (other than Undated Notes) as correct and sufficient evidence thereof. (Subordinated Indenture § 1304(a)).

For purposes of the foregoing description of the Subordinated Guarantee by the Company and/or Bank of Scotland of the Subordinated Notes (other than Undated Notes): (a) “Senior Creditors” of the Company or Bank of Scotland means creditors of the Company or Bank of Scotland, respectively whose claims are lodged or admitted to proof in the winding up, liquidation or sequestration of the Company or Bank of Scotland, respectively, and who are unsubordinated creditors of the Company or Bank of Scotland, respectively; and (b) “Subordinated Creditors” of the Company or Bank of Scotland means creditors of the Company or Bank of Scotland, respectively, (including, without limitation, Holders of Subordinated Notes (other than Undated Notes)) whose claims against the Company or Bank of Scotland, respectively, are subordinated in the event of the winding up, liquidation or sequestration of the Company or Bank of Scotland, respectively, in any manner to the claims of any unsecured and unsubordinated creditors of the Company or Bank of Scotland, respectively, but excluding those subordinated creditors of the Company or Bank of Scotland, respectively, (if any) whose claims rank or are expressed to rank junior to (i) the claims of the Trustee and Holders of such Subordinated Notes and/or (ii) the claims of any other creditors of the Company or Bank of Scotland, respectively, whose claims rank or are expressed to rank *pari passu* with the claims of the Trustee and Holders of such Subordinated Notes. (Subordinated Indenture § 1304(a)).

Subordination of the Subordinated Guarantee in respect of Undated Notes

The rights and claims of the Trustee and the Holders of Undated Notes against the Company under a Subordinated Guarantee will be subordinated to the claims of Senior Creditors (as defined in “Undated Subordinated Notes — Subordination”) of the Company in that the payment of amounts guaranteed by the Company under such Subordinated Guarantee will be conditional upon the Company being solvent at the time of payment and in that no amounts guaranteed by the Company under such Subordinated Guarantee shall be payable except to the extent that the Company could make such payment and still be solvent (within the meaning of “Undated Subordinated Notes — Subordination”), whether or not it is being liquidated or is in winding up, immediately thereafter. In such circumstances, no amounts guaranteed under such Subordinated Guarantee, which would otherwise fall due for payment shall fall so due (subject always to the provisions of the second sentence of the second paragraph under “Subordinated Notes — Events of Default; Defaults; Limited Right of Acceleration”), and, instead, such payment shall become due for payment only if and when and to the extent that the Company could make such payment in whole or in part and still be solvent (whether or not it is being liquidated or in winding up) immediately thereafter. For this purpose, the Company shall be considered to be solvent if it is able to pay its debts to Senior Creditors (as so defined) as they fall due and its Assets (as defined in “Undated Subordinated Notes — Subordination”) exceed its Liabilities (as defined in “Undated Subordinated Notes — Subordination”) to such Senior Creditors. (Subordinated Indenture § 1304(b)).

In addition, a Subordinated Guarantee made by the Company shall rank *pari passu* with the obligations of the Company in respect of its €415,000,000 Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048, £245,000,000 7.881 per cent. Subordinated Extendable Maturity Notes 2048, £300,000,000 7.50 per cent. Undated Subordinated Step-up Notes, €300,000,000 Floating Rate Undated Subordinated Step-up Notes, ¥42,500,000,000 3.50 per cent. Undated Subordinated Step-up Notes, £600,000,000 Undated Subordinated Notes, €500,000,000 Fixed to Floating Rate Undated Subordinated Notes, £500,000,000 5.75 per cent. Undated Subordinated Step-up Notes, \$1,000,000,000 6.85 per cent. Undated Subordinated Notes and £600,000,000 5.75 per cent. Undated Subordinated Step-up Notes.

A report in writing as to the solvency of the Company by two Executive Officers (as such term is defined in the Subordinated Indenture) of the Company or the independent public accountants or auditors of the Company or, if the Company has been liquidated or is being wound up, its liquidator or trustee shall, unless the contrary is proved, be treated and accepted by the Company, Bank of Scotland, the Trustee and the Holders of Undated Notes as correct and sufficient evidence thereof.

Subordinated Guarantee — General

The subordination provisions apply only to amounts payable under the Subordinated Guarantee and nothing contained therein shall affect or prejudice any claim by the Trustee against the Company or Bank of

Scotland in respect of the costs, charges, expenses, liabilities, indemnification or remuneration of the Trustee. (Subordinated Indenture § 1304(d)).

Nothing contained in the subordination provisions in any way restricts the right of the Company or Bank of Scotland to issue debt obligations, or to give any guarantee or indemnity of any nature, ranking in priority to or *pari passu* with or junior to the obligations of the Company or Bank of Scotland under their respective Subordinated Guarantees in respect of the Subordinated Notes and if any modification to the subordination provisions to permit such ranking is necessary or expedient, the Trustee is authorized without the consent of the Holders of Subordinated Notes to concur with the Company and/or Bank of Scotland, as the case may be, in executing a supplemental indenture effecting such modification. (Subordinated Indenture § 1304(e)).

Subordinated Notes — Events of Default; Defaults; Limited Right of Acceleration

An Event of Default shall occur only in the case of the winding up, liquidation or sequestration of the Company or Bank of Scotland (other than in connection with certain events not involving bankruptcy or insolvency). The applicable Pricing Supplement may specify additional Events of Default with respect to any series of Subordinated Notes. If an Event of Default shall occur, the principal amount of the Subordinated Notes (or, in the case of Subordinated Notes which are Original Issue Discount Notes, such portion of the principal amount as may be specified in the applicable Pricing Supplement) shall, without any act by the Trustee or the Holders of Subordinated Notes, become immediately due and payable without presentment, demand, protest or other notice of any kind. (Subordinated Indenture §§ 501 and 502). There will be no other right of acceleration of the maturity of the outstanding Subordinated Notes, whether upon a default in the making of any payment of principal or interest with respect to the Subordinated Notes or in the performance of any covenant of the Issuer thereof, the Company or Bank of Scotland or otherwise. The Trustee may, however, petition for the winding up or sequestration of the Company or Bank of Scotland upon the occurrence of a Default, but no other remedy shall be available to the Trustee, as described below.

The following shall be a Default with respect to the Subordinated Notes of any series: (a) failure by the Issuer of any such Subordinated Note to pay any interest on any Subordinated Note when due, continued for 30 days; or (b) failure by the Issuer of any such Subordinated Note to pay principal of (or premium, if any, on) or the Redemption Price of any Subordinated Note when due; or (c) failure by the Issuer of any such Subordinated Note to make any sinking fund payment in respect of any such Subordinated Note when due or beyond any period of grace provided with respect thereto. With respect to clause (a) above, in the case of Undated Notes, (i) a payment of interest shall be deemed to be due even if such Issuer, the Company or Bank of Scotland could not satisfy the Solvency Condition immediately after giving effect to such payment and (ii) the exercise by such Issuer, the Company or Bank of Scotland of the right not to make any payment of interest (described in the fourth paragraph under “Undated Subordinated Notes — Subordination”) shall not constitute a failure to pay interest when due for purposes of clause (a) above. If a Default occurs, the Issuer of such Subordinated Notes shall, upon demand of the Trustee, pay to the Trustee for the benefit of Holders of all such Subordinated Notes, the amount then due and payable on such Subordinated Notes, and if the Issuer fails to pay such amounts forthwith upon such demand, the Trustee may petition for the winding up, liquidation or sequestration of the Company and/or Bank of Scotland, but no other remedy shall be available to the Trustee, provided that the Trustee or any Holder of any such Subordinated Note may not, by virtue of a Default, accelerate the maturity of any of the outstanding Subordinated Notes. Upon the occurrence of a Default with respect to Subordinated Notes of any series, the Holders of such Subordinated Notes shall not at any time be entitled to exercise any right of set-off or counterclaim which may be available to any such Holder against amounts owing by the Issuer, the Company or Bank of Scotland in respect of such Subordinated Notes. If, notwithstanding the provisions of the preceding sentence, any of the rights and claims of any Holder of such Subordinated Notes is discharged by set-off, such Holder will immediately pay an amount equal to the amount of such discharge to such Issuer, the Company or Bank of Scotland, as the case may be, or, if applicable, the liquidator or trustee or receiver in bankruptcy of such Issuer, the Company or Bank of Scotland, to be held on trust for the unsubordinated creditors of the Issuer, the Company or Bank of Scotland, and until such time as payment is made will hold a sum equal to such amount in trust for such Issuer, the Company or Bank of Scotland, as the case may be, or, if applicable, the liquidator or trustee or receiver in

bankruptcy of such Issuer, the Company or Bank of Scotland. Accordingly, such discharge will be deemed not to have taken place. (Subordinated Indenture § 503).

Payments of Additional Amounts

Pursuant to the Indentures, each Issuer party thereto will agree duly and punctually to pay the principal of and premium and interest, if any, on the Notes issued by it thereunder when and as the same shall become due and payable, whether at Stated Maturity, upon acceleration, or by call for redemption. Each Issuer will agree that any amounts to be paid by such Issuer under any Indenture and the Notes issued by it thereunder will be paid without deduction or withholding for any and all present and future taxes, levies, imposts or other governmental charges whatsoever imposed, assessed, levied or collected by or for the account of the country of incorporation of such Issuer or, if different, the country of tax residence of such Issuer or, in each case, any political subdivision or taxing authority thereof or therein (the “Issuer Taxing Jurisdiction”), or if deduction or withholding of any such taxes, levies, imposts or other governmental charges shall at any time be required by the Issuer Taxing Jurisdiction, such Issuer shall pay such additional amounts in respect of any such principal, premium, interest or sinking fund payment as may be necessary in order that the net amounts paid to the Holders of such Notes or to the Trustee, as the case may be, pursuant to such Indenture and such Notes after such deduction or withholding shall equal the respective amounts of principal, premium, interest, or sinking fund payment as specified in such Notes, to which the Holders thereof or the Trustee would be entitled if no such deduction or withholding had been made; *provided, however*, that the foregoing shall not apply to any such tax, levy, impost or other governmental charge (i) which would not be payable or due but for the fact that the beneficial owner or the Holder of such Notes is a domiciliary, national or resident of, or engaging in business (whether through a branch, agency or otherwise) or maintaining a permanent establishment or being physically present in, the Issuer Taxing Jurisdiction or otherwise having some connection with the Issuer Taxing Jurisdiction other than the holding or ownership of a Note, or receiving income therefrom, or the enforcement of a Note, (ii) which would not be payable or due but for the failure of the Holder or beneficial owner of such Notes to comply with any certification, identification or other reporting requirements concerning its nationality, residence, identity or connection with the Issuer Taxing Jurisdiction if compliance is possible pursuant to the provisions of any statute or regulation or by practice of the Issuer Taxing Jurisdiction as a condition to or requirement of relief or exemption from such tax, levy, impost or other governmental charge, (iii) which would not be payable or due but for the fact that such Note was presented (if presentation is required) more than 30 days after the date such payment became due or was provided for, whichever is later, except to the extent that the Holder thereof would have been entitled to additional amounts on presenting the same for payment on or before the expiry of such period of 30 days, or (iv) which would not have been so imposed if the beneficial owner of such Note had been the Holder of such Note or which, if the beneficial owner of such Note had been the Holder of such Note, would have been excluded pursuant to clauses (i) through (iii) inclusive above. (Senior Indenture §§ 202 and 1001, Subordinated Indenture §§ 202 and 1001).

Interest

Unless otherwise indicated in the applicable Pricing Supplement, interest-bearing Notes will bear interest at either (a) a fixed rate (a “Fixed Rate Note”) or (b) a floating rate determined by reference to an interest rate formula, which may be adjusted by adding or subtracting the Spread and/or multiplying by the Spread Multiplier (a “Floating Rate Note”). Each interest-bearing Note will bear interest from and including its Original Issue Date or from and including the most recent Interest Payment Date (or, in the case of a Floating Rate Note with daily or weekly Interest Reset Dates, the day following the Regular Record Date immediately preceding such Interest Payment Date) with respect to which interest on such Note (or any predecessor Note) has been paid or duly provided for at the fixed rate per annum, or at the rate per annum determined pursuant to the interest rate formula, stated therein and in the applicable Pricing Supplement until the principal thereof is paid or made available for payment. Interest will be payable on each Interest Payment Date and at Maturity. Interest will be payable generally to the person in whose name an interest-bearing Note (or any predecessor Note) is registered at the close of business on the Regular Record Date next preceding each Interest Payment Date; *provided, however*, that interest payable at Maturity will be payable to the person

to whom principal shall be payable. The first payment of interest on any interest-bearing Note originally issued between a Regular Record Date and an Interest Payment Date will be made on the second Interest Payment Date following the Original Issue Date of such Note to the registered owner on the Regular Record Date immediately preceding such second Interest Payment Date.

Interest rates, or interest rate formulae, are subject to change by an Issuer from time to time, but no such change will affect any Note already issued or as to which an offer to purchase has been accepted by such Issuer.

Fixed Rate Notes

The applicable Pricing Supplement relating to a Fixed Rate Note will designate a fixed rate of interest per annum payable on such Note. Unless otherwise indicated in the applicable Pricing Supplement, (i) the Interest Payment Date(s) with respect to Fixed Rate Notes shall be either annually on June 1 of each year or semiannually on June 1 and December 1 of each year and at Maturity and (ii) the Regular Record Date(s) for Fixed Rate Notes shall be the date that is 15 calendar days prior to each Interest Payment Date, whether or not such date is a Business Day. Unless otherwise indicated in the applicable Pricing Supplement, interest payments for Fixed Rate Notes shall be the amount of interest accrued from and including (i) the Original Issue Date or (ii) the most recent Interest Payment Date to which interest has been paid or duly provided for, as the case may be, to but excluding the relevant Interest Payment Date and interest on such Notes will be computed on the basis of a 360-day year of twelve 30-day months and, in the case of an incomplete month, the actual number of days elapsed.

In any case where any Interest Payment Date, redemption date or Stated Maturity of any Fixed Rate Note is not a Business Day at any place of payment, then payment of principal of or any premium or interest on such Note need not be made at such place of payment on such date, but may be made on the next succeeding Business Day at such place of payment with the same force and effect as if made on the Interest Payment Date, redemption date or at the Stated Maturity, provided that no interest shall accrue for the period from and after such Interest Payment Date, redemption date or Stated Maturity, as the case may be.

Floating Rate Notes

The applicable Pricing Supplement relating to a Floating Rate Note will designate an interest rate formula for such Floating Rate Note. Such formula may be: (a) the Commercial Paper Rate, in which case such Note will be a Commercial Paper Rate Note, (b) the Prime Rate, in which case such Note will be a Prime Rate Note, (c) the CD Rate, in which case such Note will be a CD Rate Note, (d) EURIBOR, in which case such Note will be a EURIBOR Note, (e) the Federal Funds Rate, in which case such Note will be a Federal Funds Rate Note, (f) LIBOR, in which case such Note will be a LIBOR Note, (g) the Treasury Rate, in which case such Note will be a Treasury Rate Note, (h) the CMT Rate, in which case such Note will be a CMT Rate Note or (i) such other interest rate formula as is set forth in such Pricing Supplement. The applicable Pricing Supplement for a Floating Rate Note also will specify the Spread and/or Spread Multiplier, if any, and the maximum or minimum interest rate limitation, if any, applicable to each Note. In addition, such Pricing Supplement will define or specify for each Floating Rate Note the following terms, if applicable: Calculation Dates, Initial Interest Rate, Interest Payment Dates, Regular Record Dates, Index Maturity, Interest Determination Dates and Interest Reset Dates with respect to such Notes. Unless otherwise specified in the applicable Pricing Supplement, the Paying Agent will act as Calculation Agent with respect to the Floating Rate Notes.

The rate of interest on each Floating Rate Note will be reset daily, weekly, monthly, quarterly, semi-annually, or annually, as specified in the applicable Pricing Supplement. Each date on which the rate of interest on Floating Rate Notes is reset as set forth below is hereinafter referred to as an "Interest Reset Date." Except as otherwise provided in the next sentence, and unless otherwise specified in the applicable Pricing Supplement, the date on which the rate of interest on Floating Rate Notes is reset will be, in the case of Floating Rate Notes which reset daily, each Market Day; in the case of Floating Rate Notes (other than Treasury Rate Notes) which reset weekly, the Wednesday of each week; in the case of Treasury Rate Notes

which reset weekly, the Tuesday of each week, except as provided below; in the case of Floating Rate Notes which reset monthly, the third Wednesday of each month; in the case of Floating Rate Notes which reset quarterly, the third Wednesday of March, June, September and December; in the case of Floating Rate Notes which reset semiannually, the third Wednesday of two months of each year, as indicated in the applicable Pricing Supplement; and in the case of Floating Rate Notes which reset annually, the third Wednesday of one month of each year, as indicated in the applicable Pricing Supplement; *provided, however*, that (a) the interest rate in effect from the Original Issue Date of a Floating Rate Note (or that of a predecessor Note) to but excluding the first Interest Reset Date with respect to such Floating Rate Note will be the Initial Interest Rate (as set forth in the applicable Pricing Supplement) and (b) unless otherwise specified in the applicable Pricing Supplement, the interest rate for the ten days immediately prior to Maturity will be that in effect on the tenth day preceding such Maturity. If any Interest Reset Date for any Floating Rate Note would otherwise be a day that is not a Market Day with respect to such Note, such Interest Reset Date shall be the next succeeding Market Day with respect to such Notes, except that if such Note is a LIBOR Note and the next succeeding such Market Day falls in the next succeeding calendar month, such Interest Reset Date shall be the immediately preceding Market Day.

The Interest Determination Date pertaining to an Interest Reset Date for a Commercial Paper Rate Note (the “Commercial Paper Interest Determination Date”), a Prime Rate Note (the “Prime Rate Interest Determination Date”), a CD Rate Note (the “CD Rate Interest Determination Date”), a Federal Funds Rate Note (the “Federal Funds Interest Determination Date”) or a CMT Rate Note (the “CMT Rate Interest Determination Date”) will be the second Market Day preceding such Interest Reset Date. The Interest Determination Date pertaining to an Interest Reset Date for a LIBOR Note (the “LIBOR Interest Determination Date”) or a EURIBOR Note (the “EURIBOR Interest Determination Date”) will be the second London Market Day preceding such Interest Reset Date. The Interest Determination Date pertaining to an Interest Reset Date for a Treasury Rate Note (the “Treasury Interest Determination Date”) will be the day on which Treasury bills are normally auctioned for the week in which such Interest Reset Date falls, or if no auction is held for such week, the Monday of such week (or, if Monday is a legal holiday, the next succeeding Market Day) and the Interest Reset Date will be the Market Day immediately following such Treasury Interest Determination Date. Treasury bills are usually sold at auction on Monday of each week, unless that day is a legal holiday, in which case the auction is usually held on the following Tuesday, except that such auction may be held on the preceding Friday. If an auction is held for such week on Monday or the preceding Friday, such Monday or preceding Friday shall be the Treasury Interest Determination Date for such week, and the Interest Reset Date for such week shall be the Tuesday of such week (or, if such Tuesday is not a Market Day, the next succeeding Market Day). If the auction for such week is held on any day of such week other than Monday, then such date shall be the Treasury Interest Determination Date and the Interest Reset Date for such week shall be the next succeeding Market Day.

Unless otherwise specified in the applicable Pricing Supplement, the “Calculation Date”, where applicable, pertaining to any Interest Determination Date will be the first to occur of (a) (i) in the case of any CD Rate Interest Determination Date, Commercial Paper Interest Determination Date, Treasury Interest Determination Date, Federal Funds Interest Determination Date or CMT Rate Interest Determination Date, the tenth day after such interest determination date or, if any such day is not a Market Day, the next succeeding such Market Day or (ii) in the case of any Prime Rate Interest Determination Date, LIBOR Interest Determination Date or EURIBOR Interest Determination Date, such interest determination date, and (b) the Market Day preceding the applicable Interest Payment Date or the Stated Maturity (or the date of redemption or repayment, if any) as the case may be.

A Floating Rate Note may have either or both of the following: (a) a maximum interest rate limitation, or ceiling, on the rate of interest which may accrue during any interest period; and (b) a minimum interest rate limitation, or floor, on the rate of interest which may accrue during any interest period. In addition to any maximum interest rate which may be applicable to any Floating Rate Note, the interest rate on the Floating Rate Notes will in no event be higher than the maximum rate permitted by New York law, as the same may be modified by United States federal law of general application. Under present New York law, the maximum

rate is 25% per annum on a simple interest basis. This limit does not apply to Notes in which \$2,500,000 or more has been invested.

The Interest Payment Date with respect to a Floating Rate Note will be the third Wednesday of the month or months specified in the applicable Pricing Supplement. If, pursuant to the preceding sentence, an Interest Payment Date with respect to any Floating Rate Note would otherwise be a day that is not a Market Day with respect to such Note, such Interest Payment Date shall be the next succeeding Market Day with respect to such Note, except that if such Note is a LIBOR Note or a EURIBOR Note and the next succeeding such Market Day falls in the next succeeding calendar month, such Interest Payment Date shall be the immediately preceding Market Day. If the date for payment of the principal of or any premium or interest on any Floating Rate Note at Maturity is not a Business Day at any place of payment, then such payment of principal, premium or interest need not be made on such date at such place of payment, but may be made on the next succeeding Business Day at such place of payment with the same force and effect as if made on the date for such payment of the principal, premium or interest and no interest shall accrue from and after any such date for payment. Unless otherwise indicated in the applicable Pricing Supplement, the Regular Record Date with respect to Floating Rate Notes shall be the date 15 calendar days prior to each Interest Payment Date, whether or not such date shall be a Market Day.

Unless otherwise specified in the applicable Pricing Supplement, interest payments for Floating Rate Notes shall be in the amount of interest accrued from and including (i) the Original Issue Date or (ii) the most recent Interest Payment Date to which interest has been paid or duly provided for, as the case may be, to but excluding the Interest Payment Date; *provided, however*, that if the Interest Reset Dates with respect to any Floating Rate Note are daily or weekly, unless otherwise specified in the applicable Pricing Supplement, interest payable on any Interest Payment Date will include interest accrued from and including (i) the Original Issue Date or (ii) the day following the most recent Regular Record Date in respect of which interest has been paid or duly provided for, as the case may be, to but excluding the day following the Regular Record Date immediately preceding such Interest Payment Date. Notwithstanding the foregoing, interest payable at Maturity will include interest accrued to but excluding the date of Maturity. Unless otherwise specified in the applicable Pricing Supplement, the interest accrued on a Floating Rate Note for any period will be calculated by multiplying the face amount of such Floating Rate Note by an accrued interest factor. Such accrued interest factor is computed by adding the interest factor calculated for each day in such period. The interest factor (expressed as a decimal rounded upwards, if necessary, as described below) for each such day is computed by dividing the interest rate (expressed as a decimal rounded upwards, if necessary, as described below) applicable to such day by, unless otherwise specified in the applicable Pricing Supplement, 360, in the case of Commercial Paper Rate Notes, Prime Rate Notes, CD Rate Notes, Federal Funds Rate Notes, LIBOR Notes, EURIBOR Notes or by the actual number of days in the year, in the case of Treasury Rate Notes and CMT Rate Notes. All percentages resulting from any calculation of the interest rate on Floating Rate Notes will be rounded, if necessary, to the nearest one-hundredth thousandth of a percentage point, with five one-millionths of a percentage point rounded upwards (e.g., 9.876545% (or .09876545) being rounded to 9.87655% (or .0987655) and 9.876544% (or .09876544) being rounded to 9.87654% (or .0987654)), and all dollar amounts used in or resulting from such calculation on Floating Rate Notes will be rounded to the nearest cent, or in the case of Foreign Currency Notes, the nearest unit (with one-half cent or unit being rounded upwards). Unless otherwise indicated in the applicable Pricing Supplement, the interest rate in effect with respect to a Floating Rate Note on any day that is not an Interest Reset Date will be the interest rate determined as of the Interest Determination Date pertaining to the immediately preceding Interest Reset Date (or if there is none, the Initial Interest Rate), and the interest rate in effect on any day that is an Interest Reset Date will be the interest rate determined as of the Interest Determination Date pertaining to such Interest Reset Date, subject in either case to any maximum or minimum interest rate limitation referred to above; *provided, however*, that the interest rate in effect for the ten calendar days prior to Maturity shall be the interest rate in effect on the tenth calendar day prior to Maturity.

Upon the request of the holder of any Floating Rate Note or the Issuer, the Calculation Agent (which shall be the Paying Agent unless otherwise specified in the applicable Pricing Supplement) will provide the interest rate then in effect, and, if determined, the interest rate which will become effective on the next

Interest Reset Date as a result of a determination made on the most recent Interest Determination Date with respect to such Floating Rate Note.

Interest rates on Floating Rate Notes will be determined by the Calculation Agent as follows:

Commercial Paper Rate Notes

Each Commercial Paper Rate Note will bear interest at the interest rate (calculated with reference to the Commercial Paper Rate and the Spread and/or Spread Multiplier, if any) specified on the face of such Commercial Paper Rate Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement, “Commercial Paper Rate” means, with respect to any Commercial Paper Interest Determination Date, the Money Market Yield (calculated as described below) of the rate on such date for commercial paper having the Index Maturity specified in the applicable Pricing Supplement as published in H.15(519) under the heading “Commercial Paper — Non-financial.” In the event that such rate is not published prior to 3:00 P.M., New York City time, on the Calculation Date pertaining to such Commercial Paper Interest Determination Date, then the Commercial Paper Rate shall be the Money Market Yield of the rate on such Commercial Paper Interest Determination Date for commercial paper having the Index Maturity specified in the applicable Pricing Supplement as published in H.15 Daily Update under the heading “Commercial Paper — Non-financial.” If by 3:00 P.M., New York City time, on such Calculation Date such rate is not yet published in either H.15(519) or H.15 Daily Update, the Commercial Paper Rate for that Commercial Paper Interest Determination Date shall be calculated by the Calculation Agent and shall be the Money Market Yield of the arithmetic mean of the offered rates, as of 11:00 A.M., New York City time, on that Commercial Paper Interest Determination Date, of three leading dealers of commercial paper in The City of New York selected by the Calculation Agent for commercial paper having the Index Maturity specified in the applicable Pricing Supplement placed for an industrial issuer whose bond rating is “AA,” or the equivalent, from a nationally recognized rating agency; *provided, however*, that if the dealers selected as aforesaid by the Calculation Agent are not quoting as mentioned in this sentence, the Commercial Paper Rate will be the Commercial Paper Rate in effect on such Commercial Paper Interest Determination Date.

“Money Market Yield” shall be a yield (expressed as a percentage) calculated in accordance with the following formula:

$$\text{Money Market Yield} = \frac{D \times 360}{360 - (D \times M)} \times 100$$

where “D” refers to the per annum rate for commercial paper quoted on a bank discount basis and expressed as a decimal; and “M” refers to the actual number of days in the interest period for which interest is being calculated.

Prime Rate Notes

Each Prime Rate Note will bear interest at the interest rate (calculated with reference to the Prime Rate and the Spread and/or Spread Multiplier, if any) specified on the face of such Prime Rate Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement, “Prime Rate” means, with respect to any Prime Rate Interest Determination Date, the rate set forth on such date in H.15(519) under the heading “Bank Prime Loan.” In the event that such rate is not published prior to 3:00 P.M., New York City time, then the Prime Rate will be the rate on such Prime Rate Interest Determination Date as published in H.15 Daily Update under the heading “Bank Prime Loan”. In the event such rate is not published in either H.15(519) or H.15 Daily Update, then the Prime Rate will be the arithmetic mean of the rates of interest publicly announced by each bank that appears on the Reuters Screen U.S.PRIME1 Page as such bank’s prime rate or base lending rate as in effect for that Prime Rate Interest Determination Date. If fewer than four such rates but more than one such rate appear on the Reuters Screen U.S.PRIME1 Page for the Prime Rate Interest Determination Date, the Prime Rate will be the arithmetic mean of the prime rates quoted on the basis of the

actual number of days in the year divided by 360 as of the close of business on such Prime Rate Interest Determination Date by at least two of the three major money center banks in The City of New York selected by the Calculation Agent from which quotations are requested. If fewer than two quotations are provided, the Prime Rate shall be determined on the basis of the rates furnished in The City of New York by the appropriate number of substitute banks or trust companies organized and doing business under the laws of the United States, or any State thereof, in each case having total equity capital of at least \$500 million and being subject to supervision or examination by Federal or State authority, selected by the Calculation Agent to provide such rate or rates, provided, however, that if the banks or trust companies selected as aforesaid by the Calculation Agent are not quoting rates as set forth above, the “Prime Rate” in effect for such Interest Reset Period will be the same as the Prime Rate for the immediate preceding Interest Reset Period (or, if there was no such Interest Reset Period, the rate of interest payable on the Prime Rate Notes for which such Prime Rate is being determined shall be the Initial Interest Rate).

CD Rate Notes

Each CD Rate Note will bear interest at the interest rate (calculated with reference to the CD Rate and the Spread and/or Spread Multiplier, if any) specified on the face of such CD Rate Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement, “CD Rate” means, with respect to any CD Rate Interest Determination Date, the rate on such date for negotiable certificates of deposit having the Index Maturity specified in the applicable Pricing Supplement as published in H.15(519) under the heading “CDs (Secondary Market)”. In the event that such rate is not published prior to 3:00 P.M., New York City time, on the Calculation Date pertaining to such CD Rate Interest Determination Date, then the CD Rate shall be the rate on such CD Rate Interest Determination Date for negotiable certificates of deposit having the Index Maturity specified in the applicable Pricing Supplement as published in H.15 Daily Update under the heading “CDs (Secondary Market)”. If by 3:00 P.M., New York City time, on such Calculation Date such rate is not published in either H.15(519) or H.15 Daily Update, the CD Rate for that CD Interest Determination Date shall be calculated by the Calculation Agent and shall be the arithmetic mean of the secondary market offered rates, as of 10:00 A.M., New York City time, on that CD Rate Interest Determination Date, of three leading nonbank dealers in negotiable U.S. dollar certificates of deposit in The City of New York selected by the Calculation Agent for negotiable certificates of deposit of major United States money market banks with a remaining maturity closest to the Index Maturity specified in the applicable Pricing Supplement in a denomination of \$5,000,000; *provided, however*, that if the dealers selected as aforesaid by the Calculation Agent are not quoting as mentioned in this sentence, the CD Rate will be the CD Rate in effect on such CD Rate Interest Determination Date.

Federal Funds Rate Notes

Each Federal Funds Rate Note will bear interest at the interest rate (calculated with reference to the Federal Funds Rate and the Spread and/or Spread Multiplier, if any) specified on the face of such Federal Funds Rate Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement “Federal Funds Rate” means, with respect to any Federal Funds Interest Determination Date, the rate on such date for Federal Funds having the Index Maturity specified in the applicable Pricing Supplement as published in H.15(519) under the heading “Federal Funds (Effective)” as displayed on Moneyline Telerate on page 120. In the event that such rate is not published prior to 3:00 P.M., New York City time, on the Calculation Date pertaining to such Federal Funds Interest Determination Date, then the Federal Funds Rate will be the rate on such Federal Funds Interest Determination Date as published in H.15 Daily Update under the heading “Federal Funds (Effective).” If by 3:00 P.M., New York City time, on such Calculation Date such rate is not published in either H.15(519) or H.15 Daily Update, the Federal Funds Rate for that Federal Funds Interest Determination Date shall be calculated by the Calculation Agent and shall be the arithmetic mean of the rates, as of 9:00 A.M., New York City time, on that Federal Funds Interest Determination Date, for the last transaction in overnight Federal Funds arranged by three leading brokers of Federal Funds transactions in The

City of New York selected by the Calculation Agent; *provided, however*, that if the brokers selected as aforesaid by the Calculation Agent are not quoting as mentioned in this sentence, the Federal Funds Rate will be the Federal Funds Rate in effect on such Federal Funds Interest Determination Date.

LIBOR Notes

Each LIBOR Note will bear interest at the interest rate (calculated with reference to LIBOR and the Spread and/or Spread Multiplier, if any) specified on the face of such LIBOR Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement, LIBOR will be determined by the Calculation Agent in accordance with the following provisions:

(a) With respect to any LIBOR Interest Determination Date, LIBOR will be determined on the basis of the offered rate for deposits of not less than \$1,000,000 having the Index Maturity specified in the applicable Pricing Supplement, commencing on the second London Market Day immediately following such LIBOR Interest Determination Date, which appears on (1) if “LIBOR Reuters” is specified in the applicable Pricing Supplement, the display designated as Page LIBO or LIBP on the Reuter Monitor Money Rates Service (or such other page as may replace such page on that service for the purpose of displaying London interbank offered rates of major banks for deposits in U.S. dollars) or (2) if “LIBOR Telerate” is specified in the applicable Pricing Supplement or neither “LIBOR Reuters” nor “LIBOR Telerate” is specified in the applicable Pricing Supplement as the method for calculating LIBOR, the display designated as Page 3740 or Page 3750, as applicable, on Moneyline Telerate (or such other page as may replace any such page on that service for the purpose of displaying London interbank offered rates of major banks for deposits in U.S. dollars) in each case as of 11:00 A.M., London time, on that LIBOR Interest Determination Date. If no such offered rate appears, LIBOR for such LIBOR Interest Determination Date will be determined as described in (b) below.

(b) With respect to a LIBOR Interest Determination Date on which no rate appears on Reuter Page LIBO or LIBP (if “LIBOR Reuters” is specified in the applicable Pricing Supplement) or no rate appears on Moneyline Telerate Page 3740 or 3750 (if “LIBOR Telerate” is specified in the applicable Pricing Supplement or neither “LIBOR Reuters” nor “LIBOR Telerate” is specified in the applicable Pricing Supplement as the method for calculating LIBOR) as described in (a) above, LIBOR will be determined on the basis of the rates at approximately 11:00 A.M., London time, on such LIBOR Interest Determination Date at which deposits in U.S. dollars having the Index Maturity specified in the applicable Pricing Supplement are offered to prime banks in the London interbank market by four major banks in the London interbank market selected by the Calculation Agent and in a principal amount equal to an amount of not less than \$1,000,000 that in the Calculation Agent’s judgment is representative for a single transaction in such market at such time. The Calculation Agent will request the principal London office of each of such banks to provide a quotation of its rate. If at least two such quotations are provided, LIBOR for such LIBOR Interest Determination Date will be the arithmetic mean of such quotations as determined by the Calculation Agent. If fewer than two quotations are provided, LIBOR for such LIBOR Interest Determination Date will be the arithmetic mean of the rates quoted at approximately 11:00 A.M., London time, on such LIBOR Interest Determination Date by three major banks in London, England, selected by the Calculation Agent, for loans in U.S. dollars to leading European banks having the specified Index Maturity and in a principal amount equal to an amount of not less than \$1,000,000 that in the Calculation Agent’s judgment is representative for a single transaction in such market at such time; *provided, however*, that if fewer than three banks selected as aforesaid by the Calculation Agent are not quoting as mentioned in this sentence, LIBOR will be the LIBOR in effect on such LIBOR Interest Determination Date.

EURIBOR Notes

Each EURIBOR Note will bear interest at the interest rate (calculated with reference to EURIBOR and the Spread and/or Spread Multiplier, if any) specified on the face of such EURIBOR Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement, EURIBOR will be determined by the Calculation Agent in accordance with the following provisions:

(a) With respect to any EURIBOR Interest Determination Date, EURIBOR will be determined on the basis of the offered rate for deposits of not less than the equivalent of U.S.\$1,000,000 in euros having the Index Maturity specified in the applicable Pricing Supplement, commencing on the second London Market Day immediately following such EURIBOR Interest Determination Date, which rate is published jointly by the European Banking Federation and ACI — The Financial Market Association and which rate appears on the display on Moneyline Telerate, on page 248, commonly referred to as “Telerate Page 248” (or such other page as may replace any such page on that service for the purpose of displaying Euro-zone Interbank offered rates of major banks) as of 11:00 A.M., Brussels time, on that EURIBOR Interest Determination Date. If no such offered rate appears, EURIBOR for such EURIBOR Interest Determination Date will be determined as described in (b) below.

(b) With respect to a EURIBOR Interest Determination Date on which no rate appears on Telerate Page 248 described in (a) above, EURIBOR will be determined on the basis of the rates at approximately 11:00 A.M., Brussels time, on such EURIBOR Interest Determination Date at which deposits in euros having the Index Maturity specified in the applicable Pricing Supplement are offered to prime banks in the Euro-zone Interbank market by the four major banks in the Euro-zone Interbank market selected by the Calculation Agent and in a principal amount equal to an amount of not less than \$1,000,000 that in the Calculation Agent’s judgment is representative for a single transaction in such market at such time. The Calculation Agent will request the principal Euro-zone office of each of such banks to provide a quotation of its rate. If at least two such quotations are provided, EURIBOR for such EURIBOR Interest Determination Date will be the arithmetic mean of such quotations as determined by the Calculation Agent. If fewer than two quotations are provided, EURIBOR for such EURIBOR Interest Determination Date will be the arithmetic mean of the rates quoted at approximately 11:00 A.M., Brussels time, on such EURIBOR Interest Determination Date, by four major banks in the Euro-zone selected by the Calculation Agent, for loans in euros to leading European banks having the specified Index Maturity and in a principal amount equal to an amount of not less than \$1,000,000 that in the Calculation Agent’s judgment is representative for a single transaction in such market at such time, *provided, however*, that if fewer than four banks selected as aforesaid by the Calculation Agent are quoting as mentioned in this sentence, EURIBOR will be the EURIBOR in effect on such EURIBOR Interest Determination Date.

Treasury Rate Notes

Each Treasury Rate Note will bear interest at the interest rate (calculated with reference to the Treasury Rate and the Spread and/or Spread Multiplier, if any) specified on the face of such Treasury Rate Note and in the applicable Pricing Supplement.

Unless otherwise indicated in the applicable Pricing Supplement, “Treasury Rate” means, with respect to any Treasury Interest Determination Date, the rate for the most recent auction of direct obligations of the United States (“Treasury Bills”) having the Index Maturity specified in the applicable Pricing Supplement on the display on Moneyline Telerate on page 56 or page 57 under the caption “AVGE INVEST YIELD”. If not so published by 3:00 P.M., New York City time, on the Calculation Date pertaining to such Treasury Interest Determination Date, the auction average rate (expressed as a bond equivalent on the basis of a year of 365 or 366 days, as applicable, and applied on a daily basis) for such auction as otherwise announced by the United States Department of the Treasury. In the event that the results of the auction of Treasury Bills having the Index Maturity specified in the applicable pricing supplement are not published or reported as provided above by 3:00 P.M., New York City time, or if no auction is held, then the Treasury Rate will be the rate as

published in H.15(519) under the heading “U.S. Government Securities/Treasury Bills/Secondary Market” or any successor publication or heading for Treasury Bills having the Index Maturity specified in the applicable pricing supplement. In the event that the results of the auction of the Treasury bills having the Index Maturity specified in the applicable Pricing Supplement are not published or reported as provided above by 3:00 P.M., New York City time, on such Calculation Date, or if no such auction is held in a particular week, then the Treasury Rate shall be calculated by the Calculation Agent and shall be a yield to maturity (expressed as a bond equivalent on the basis of a year of 365 or 366 days, as applicable, and applied on a daily basis) of the arithmetic mean of the secondary market bid rates as of approximately 3:30 P.M., New York City time, on such Treasury Interest Determination Date, of three leading primary United States government securities dealers selected by the Calculation Agent, for the issue of Treasury bills with a remaining maturity closest to the specified Index Maturity; *provided, however*, that if the dealers selected as aforesaid by the Calculation Agent are not quoting as mentioned in this sentence, the Treasury Rate will be the Treasury Rate in effect on such Treasury Interest Determination Date.

CMT Rate Notes

Each CMT Rate Note will bear interest at the interest rate (calculated with reference to the CMT Rate and the Spread and/or Spread Multiplier, if any) specified on the face of such CMT Rate Note and in the applicable Pricing Supplement.

Unless otherwise indicated in an applicable Pricing Supplement, “CMT Rate” means, with respect to any CMT Interest Determination Date, the rate displayed for the Index Maturity designated in such CMT Rate Note on the Designated CMT Telerate Page (as defined below) under the caption “... Treasury Constant Maturities ... Federal Reserve Board Release H.15”, “Mondays Approximately 3:45 P.M.” under the column for the Designated CMT Maturity Index (as defined below) for (i) if the Designated CMT Telerate Page is 7051, the rate on such CMT Interest Determination Date and (ii) if the Designated CMT Telerate Page is 7052, the week or the month, as applicable, ended immediately preceding the week in which the related CMT Interest Determination Date occurs. If such rate is no longer displayed on the relevant page, or if not displayed by 3:00 p.m., New York City time, on the related Calculation Date, then the CMT Rate for such CMT Interest Determination Date will be such Treasury Constant Maturity rate for the Designated CMT Maturity Index as published in the relevant H.15(519). If such rate is no longer published, or if not published by 3:00 p.m., New York City time, on the related Calculation Date, then the CMT Rate for such CMT Interest Determination Date will be such Treasury Constant Maturity rate for the Designated CMT Maturity Index (or other United States Treasury rate for the Designated CMT Maturity Index) for the CMT Interest Determination Date with respect to the related CMT Interest Reset Date as may then be published by either the Board of Governors of the Federal Reserve System or the United States Department of the Treasury that the Calculation Agent determines to be comparable to the rate formerly displayed on the Designated CMT Telerate Page and published in the relevant H.15(519). If such information is not provided by 3:00 p.m., New York City time, on the related Calculation Date, then the CMT Rate for the CMT Interest Determination Date will be calculated by the Calculation Agent and will be a yield to maturity, based on the arithmetic mean of the secondary market closing offer side prices as of approximately 3:30 p.m., New York City time, on the CMT Interest Determination Date reported, according to their written records, by three leading primary United States government securities dealers (each a “Reference Dealer”) in the City of New York (which may include the Agents or their affiliates) selected by the Calculation Agent (from five such Reference Dealers selected by the Calculation Agent after consultation with the Company, and eliminating the highest quotation (or, in the event of equality, one of the highest) and the lowest quotation (or, in the event of equality, one of the lowest), for the most recently issued direct noncallable fixed rate obligations of the United States (“Treasury Notes”) with an original maturity of approximately the Designated CMT Maturity Index and remaining term to maturity of not less than such Designated CMT Maturity Index minus one year. If the Calculation Agent cannot obtain three such Treasury Notes quotations, the CMT Rate for such CMT Interest Determination Date will be calculated by the Calculation Agent and will be a yield to maturity based on the arithmetic mean of the secondary market offer side prices as of approximately 3:30 p.m., New York City time, on the CMT Interest Determination Date of three Reference Dealers in the City of New York (from five such Reference Dealers selected by the Calculation Agent, after consultation with the Company, and eliminating

the highest quotation (or, in the event of equality, one of the highest) and the lowest quotation (or, in the event of equality, one of the lowest), for Treasury Notes with an original maturity of the number of years that is the next highest to the Designated CMT Maturity Index and a remaining term to maturity closest to the Designated CMT Maturity Index and in an amount of at least \$100,000,000. If three or four (and not five) of such Reference Dealers are quoting as described above, then the CMT Rate will be based on the arithmetic mean of the offer prices obtained and neither the highest nor the lowest of such quotes will be eliminated: *provided, however*, that if fewer than three Reference Dealers selected by the Calculation Agent are quoting as described herein, the CMT Rate for such Interest Reset Date will be the same as the CMT Rate in effect on such CMT Interest Determination Date. If two Treasury Notes with an original maturity as described in the second preceding sentence have remaining terms to maturity equally close to the Designated CMT Maturity Index, the quotes for the Treasury Note with the shorter remaining term to maturity will be used.

“Designated CMT Telerate Page” means the display on the Moneyline Telerate on the page designated in an applicable Pricing Supplement (or any other page as may replace such page on that service for the purpose of displaying Treasury Constant Maturities as reported in H.15(519)), for the purpose of displaying Treasury Constant Maturities as reported in H.15(519). If no such page is specified in the applicable Pricing Supplement, the Designated CMT Telerate Page shall be 7052, for the most recent week.

“Designated CMT Maturity Index” shall be the original period to maturity of the U.S. Treasury securities (either 1, 2, 3, 5, 7, 10, 20 or 30 years) specified in an applicable Pricing Supplement with respect to which the CMT Rate will be calculated. If no such maturity is specified in the applicable Pricing Supplement, the Designated CMT Maturity Index shall be two years.

Indexed Notes

Notes may be issued, from time to time, with the principal amount payable on any principal payment date, or the amount of interest payable on any interest payment date, to be determined by reference to the value of one or more currency exchange rates, commodity prices, equity indices or other factors. Holders of such Notes may receive a principal amount on any principal payment date, or a payment of interest on any interest payment date, that is greater than or less than the amount of principal or interest that would otherwise be payable on such dates, depending upon the value on such dates of the applicable currency, commodity, equity index or other factor. Additional information as to the methods for determining the amount of principal or interest payable on any date, the currencies, commodities, equity indices or other factors to which the amount payable on such date is linked and certain additional tax considerations will be set forth in the applicable Pricing Supplement.

Amortizing Notes

Amortizing Notes are Fixed Rate Notes for which payments combining principal and interest are made in installments over the life of the Note (“Amortizing Notes”). Unless otherwise specified in the applicable Pricing Supplement, interest on each Amortizing Note will be computed on the basis of a 360-day year of twelve 30-day months. Payments with respect to Amortizing Notes will be applied first to interest due and payable thereon and then to the reduction of the unpaid principal amount thereof. Further information concerning additional terms and conditions of any issue of Amortizing Notes, as well as the tax consequences of that issue, will be provided in the applicable Pricing Supplement. A table setting forth repayment information in respect of each Amortizing Note will be included in the applicable Pricing Supplement and set forth on such Notes.

Optional Redemption

Unless otherwise specified in the applicable Pricing Supplement, the Notes will not be redeemable at the option of the Issuer thereof, except for the reasons set forth in “Optional Tax Redemption” below. In the event that Notes are so redeemable, notice of redemption will be provided by mailing a notice of such redemption to each Holder of such Notes by first class mail, postage prepaid, at least 30 days and not more than 60 days prior to the date fixed for redemption to the respective address of each such Holder as that address appears upon the

books maintained by the Paying Agent. (Senior Indenture §§ 301(6) and 1104, Subordinated Indenture §§ 301(6) and 1104). Unless otherwise specified in the applicable Pricing Supplement, the Notes will not be subject to any sinking fund.

Optional redemption, or redemption pursuant to a sinking fund or analogous provision, of Subordinated Notes by the Issuer thereof, the Company or Bank of Scotland under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, shall not be permitted in whole or in part prior to the date falling five years and one day after the Original Issue Date of such Subordinated Notes.

Under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, any optional redemption, or redemption pursuant to a sinking fund or analogous provision, of Subordinated Notes would require the prior consent of the Financial Services Authority.

Repayment at Holders' Option, Repurchase

Procedures, if any, relating to repayment of Notes at the option of the Holder thereof will be described in the applicable Pricing Supplement. (Senior Indenture § 301(7), Subordinated Indenture § 301(7)). Under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, Subordinated Notes intended to constitute Tier 2 Capital may not at any time be repaid at the option of the Holder thereof.

The Issuer of any Notes, the Company or Bank of Scotland may purchase Notes at any price in the open market or otherwise. Notes so purchased by the Issuer thereof, the Company or Bank of Scotland may, at the discretion of such Issuer, the Company or Bank of Scotland, as the case may be, be held or resold or surrendered to the Trustee for cancellation. Unless otherwise provided in the applicable Pricing Supplement, Subordinated Notes may not be purchased in whole or in part by the Issuer thereof, the Company or Bank of Scotland prior to the date falling five years and one day from their Original Issue Date.

Under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, any purchase of Subordinated Notes by the Issuer thereof, the Company or Bank of Scotland would require the prior consent of the Financial Services Authority.

Optional Tax Redemption

Unless otherwise provided in the applicable Pricing Supplement, if at any time an Issuer (or any subsidiary of the Company which has assumed the obligations of an Issuer), the Company or Bank of Scotland shall determine that as a result of a change in or amendment to the laws of the Issuer Taxing Jurisdiction or the Company Taxing Jurisdiction or with respect to any subsidiary of the Company that has assumed the obligations of an Issuer under an Indenture, the country in which such subsidiary is organized or, if different, the country of tax residence of such subsidiary or any political subdivision or taxing authority thereof or therein (the "Subsidiary Taxing Jurisdiction" and, together with the Issuer Taxing Jurisdiction and the Company Taxing Jurisdiction, each, the "Relevant Taxing Jurisdiction") affecting taxation, or any change in an application or interpretation of such laws, which change, amendment, application or interpretation becomes effective on or after the Original Issue Date of the relevant series of Notes or such other date specified in the applicable Pricing Supplement or, in the event of the assumption of the obligations of such Issuer in respect of a series of Notes by the Company, Bank of Scotland or a subsidiary of the Company pursuant to the provisions of an Indenture, the date of any such assumption (the "Relevant Date") (i) in making any payment under a Senior Guarantee or a Subordinated Guarantee (collectively the "Guarantee") or an Indenture the Company, Bank of Scotland or such Issuer (or such subsidiary), as the case may be, would be required to pay additional amounts with respect thereto as a result of any taxes, levies, imposts or other governmental charges imposed (whether by way of withholding or deduction or otherwise) by or for the account of any Relevant Taxing Jurisdiction, (ii) any tax would be imposed (whether by way of deduction or withholding or otherwise) or relief from tax would be withdrawn by any Relevant Taxing Jurisdiction, upon or with respect to any interest payments received or receivable by such Issuer (or such subsidiary) from the Company, Bank of Scotland or any other subsidiaries incorporated in, or resident for tax purposes under the

laws of, the United Kingdom, or (iii) based upon an opinion of legal advisors to such Issuer (or such subsidiary), the Company or Bank of Scotland, as the case may be, as a result of any action taken by any taxing authority of, or any action brought in a court of competent jurisdiction in, any Relevant Taxing Jurisdiction (whether or not such action was taken or brought with respect to such Issuer (or such subsidiary), the Company or Bank of Scotland), which action is taken or brought on or after the Relevant Date, there is a substantial probability that the circumstances described in clause (i) or (ii) would exist, the Notes will be redeemable as a whole at the option of such Issuer (or such subsidiary), the Company or Bank of Scotland upon not less than 30 nor more than 60 days' notice given as provided in an Indenture at any time subject, in the case of Undated Notes, to the Solvency Condition being satisfied at such time, at a Redemption Price equal to 100% of the principal amount thereof, together with any accrued interest to the date fixed for redemption (except in the case of Original Issue Discount Notes which may be redeemed at the Redemption Price specified in the applicable Pricing Supplement). (Senior Indenture §§ 1104 and 1108, Subordinated Indenture §§ 1104 and 1108).

Under the requirements of the Financial Services Authority at the date of this Offering Memorandum relating to Tier 2 Capital, any optional tax redemption of Subordinated Notes would require the prior consent of the Financial Services Authority.

Modification and Amendment

Modification and amendments of an Indenture may be made by each Issuer party thereto, the Company, Bank of Scotland and the Trustee, with the consent of the holders of 66⅔% in aggregate principal amount of the Notes of each series outstanding under such Indenture affected by such modification or amendment, *provided* that no such modification or amendment may, without the consent of the holder of each such Note affected thereby, among other things: (a) change the Stated Maturity of principal of or any installment of principal of or interest, if any, on, or any sinking fund payment under, any such Note; (b) reduce the principal amount of, or any interest on, any such Note or any premium payable upon the redemption thereof or the amount of the principal of an Original Issue Discount Note that would be due and payable upon the acceleration of the maturity thereof or any sinking fund payment with respect thereto; (c) change the currency of payment of principal of, premium, if any, or interest, if any, on any such Note; (d) impair the right to institute suit for the enforcement of any such payment on any such Note; (e) modify the provisions of the Subordinated Indenture with respect to the subordination of any Subordinated Notes or the Subordinated Guarantee in a manner adverse to Holders of such Subordinated Notes; (f) reduce the above-stated percentage of holders of Notes of any series necessary to modify or amend such Indenture; (g) reduce the percentage of principal amount of outstanding Notes of any series necessary to waive any past default to less than a majority; (h) modify the foregoing requirements; or (i) change in any manner adverse to the interests of the holders of outstanding Notes issued under such Indenture the terms and provisions of any Guarantee in respect of the due and punctual payment of the principal of and premium, if any, and interest, if any, on such Notes or the sinking fund payments, if any, provided for in respect of such Notes (including, in each case, additional amounts payable under any Guarantee). (Senior Indenture § 902, Subordinated Indenture § 902). In addition, material variations in the terms and conditions of any series of Subordinated Notes, including modifications relating to the subordination of the Subordinated Guarantee, redemption, Defaults or Events of Default, may require the prior consent of the Financial Services Authority.

The Issuers party thereto, the Company, Bank of Scotland and the Trustee may at any time change or eliminate certain provisions of an Indenture which would be required by the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act") if the Notes issued thereunder and any Guarantee (or any other securities issued under such Indenture) were registered under the Securities Act, if, at such time, such provisions are no longer required by the Trust Indenture Act, except that (subject to the provisions of such Indenture relating to supplemental indentures) provisions in such Indenture concerning, among other things, (i) the eligibility requirements for the Trustee, (ii) certain duties, responsibilities and special powers of the Trustee, (iii) rights of the holders of a majority in aggregate principal amount of securities of any series to control proceedings for remedies and to waive past defaults and (iv) holders' rights to receive amounts due or

to institute collection proceedings may not be so changed or eliminated. (Senior Indenture § 107, Subordinated Indenture § 107).

Events of Default — General

The Holders of a majority in aggregate principal amount of outstanding Notes of a series may waive any past default with respect to such Notes, except a default in the payment of principal, premium or interest or in respect of other provisions requiring the consent of the Holder of each Note of such series. (Senior Indenture § 513, Subordinated Indenture § 513).

Subject to the provisions of each Indenture relating to the duties of the Trustee, in case of an Event of Default or, in the case of Subordinated Notes, Default shall occur and be continuing with respect to the Notes of a series, the Trustee will be under no obligation to any of the Holders of Notes of such series unless such Holders shall have offered to the Trustee reasonable indemnity. (Senior Indenture § 603, Subordinated Indenture § 603). Subject to such provisions for the indemnification of the Trustee, the Holders of a majority in aggregate principal amount of the outstanding Notes of such series shall have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee or exercising any trust or power conferred on the Trustee. (Senior Indenture § 512, Subordinated Indenture § 512).

Each Indenture provides that the Trustee will, within 90 days after the occurrence of any default with respect to the Notes of any series, give to the Holders of Notes of such series notice of such default known to it, unless such default shall have been cured or waived; provided that, except in the case of a default in the payment of principal of or premium or interest on or any sinking fund installment with respect to the Notes of such series, the Trustee shall be protected in withholding such notice if it determines in good faith that the withholding of such notice is in the interest of such Holders. (Senior Indenture § 602, Subordinated Indenture § 602).

Each Issuer, the Company and Bank of Scotland are required to furnish to the Trustee annually a statement as to performance or fulfillment of their obligations under each Indenture and as to the absence of default or specifying any such default. (Senior Indenture § 1005, Subordinated Indenture § 1005).

Consolidation, Merger and Sale of Assets

Any Issuer (other than the Company and Bank of Scotland) and the Company and Bank of Scotland may, without the consent of any of the Holders of Notes, consolidate with, merge or amalgamate into or transfer their respective assets substantially as an entirety to, any corporation organized, in the case of such Issuer, under the laws of its country of incorporation and, in the case of the Company and Bank of Scotland, under the laws of the United Kingdom, or, in either case any political subdivision thereof, provided that the successor corporation assumes such Issuer's obligations on the Notes and under the Indentures or the Company's and Bank of Scotland's obligations on their respective Guarantees and under the Indentures, as the case may be, and that certain other conditions are met. (Senior Indenture § 801, Subordinated Indenture § 801).

Assumption of Obligations

The Company or Bank of Scotland or any of their respective subsidiaries may, subject to certain restrictions, assume the obligations of any Issuer (other than the Company or Bank of Scotland) as obligor under the Notes. In the case of any Subordinated Notes, if the Company or Bank of Scotland assumes such obligations, such obligations shall be subordinated to the same extent as the obligations of the Company and Bank of Scotland under their respective Guarantees contained in the Subordinated Indenture or, if any subsidiary of the Company having as its principal business the business of banking assumes such obligations, such obligations shall be subordinated in the winding up or liquidation of such subsidiary to the claims of depositors and other creditors of such subsidiary (other than subordinated creditors).

The Company or Bank of Scotland shall assume the obligations of any Issuer (other than the Company and Bank of Scotland) under the Subordinated Notes upon the occurrence of certain events of bankruptcy,

insolvency or reorganization of such Issuer. Upon any such assumption by the Company or Bank of Scotland, the obligations of the Company or Bank of Scotland, as the case may be, as principal debtor shall be subordinated to the same extent, and governed by the same laws, as its obligations under the Subordinated Guarantee contained in the Subordinated Indenture. Neither the Company nor Bank of Scotland shall, by virtue of such assumption, be obligated to pay any principal, premium, interest or any other amounts in respect of Subordinated Notes sooner than the same would have been payable by such Issuer pursuant to the Subordinated Indenture except if an Event of Default under the Subordinated Indenture has occurred.

In the event of any such assumption, the Company, Bank of Scotland or such subsidiary, as the case may be, will pay all amounts of principal, premium and interest without deduction or withholding for any and all present and future taxes, levies, imposts or other governmental charges whatsoever imposed, assessed, levied or collected by or for the account of the Company Taxing Jurisdiction, in the case of the Company, or the Subsidiary Taxing Jurisdiction, in the case of such subsidiary, or, if such deduction or withholding is required, the Company or such subsidiary will pay such additional amounts in respect of principal, premium and interest as may be necessary in order that the net amounts paid to the Holders of Notes or to the Trustee, as the case may be, after such deduction or withholding shall equal the respective amounts of principal and interest to which such Holders or the Trustee would be entitled if no such deduction or withholding had been made, subject to certain exceptions in the circumstances described in clauses (i) through (iv) under “Senior Notes — Senior Guarantee” and “Subordinated Notes — Subordinated Guarantee” above with respect to the Company Taxing Jurisdiction, in the case of the Company, or the Subsidiary Taxing Jurisdiction, in the case of such subsidiary. The Company and such subsidiary will also be entitled to redeem the Notes in the circumstances described in “Optional Tax Redemption” above with respect to the Relevant Taxing Jurisdiction, subject to certain conditions. (Senior Indenture §§ 802, 803 and 1108, Subordinated Indenture §§ 802, 803 and 1108).

Defeasance and Discharge

Each Indenture provides that each Issuer party thereto, the Company and Bank of Scotland, at such Issuer's, the Company's or Bank of Scotland's option, (a) will be discharged from any and all obligations in respect of the Notes issued thereunder and the Guarantees contained therein (except for certain obligations to register the transfer of or exchange Notes, replace stolen, lost or mutilated Notes, and maintain paying agencies and to hold certain moneys in trust for payment) or (b) need not comply with certain provisions of such Indenture if, in each case, such Issuer, the Company or Bank of Scotland irrevocably deposits with the Trustee under such Indenture, in trust, U.S. money or U.S. Government Obligations or both, which, with respect to U.S. Government Obligations through the payment of interest, if any, thereon and principal thereof in accordance with their terms will provide money in an amount in cash sufficient to pay all the principal (including sinking fund payments) of and premium and interest on such Notes on the dates such principal, premium and interest is due in accordance with the terms of such Notes. In the case of a discharge described in clause (a) above, such Issuer, the Company or Bank of Scotland is required to deliver to the Trustee under such Indenture prior to such discharge either an Opinion of Counsel to the effect that such Holders of Notes will not recognize income, gain or loss for U.S. federal income tax purposes as a result of such deposit and related defeasance and will be subject to U.S. federal income tax on the same amount, in the same manner and at the same times as would have been the case if such deposits and related defeasance had not been exercised or a ruling to such effect received from or published by the Internal Revenue Service. (Senior Indenture § 1401, Subordinated Indenture § 1401).

With respect to the Subordinated Notes, under the practices of the Financial Services Authority at the date of this Offering Memorandum, any such defeasance and discharge would require the prior consent of the Financial Services Authority.

Governing Law

The Notes and the Indentures will be governed by the laws of the State of New York, except that the subordination provisions of the Subordinated Indenture relating to (i) Subordinated Notes (see “Subordinated Notes (other than Undated Notes) issued by Issuers other than Bank of Scotland —

Subordination”, “Subordinated Notes (other than Undated Notes) Issued by Bank of Scotland — Subordination” and “Undated Subordinated Notes — Subordination”) and (ii) the Subordinated Guarantees (see “Subordination of the Subordinated Guarantees — in respect of Subordinated Notes other than Undated Notes” and “Subordination of the Subordinated Guarantees in respect of Undated Notes”) will be governed by the laws of England. (Senior Indenture § 112, Subordinated Indenture § 112).

Concerning the Trustee

The Bank of New York is Trustee under each Indenture. The Company maintains an account and conducts other banking transactions with the Trustee in the ordinary course of its business.

Consent to Service of Process

Each Indenture provides that each Issuer, the Company and Bank of Scotland will irrevocably designate the Bank of Scotland’s New York Branch, located at 565 Fifth Avenue, New York, New York 10017, as its authorized agent for service of process in any legal action or proceeding arising out of or relating to such Indenture, the Notes issued thereunder or the Guarantees contained therein brought in any Federal or State court in The City of New York, New York, and the Company’s London Chief Office, located at 33 Old Broad Street, London EC2N 1HZ, Attention: Legal Department, as its authorized agent for service of process in any legal action or proceeding arising out of or relating to such Indenture, such Notes or such Guarantee in England, and, in each case, will irrevocably submit to the jurisdiction of such courts. (Senior Indenture § 114, Subordinated Indenture § 114).

Book-Entry, Delivery and Form

Rule 144A Notes initially will be represented by one or more Notes in registered, global form without interest coupons (collectively, the “Rule 144A Global Notes”). Regulation S Notes initially will be represented by one or more Notes in registered, global form without interest coupons (collectively, the “Regulation S Global Notes”). Upon issuance, the Global Notes will be deposited with the Trustee as custodian for DTC, in New York, New York, and registered in the name of DTC or its nominee, in each case for credit to an account of a direct or indirect participant in DTC as described below. Beneficial interests in the Rule 144A Global Notes may not be exchanged for beneficial interests in the Regulation S Global Notes at any time except in the limited circumstances described below. See “— Depository Procedures — Exchanges Among the Global Notes.”

Except as set forth below, the Global Notes may be transferred, in whole and not in part, only to another nominee of DTC or to a successor of DTC or its nominee. Beneficial interests in the Global Notes may not be exchanged for Notes in the definitive form except in the limited circumstances described below. See “— Depository Procedures — Exchange of Global Notes for Definitive Notes.”

Notes sold to QIBs in reliance on Rule 144A (including beneficial interests in the Rule 144A Global Notes) will be subject to certain restrictions on transfer and will bear a restrictive legend as described under “Notice to Purchasers”. In addition, transfers of beneficial interests in the Global Notes will be subject to the applicable rules and procedures of DTC and its direct or indirect participants (including, if applicable, those of Euroclear and Clearstream, Luxembourg) which may change from time to time.

Depository Procedures

The following description of the operations and procedures of DTC, Euroclear and Clearstream, Luxembourg is provided solely as a matter of convenience. These operations and procedures are solely within the control of the respective settlement systems and are subject to changes by them from time to time. The Issuers, the Company and Bank of Scotland, take no responsibility for these operations and procedures and urge investors to contact the system of their participants directly to discuss these matters.

DTC has advised the Issuers that DTC is a limited-purpose trust company organized under the laws of the State of New York, a member of the Federal Reserve System, a “banking organization” within the

meaning of the New York Uniform Commercial Code and a “clearing agency” registered pursuant to the provision of Section 17A of the Exchange Act. DTC was created to hold securities for its participating organizations (collectively, the “Participants”) and to facilitate the clearance and settlement of transactions in those securities between Participants through electronic book-entry changes in the accounts of its Participants. The Participants include securities brokers and dealers (including the Agents, banks, trust companies, clearing corporations and certain other organizations). Access to DTC’s system is also available to other entities such as banks, brokers, dealers and trust companies, that clear through or maintain a custodial relationship with a Participant either directly or indirectly (collectively, the “Indirect Participants”). Persons who are not Participants may beneficially own securities held by or on behalf of DTC only through the Participant or the Indirect Participants. The ownership interest in, and transfers of ownership interests in, each security held by or on behalf of DTC are recorded on the records of the Participant and Indirect Participants.

DTC has also advised the Issuers that, pursuant to procedures established by it, (i) upon deposit of Global Notes, DTC will credit the accounts of Participants designated by the Initial Purchasers with portions of the principal amount of the Global Notes and (ii) ownership of such interest in the Global Notes will be shown on, and the transfer of ownership thereof will be affected only through, records maintained by DTC (with respect to the Participants) or by the Participants and the Indirect Participants (with respect to other owners of beneficial interests in the Global Notes).

Investors in the Global Notes may hold their interest therein directly through DTC, if they are Participants in such system, or indirectly through organizations (including Euroclear and Clearstream, Luxembourg) which are Participants in such system. Euroclear and Clearstream, Luxembourg will hold interests in the Regulation S Global Note on behalf of their participants through customers’ securities accounts in their respective names on the books of their respective depositories. All interests in a Global Note, including those held through Euroclear or Clearstream, Luxembourg, may be subject to the procedures and requirements of DTC. Those interests held through Euroclear or Clearstream, Luxembourg may also be subject to the procedures and requirements of such systems. The laws of some states require that certain persons take physical delivery in definitive form of securities that they own. Consequently, the ability to transfer beneficial interests in a Global Notes to such persons will be limited to that extent. Because DTC can act only on behalf of Participants, which in turn act on behalf of Indirect Participants and certain banks, the ability of a person having beneficial interests in a Global Note to pledge such interest to persons or entities that do not participate in the DTC system, or otherwise take actions in respect of such interests, may be affected by the lack of a physical certificate evidencing such interest.

Except as described below, owners of interests in the Global Notes will not have Notes registered in the name of DTC or its nominee will not be considered the registered owners or “Holders” thereof under the Indenture for any purpose.

Payments in respect of the principal of, premium, if any and interest on a Global Note registered in the name of DTC or its nominee and will be payable to DTC in its capacity as the registered Holder under the Indenture. Under the terms of the Indenture, the Issuers and the Indenture Trustee will treat the persons in whose names the Notes, including the Global Notes, are registered as the owners thereof for the purpose of receiving such payments and for any and all other purposes whatsoever. Consequently, neither the Issuers, the Trustee nor any agent of the Issuers or the Trustee has or will have any responsibility or liability for (i) any aspect of DTC’s records or any Participant’s or Indirect Participant’s records relating to or payments made on account of beneficial ownership interest in the Global Notes, or for maintaining supervising or reviewing any of DTC’s records or any Participant’s or Indirect Participant’s records relating to or payments made on account of beneficial ownership interests in the Global Notes or (ii) any other matter relating to the actions and practices of DTC or any of its Participants or Indirect Participants. DTC has advised the Issuers that its current practice, upon receipt of any payment in respect of securities such as the Notes (including principal and interest), is to credit the accounts of the relevant Participants with the payment on the interest payment date, in amount proportionate to their respective holdings in the principal amount of beneficial interest in the relevant security as shown on the records of DTC unless DTC has reason to believe it will not receive payment on such interest payment date. Payments by the Participants and the Indirect Participants to the beneficial owners of Senior Notes will be governed by standing instructions and customary practices and will be the

responsibility of the Participants or the Indirect Participants and will not be the responsibility of DTC, the Indenture Trustee or the Issuers. Neither the Issuers nor the Indenture Trustee will be liable for any delay by DTC or any of its Participants in identifying the beneficial owners of the Notes, and the Issuers and the Indenture Trustee may conclusively rely on and will be protected in relying on instructions from DTC or its nominee for all purposes.

Except for trades involving only Euroclear and Clearstream, Luxembourg participants, interests in the Global Notes are expected to be eligible to trade in DTC's Same Day Funds Settlement System and secondary market trading activity in such interest will, therefore, settle in immediately available funds, subject in all cases to the rules and procedures of DTC and its Participants. See "— Same Day Settlement and Payment".

Subject to the transfer restrictions set forth under "Notice to Purchasers", transfers between Participants in DTC will be effected in accordance with DTC's procedures, and will be settled in same day funds, and transfers between participants in Euroclear and Clearstream, Luxembourg will be effected in the ordinary way in accordance with their respective rules and operating procedures.

Subject to compliance with the transfer restrictions applicable to the Notes described herein, cross-market transfers between the Participants in DTC, on the one hand, and Euroclear or Clearstream, Luxembourg participants, on the other hand, will be effected through DTC in accordance with DTC's rules on behalf of Euroclear or Clearstream, Luxembourg, as the case may be, by its respective depository; however, such cross-market transactions will require delivery of instructions to Euroclear or Clearstream, Luxembourg, as the case may be, by the counterparty in such system in accordance with the rules and procedures and within the established deadlines (Brussels time) of such system. Euroclear or Clearstream, Luxembourg, as the case may be, will, if the transaction meets its settlement requirements, deliver instructions to its respective depository to take action to effect final settlements on its behalf by delivering or receiving interests in the relevant Global Note in DTC, and making or receiving payment in accordance with normal procedures for same-day funds settlement applicable to DTC. Euroclear participants and Clearstream, Luxembourg participants may not deliver instructions directly to the depositories for Euroclear or Clearstream, Luxembourg.

DTC has advised the Issuers that it will take any action permitted to be taken by a Holder of Notes only at the direction of one or more Participants to whose account DTC has credited the interest in the Global Notes and only in respect of such portion of the aggregate principal amount of the Notes as to which such Participant or Participants has or have given such direction. However, if there is an Event of Default under the Notes, DTC reserves the right to exchange the Global Notes for Notes in definitive form, and to distribute such Notes to its Participants (as described below).

Although DTC, Euroclear and Clearstream, Luxembourg have agreed to the foregoing procedures to facilitate transfer of interest in the Global Notes among Participants in DTC, Euroclear and Clearstream, Luxembourg, they are under no obligation to perform or to continue to perform such procedures, and such procedures may be discontinued at any time. Neither the Issuers nor the Indenture Trustee nor any of their respective agents will have any responsibility for the performance by DTC, Euroclear or Clearstream, Luxembourg or their respective participants or indirect participants of their respective obligations under the rules and procedures governing their operations.

Exchange of Global Notes for Definitive Notes

A Global Note is exchangeable for definitive Notes in registered definitive form ("Definitive Notes") if (i) DTC notifies the Issuers that it is unwilling or unable to continue as depository for the Global Notes or has ceased to be a clearing agency registered under the Exchange Act and, in either case, the Issuers thereupon fail to appoint a successor depository within 120 days after the date of such notice, (ii) the Issuers, at their option, notify the Trustee in writing that they elect to cause the issuance of the Definitive Notes, (iii) the beneficial owner thereto so requests or (iv) the transfers of such Notes is not a QIB or a Regulation S Purchaser. See "— Exchange Among the Registered Notes". In all cases, Definitive Notes delivered in exchange for any Global Note or beneficial interests therein will be registered in the names, and issued in any

approved denominations, requested by or on behalf of the depository (in accordance with its customary procedures and will bear the restrictive legend referred to in “Notice to Purchasers”), unless the Issuers determine otherwise in compliance with applicable law.

Exchange of Definitive Notes for Global Notes

Notes issued in definitive form may not be transferred for beneficial interests in any Global Note unless the transferor first delivers to the Trustee a written certificate to the effect that such transfer will comply with the appropriate transfer restrictions applicable to such Notes. See “Notice to Purchasers”.

Exchange of Definitive Notes for Definitive Notes

Definitive Notes may be exchanged or transferred by presenting or surrendering such Definitive Notes at the office of the registrar with a written instruction of transfer in form satisfactory to the registrar, duly executed by such Holder or his attorney, duly authorized in writing. If the Notes being exchanged or transferred are Restricted Notes, such Holder shall also provide a written certificate to the effect that such transfer will comply with the appropriate transfer restriction applicable to such Notes. See “Notice to Purchasers”.

Exchange Among the Global Notes

Beneficial interests in a Rule 144A Global Note may be transferred to a person who takes delivery in the form of an interest in a Regulation S Global Note upon receipt by the Trustee of a written certificate to the effect that such transfer is being made in accordance with Rule 903 or 904 of Regulation S.

Transfers involving an exchange of a beneficial interest in one of the Global Notes for a beneficial interest in another Global Note will be effected in DTC by means of an instruction originated by the Indenture Trustee through the DTC Deposit/Withdraw at Custodian system. Accordingly, in connection with any such transfer, appropriate adjustments will be made to reflect a decrease in the principal amount of the Global Note representing the beneficial interest that is transferred and a corresponding increase in the principal amount of the other Global Note, as applicable. Any beneficial interest in one of the Global Notes will, upon transfer, cease to be an interest in such Global Note and will become an interest in another Global Note and, accordingly, will thereafter be subject to all transfer restriction and other procedures applicable to interests in such other Global Note for so long as it remains such an interest.

Same Day Settlement and Payment

The Notes represented by the Global Notes will be eligible to trade in DTC’s Same Day Funds Settlement System, and any permitted secondary market trading activity in such Notes will, therefore, be required by DTC to be settled in immediately available funds. The Issuers expect that secondary trading in any definitive Notes will also be settled in immediately available funds.

Because of time zone differences, the securities account of a Euroclear or Clearstream, Luxembourg participant purchasing an interest in a Global Note from a Participant in DTC will be credited, and any such crediting will be reported to the relevant Euroclear or Clearstream, Luxembourg participant, during the securities settlement processing day (which must be a business day for Euroclear and Clearstream, Luxembourg) immediately following the settlement date of DTC. DTC has advised the Issuers that cash received in Euroclear or Clearstream, Luxembourg as a result of sales of interest in a Global Note by or through a Clearstream, Luxembourg participant to a Participant in DTC will be received with value on the settlement date of DTC but will be available in the relevant Euroclear or Clearstream, Luxembourg cash account only as of the business day for Euroclear or Clearstream, Luxembourg following DTC’s settlement date.

SPECIAL PROVISIONS RELATING TO FOREIGN CURRENCY NOTES

General

Unless otherwise indicated in the applicable Pricing Supplement, the Notes will be denominated in U.S. dollars and payments of principal of and any premium and interest on the Notes will be made in U.S. dollars in the manner indicated in this Offering Memorandum and the applicable Pricing Supplement. If any of the Notes are to be denominated in a currency other than U.S. dollars (a “Specified Currency”), the following special provisions shall apply which supplement, and to the extent inconsistent therewith replace, the description of general terms and conditions of the Notes set forth above under the heading “Description of the Notes and the Guarantees.”

THIS OFFERING MEMORANDUM DOES NOT DESCRIBE ALL RISKS OF AN INVESTMENT IN FOREIGN CURRENCY NOTES THAT RESULT FROM SUCH NOTES BEING DENOMINATED IN, OR THE PAYMENTS WITH RESPECT TO SUCH NOTES BEING RELATED TO THE VALUE OF, A FOREIGN CURRENCY EITHER AS SUCH RISKS EXIST AT THE DATE OF THIS OFFERING MEMORANDUM OR AS SUCH RISKS MAY CHANGE FROM TIME TO TIME. PROSPECTIVE PURCHASERS SHOULD CONSULT THEIR OWN FINANCIAL AND LEGAL ADVISERS AS TO THE RISKS ENTAILED IN AN INVESTMENT IN FOREIGN CURRENCY NOTES AND AS TO ANY MATTERS THAT MAY AFFECT THE PURCHASE OR HOLDING OF A FOREIGN CURRENCY NOTE OR THE RECEIPT OF PAYMENTS OF PRINCIPAL OF AND ANY PREMIUM AND INTEREST ON A FOREIGN CURRENCY NOTE IN A SPECIFIED CURRENCY. FOREIGN CURRENCY NOTES ARE NOT AN APPROPRIATE INVESTMENT FOR INVESTORS WHO ARE UNSOPHISTICATED WITH RESPECT TO FOREIGN CURRENCY TRANSACTIONS.

Unless otherwise indicated in the applicable Pricing Supplement, a Foreign Currency Note will not be sold in, or to a resident of, the country of the Specified Currency in which such Note is denominated. The information set forth in this Offering Memorandum is directed to prospective purchasers who are United States residents, and each Issuer disclaims any responsibility to advise prospective purchasers who are residents of countries other than the United States with respect to any matters that may affect the purchase, holding or receipt of payments of principal of and any premium and interest on Foreign Currency Notes. Such persons should consult their own legal advisers with regard to such matters.

Foreign Currency Notes are issuable only in fully registered form, without coupons. The authorized denominations of Foreign Currency Notes will be indicated in the applicable Pricing Supplement.

Purchase

Unless otherwise indicated in the applicable Pricing Supplement, purchasers are required to pay for Foreign Currency Notes in the Specific Currency. At the present time there are limited facilities in the United States for the conversion of U.S. dollars into foreign currencies or currency units and *vice versa*, and banks do not generally offer non-U.S. dollar checking or savings account facilities in the United States. If requested on or prior to the fifth Market Day preceding the date of delivery of the Notes, or by such other day as determined by the Agent who presented such offer to purchase Notes to the Issuer thereof, such Agent is prepared to arrange for the conversion of U.S. dollars into the Specified Currency to enable the purchaser to pay for such Notes. Each such conversion will be made by such Agent on such terms and subject to such conditions, limitations and charges as such Agent may from time to time establish in accordance with its regular foreign exchange practices. All costs of exchange will be borne by the purchasers of the Foreign Currency Notes.

Payment of Principal and any Premium and Interest

Unless otherwise specified in the applicable Pricing Supplement, payments of principal of and any premium and interest on Foreign Currency Notes will be made in U.S. dollars unless the holder thereof elects to receive such payments in the Specified Currency as described below.

Any U.S. dollar amount to be received by a holder of a Foreign Currency Note will be based on the highest bid quotation in The City of New York received by the Exchange Rate Agent at approximately 11:00 A.M., New York City time, on the second Market Day with respect to such Note preceding the applicable payment date from three recognized foreign exchange dealers (one of which may be the Exchange Rate Agent) for the purchase by the quoting dealer of the Specified Currency for U.S. dollars for settlement on such payment date in the aggregate amount of the Specified Currency payable to all holders of Foreign Currency Notes scheduled to receive U.S. dollar payments and at which the applicable dealer commits to execute a contract. If such bid quotations are not available, payments will be made in the Specified Currency. All currency exchange costs will be borne by the holder of the Foreign Currency Note by deductions from such payments.

Unless otherwise specified in the applicable Pricing Supplement, a holder of a Foreign Currency Note may elect to receive payment of the principal of and any premium and interest on such Note in the Specified Currency by transmitting a written request for such payment to the Paying Agent at its office in London on or prior to the relevant Regular Record Date or at least sixteen days prior to Maturity, as the case may be. Such request, which must include the wire transfer instructions referred to below, may be in writing (mailed or hand delivered) or by cable, telex or other form of facsimile transmission. A holder of a Foreign Currency Note may elect to receive payment in the Specified Currency for all principal and any premium and interest payments and need not file a separate election for each payment. All costs associated with such currency exchange will be paid by the holder. Such election will remain in effect until revoked by written notice to the Paying Agent, but written notice of any such revocation must be received by the Paying Agent on or prior to the relevant Regular Record Date or at least sixteen days prior to Maturity, as the case may be. Holders of Foreign Currency Notes whose Notes are to be held in the name of a broker or nominee should contact such broker or nominee to determine whether and how an election to receive payments in the Specified Currency may be made.

The payment of principal of and any premium or interest on Foreign Currency Notes paid in the Specified Currency other than at Maturity will be made by check drawn upon a bank office located outside the United States, and any such payments due at Maturity will be made by wire transfer of immediately available funds to an account maintained by the Holder with a bank office located in the country which issued the Specified Currency upon presentation of such Notes to the Paying Agent or any other paying agent in time for such wire transfer to be made by the Paying Agent or such other paying agent in accordance with its normal procedures.

Payment Currency

If a Specified Currency is not available for the payment of principal or any premium or interest with respect to a Foreign Currency Note due to the imposition of exchange controls or other circumstances beyond the control of an Issuer, such Issuer will be entitled to satisfy its obligations to holders of Foreign Currency Notes by making such payment in U.S. dollars on the basis of the Market Exchange Rate on the second Market Day prior to the date of such payment, or if such Market Exchange Rate is not then available, on the basis of the most recently available Market Exchange Rate.

Foreign Currency Risks

Exchange Rates and Exchange Controls. An investment in Foreign Currency Notes entails significant risks that are not associated with a similar investment in a security denominated in U.S. dollars. Such risks include, without limitation, the possibility of significant changes in the rate of exchange between the U.S. dollar and the Specified Currency and the possibility of the imposition or modification of foreign exchange controls by either the United States or foreign governments. Such risks generally depend on economic and political events and the supply of and demand for the relevant currencies over which an Issuer has no control. In recent years, rates of exchange between the U.S. dollar and certain foreign currencies have been highly volatile and such volatility may be expected in the future. Fluctuations in any particular exchange rate that have occurred in the past are not necessarily indicative, however, of fluctuations in the rate that may occur during the term of any Foreign Currency Note. Depreciation of the Specified Currency applicable to a

Foreign Currency Note against the U.S. dollar would result in a decrease in the U.S. dollar-equivalent yield of such Note, in the U.S. dollar-equivalent value of the principal repayable at Maturity of such Note and, generally, in the U.S. dollar-equivalent market value of such Note.

Governments have imposed from time to time exchange controls and may in the future impose or revise exchange controls at or prior to the Maturity of a Foreign Currency Note. Such exchange controls could affect exchange rates as well as the availability of a specified foreign currency at the time of payment of principal of and any premium and interest on a Foreign Currency Note. Even if there are no exchange controls, it is possible that the Specified Currency for any particular Foreign Currency Note would not be available at the Maturity of such Note due to circumstances beyond the control of an Issuer.

Judgments. In the event an action based on Foreign Currency Notes is commenced in a court of the United States, it is likely that such court would grant judgment relating to such Notes only in U.S. dollars. It is not clear, however, whether, in granting such a judgment, the rate of conversion into U.S. dollars would be determined with reference to the date of default, the date that judgment is rendered or some other date. Holders of Foreign Currency Notes would bear the risk of exchange rate fluctuations between the time the judgment is calculated and the time the Paying Agent converts the Specified Currency to U.S. dollars for payment of the judgment.

Special United States federal income tax considerations applicable to holders of Foreign Currency Notes who are United States persons are described under “United States Taxation.”

TAXES

The following discussion is a summary of certain tax consequences of the acquisition, ownership and disposition of the Notes under the law and practice in the United States, The Netherlands and the United Kingdom. The discussion reflects laws, regulations, rulings and decisions currently in effect, which may be subject to retroactive changes. The discussion is only a summary for general information purposes. It is not intended as tax advice and it does not purport to describe all of the tax considerations that may be relevant to a prospective purchaser. **PROSPECTIVE PURCHASERS ARE URGED TO SATISFY THEMSELVES AS TO THE OVERALL TAX CONSEQUENCES OF PURCHASING, HOLDING AND/OR SELLING THE NOTES.**

United States Federal Income Taxation

The following summary of the principal U.S. federal income tax consequences of the ownership of the Notes is based upon the advice of Milbank, Tweed, Hadley & McCloy LLP. It deals only with Notes held as capital assets by initial purchasers, and does not discuss all of the tax consequences that may be relevant to a particular holder in light of the holder's circumstances or to holders subject to special rules, such as dealers in securities or currencies, life insurance companies, traders who elect to mark the Notes to market, controlled foreign corporations, persons holding Notes as part of a hedge, straddle, conversion or integrated transaction or holders whose functional currency is not the U.S. Dollar. Unless otherwise indicated in the applicable Pricing Supplement, a Note will constitute indebtedness for U.S. federal income tax purposes. Subordinated Notes in general, and Undated Notes in particular, may constitute equity for that purpose, and the applicable Pricing Supplement will further address that issue and other U.S. federal income tax considerations not addressed herein in appropriate cases. Prospective purchasers are urged to obtain advice concerning the possibility that such Notes may constitute equity.

United States Holders

Interest. Interest on a Note (other than interest on a Note issued with original issue discount ("OID")), that is not a "qualified stated interest" payment (as defined below)), whether payable in U.S. Dollars or in a single foreign currency (including, as used throughout this discussion, the ECU), will be includible in gross income by a holder that is (a) a citizen or resident of the United States, (b) a domestic partnership or corporation, (c) a trust subject to the control of a U.S. person and the primary supervision of a U.S. court, or (d) an estate the income of which is subject to U.S. federal income tax regardless of its source (a "U.S. Holder") as ordinary income at the time it is received or accrued, depending on the holder's method of accounting for tax purposes. Interest on a Note will be income from sources outside the United States, and it generally will be treated as "passive" or, for certain holders, "financial services" income for the purposes of calculating the foreign tax credit allowable under U.S. federal income tax law.

The amount of interest income on a Foreign Currency Note will be the U.S. Dollar value of the interest based on the exchange rate in effect on the date of receipt or, in the case of an accrual basis U.S. Holder, based on the average exchange rates in effect during the interest accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year), in either case regardless of whether the payment is in fact converted into U.S. Dollars. Upon receipt of an interest payment (including a payment attributable to accrued but unpaid interest upon the sale or retirement of a Note) in a foreign currency, an accrual basis U.S. Holder will recognize ordinary income or loss measured by the difference between the U.S. dollar value of the payment received calculated in accordance with the exchange rate in effect on the date of receipt and in accordance with such average exchange rate in effect during the interest accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year). For an alternative method of determining the U.S. Dollar value of any accrued interest income and foreign currency received, see the discussion below under the heading "Original Issue Discount — Spot Rate Convention Election".

Original Issue Discount

A Note will have OID to the extent that the Note's "stated redemption price at maturity" exceeds its "issue price." Generally, a Note will not be treated as having OID if such excess is less than $\frac{1}{4}$ of 1% of the Note's stated redemption price at maturity multiplied by the number of complete years to maturity or, in the case of an Amortizing Note, the weighted average maturity using the number of completed years from issuance to each partial principal payment ("*de minimis* OID"). Undated Notes, if treated as indebtedness for U.S. federal income tax purposes, may be treated as having OID. The applicable Pricing Supplement will address that issue further.

The issue price of a Note is the initial offering price at which a substantial amount of the Notes are sold for money (excluding sales to bond houses, brokers or similar persons). The stated redemption price at maturity of a Note is the total of all payments due on the Note other than payments of "qualified stated interest." Qualified stated interest generally is interest that is payable unconditionally in cash or in property (other than debt of the Issuer) at least annually at a single rate that appropriately takes into account the length of the interval between payments. The yield to maturity of a Note is the discount rate that causes the present value of all payments on the Note as of its original issue date to equal the issue price of such Note.

Fixed Rate Notes. A U.S. Holder of a Note issued with OID and a maturity of more than one year must include OID in income over the term of the Note. A U.S. Holder generally must include in gross income the sum of the daily portions of OID that accrue on the Note for each day during the term of the Note on which such U.S. Holder held the Note. Accordingly, a U.S. Holder of a Note with OID will include in income amounts attributable to OID before receiving cash attributable to that income.

To determine the daily portion of OID, OID accruing during an accrual period (generally the period between dates on which interest is paid) is divided by the number of days in the period. The amount of OID accruing during an accrual period is determined by using a constant yield to maturity method. In the case of an initial Holder, the accrued amount for any period is the excess of (a) the product of the Note's adjusted issue price at the beginning of the accrual period and its yield to maturity (determined on the basis of compounding at the close of each accrual period and appropriately adjusted for the length of the accrual period) over (b) the amount of any qualified stated interest payments allocable to the accrual period. A Note's adjusted issue price at the beginning of any accrual period generally equals the issue price of the Note increased by the aggregate amount of OID accrued on the Note in all prior accrual periods and reduced by the amount of payments in prior accrual periods other than payments of qualified stated interest.

A U.S. Holder of a Note issued with OID that purchases the Note for more than the Note's adjusted issue price but less than the Note's stated redemption price at maturity may reduce the daily portions of OID includible in gross income by daily portions of the acquisition premium paid for the Note.

Floating Rate Notes. Special rules apply to a U.S. Holder of a "Floating Rate Note." A Note is considered to be a Floating Rate Note if interest is payable at (a) one or more "qualified floating rates," (b) a single fixed rate and one or more qualified floating rates, (c) a single "objective rate" or (d) a single fixed rate and a single objective rate that is a "qualified inverse floating rate."

Definition of Qualified Floating Rate. A qualified floating rate is any floating rate that reasonably can be expected to measure contemporaneous variations in the cost of newly-borrowed funds in the currency in which the Note is denominated (for example, LIBOR). Certain multiples of a qualified floating rate are treated as a qualified floating rate. A rate is a qualified floating rate if it equals (a) the product of a qualified floating rate and a fixed multiple that is greater than 0.65 but not more than 1.35 or (b) the product of a qualified floating rate and a fixed multiple that is greater than 0.65 but not more than 1.35, increased or decreased by a fixed rate. Two or more qualified floating rates that reasonably can be expected to have approximately the same values throughout the term of the Note will constitute a single qualified floating rate. Similarly, a fixed rate for an initial period of one year or less followed by a qualified floating rate together constitute a single qualified floating rate if the value of the qualified floating rate on the issue date is intended to approximate the fixed rate. The qualified floating rate will be conclusively presumed to approximate the fixed rate or the predecessor

floating rate if the value of the qualified floating rate on the issue date does not differ from the value of the fixed rate or predecessor floating rate by more than 25 basis points.

An otherwise qualified floating rate that has restrictions will not be a qualified floating rate unless the restrictions fall into one of the following categories: (a) a cap, a floor or a periodic adjustment restriction (a “governor”) that is fixed throughout the term of the Note, (b) a cap or similar restriction that is not reasonably expected as of the issue date significantly to decrease the yield on the Note, (c) a floor or similar restriction that is not reasonably expected as of the issue date significantly to increase the yield on the Note or (d) a governor or similar restriction that is not reasonably expected as of the issue date significantly to increase or decrease the otherwise applicable yield on the Note. Notes with floating rate interest payments subject to caps, floors, or governors that do not meet the above requirements could be treated as debt instruments providing for contingent payments. (See “Debt Instruments with Contingent Payments” below.)

Definition of Objective Rate. An objective rate is (a) any rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information or (b) other rates designated from time to time by the Internal Revenue Service. A rate based on information under the control of the Issuer or unique to the circumstances of the Issuer (such as the dividends, profits or value of the Issuer’s stock) is not based on objective information. A rate will not be considered an objective rate if it reasonably is expected that the average value of the rate during the first half of the Note’s term will be either significantly less than or significantly greater than the average value of the rate during the final half of the Note’s term. In addition, a fixed rate for an initial period of one year or less followed by an objective rate together constitute a single objective rate if the value of the objective rate on the issue date is intended to approximate the fixed rate. The objective rate will be conclusively presumed to approximate the fixed rate if the value of the objective rate on the issue date does not differ from the value of the fixed rate by more than 25 basis points.

Definition of Qualified Inverse Floating Rate. A qualified inverse floating rate is an objective rate that (a) is equal to a fixed rate minus a qualified floating rate and (b) reasonably can be expected inversely to reflect contemporaneous variations in the qualified floating rate (disregarding the permissible restrictions discussed above under “Definition of Qualified Floating Rate”).

Accrual of OID on Floating Rate Notes. The OID for any accrual period on a Floating Rate Note is generally computed by converting a Floating Rate Note into a fixed rate debt instrument and then applying the general OID rules discussed above to that hypothetical fixed rate debt instrument. If a Floating Rate Note provides for stated interest at a single qualified floating rate or a single objective rate, all stated interest with respect to the Floating Rate Note will be qualified stated interest. The amount of any qualified stated interest and OID accrued during an accrual period will be determined under the OID rules applicable to fixed rate debt instruments by assuming that the floating rate is a fixed rate equal to (a) in the case of a qualified floating rate or qualified inverse floating rate, the value as of the issue date of the qualified floating rate or qualified inverse floating rate or (b) in the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that reasonably is expected for the Floating Rate Note. The qualified stated interest allocable to the accrual period is adjusted to reflect the interest actually paid during the period.

If a Floating Rate Note provides for stated interest other than at a single qualified floating rate or a single objective rate, special rules apply to determine the amounts of interest and OID accruals. Under those rules, the Floating Rate Note will be converted into a hypothetical fixed rate debt instrument that has terms identical to those of the Floating Rate Note, except that the hypothetical fixed rate debt instrument has fixed rates substituted for the qualified floating rates or objective rate provided under the Floating Rate Note. The fixed rate substitute (a) for each qualified floating rate is the value of each such rate as of the issue date (with appropriate adjustment for any differences in intervals between interest adjustment dates), (b) for a qualified inverse floating rate is the value of the qualified inverse floating rate as of the issue date and (c) for an objective rate (other than a qualified inverse floating rate) is a fixed rate that reflects the yield reasonably expected on the Floating Rate Note. The amounts of qualified stated interest and any OID are determined for the hypothetical fixed rate debt instrument under the rules applicable to fixed rate debt instruments. Qualified stated interest or OID allocable to an accrual period is increased (or decreased) if the interest actually

accrued or paid during an accrual period exceeds (or is less than) the interest assumed to be accrued or paid during the accrual period under the hypothetical fixed rate debt instrument. This increase or decrease is an adjustment to qualified stated interest for the accrual period if the hypothetical fixed rate debt instrument provides for qualified stated interest and the increase or decrease is reflected in the amount actually paid during the accrual period. Otherwise, this increase or decrease is an adjustment to OID for the accrual period.

Foreign Currency Notes. OID for any accrual period on a Foreign Currency Note will be determined in units of the foreign currency and then translated into U.S. Dollars based on the average exchange rate in effect during the accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year). Upon receipt of the amount attributable to OID (whether in connection with a payment of interest or on the sale or retirement of the Foreign Currency Note), a U.S. Holder will recognize ordinary income or loss measured by the difference between the U.S. dollar value of the payment received calculated in accordance with the exchange rate in effect on the date of receipt or on the date of disposition of the Foreign Currency Note, as the case may be, and in accordance with such average exchange rate in effect during the accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year). For an alternative method of determining the U.S. Dollar value of any accrued OID and foreign currency received, see the discussion below under the heading “Spot Rate Convention Election”. Under proposed U.S. Treasury regulations, Notes that are denominated in a so-called hyperinflationary currency or are treated as having contingent interest payments are subject to different rules. U.S. Holders intending to purchase Foreign Currency Notes should examine the applicable Pricing Supplement and should consult with their tax advisers.

Spot Rate Convention Election. A U.S. Holder may elect to translate OID (and, in the case of an accrual basis U.S. Holder, accrued interest) into U.S. Dollars at the exchange rate in effect on the last day of an accrual period for the OID or accrued interest or, in the case of an accrual period that spans two taxable years, at the exchange rate in effect on the last day of the first taxable year for the OID or interest accrued through that date. Additionally, if a payment of original issue discount or accrued interest is actually received within five business days of the last day of the accrual period (or taxable year, in the case of a partial accrual period) an electing U.S. Holder may instead translate such OID or accrued interest into U.S. Dollars at the exchange rate in effect on the day of actual receipt. Any such election will apply to all debt instruments held by the U.S. Holder at the beginning of the first taxable year to which the election applies or thereafter acquired by the U.S. Holder, and will be irrevocable without the consent of the Internal Revenue Service.

Optional Redemption and Mandatory Redemption. If the Issuer has the right to call a Note (a “call option”) or the obligation to redeem a Note in certain circumstances, the manner in which the rules described above would be applied will depend in part upon whether and when the Issuer is presumed to redeem the Notes. The Issuer would be deemed (for the purpose of determining the amount and timing of interest income and OID on a Note) to exercise or not to exercise a call option or combination of call options in a manner that minimizes the yield on a Note. In addition, if based on all the facts and circumstances as of the issue date of a Note, it is more likely than not that the Note will not be paid under its stated payment schedule, then the yield and maturity of the Note is computed based on the payment schedule most likely to occur. A determination by the Issuer of the payment schedule most likely to occur is binding on all U.S. Holders of a Note, except for a U.S. Holder that explicitly discloses on its U.S. federal income tax return for the taxable year in which it acquired the Note that it has determined the yield and maturity of the Note on a different basis.

Debt Instruments with Contingent Payments. Contingent interest payments generally are includible in income based on an accrual schedule calculated by the Issuer on the issue date that estimates, based on available market information, the contingent payments reasonably expected to be made over the term of the Note. To determine the accrual schedule, the Issuer must determine the yield (the “comparable yield”) at which it would issue a fixed rate debt instrument with similar terms and conditions. The Issuer must then determine the projected payment schedule for the Notes including any noncontingent payments and an amount for each contingent payment based on market information or the expected value of the payment as of the issue date. If the projected payment schedule does not produce the comparable yield, it must be adjusted to produce the comparable yield with adjustments made first to amounts in respect of contingent payments not based on market information. The accrual schedule generally remains fixed throughout the term of the Notes

and is binding on all holders. U.S. Holders are urged to consult their tax advisers regarding the tax treatment of contingent payments. Certain Floating Rate Notes could constitute debt instruments with contingent payments.

Anti-Abuse Rule. The Internal Revenue Service can apply or depart from the regulations as necessary or appropriate to achieve a reasonable result where a principal purpose of the issuer or the taxpayer in structuring a Note or applying the regulations is to achieve a result that is unreasonable in light of the purposes of the applicable statutes (which generally are intended to achieve the clear reflection of income for both borrowers and lenders).

Short-Term Notes. A U.S. Holder of a Note with a maturity date no more than one year from the issue date (a "Short-Term Note") will be subject to special rules. U.S. Holders that do not use the accrual method of accounting for tax purposes generally will not be required to recognize OID on Short-Term Notes until they receive payments on such Notes. U.S. Holders on the accrual method, regulated investment companies, common trust funds, and certain others, however, must accrue OID on Short-Term Notes on a straight-line basis unless they elect to accrue the discount on a constant yield basis with daily compounding. For this purpose, OID on a Short-Term Note is the amount by which the total principal and interest payments on such Note exceed its issue price. U.S. Holders may elect to include discount on Short-Term Notes into income based on acquisition discount rather than OID. Acquisition discount is the excess of a Short-Term Note's stated redemption price at maturity over the U.S. Holder's basis in the Note. A U.S. Holder that has not accrued OID or acquisition discount also must defer deductions for net interest expense on any borrowing attributable to the Short-Term Note to the extent that the expense does not exceed accrued but unrecognized interest and OID (or acquisition discount) on the Note.

Gain recognized on the sale or exchange of a Short-Term Note by a U.S. Holder that has not accrued OID or acquisition discount on the Short-Term Note will be ordinary income to the extent attributable to accrued interest and OID (or acquisition discount). In the case of a Short-Term Note payable in a foreign currency, a U.S. Holder that has not accrued OID or acquisition discount should include the U.S. Dollar value of the OID or acquisition amount in income on the date payment is received or the Note is sold, and a U.S. Holder that currently accrues OID or acquisition discount should be taxed on it (and related foreign currency gain or loss) under rules similar to those applicable to a Note with OID that is payable in a foreign currency.

Reporting. Any Note that is issued with OID will bear a legend stating (i) the issue price of the Note, (ii) the total amount of OID, (iii) the issue date of the Note, (iv) the yield to maturity of the Note and (v) in the case of a Note that has a short interest accrual period, the amount of OID allocable to such short period and the method used to compute the yield on the Note. Alternatively, the Note will bear a legend stating that it is issued with OID and the holder will be provided the name and title and either the address or telephone number of a representative of the issuer who will, beginning no later than 10 days after the issue date of the Note, promptly make available to the holder, upon request, the information described in (i) through (v) above.

Market Discount

A U.S. Holder that purchases a Note at a market discount generally will be required to treat payments other than qualified stated interest payments as ordinary income to the extent of the accrued market discount and to treat gain on the sale or retirement of the Note as ordinary income to the extent of the accrued market discount not previously included in income. See "Sale or Exchange of Notes" below. Market discount is the amount by which the stated redemption price at maturity (or, in the case of a Note with OID, the revised issue price) exceeds the purchaser's basis in the Note immediately after acquisition. A Note is not treated as purchased at a market discount, however, if the discount is less than $\frac{1}{4}$ of 1% of the stated redemption price at maturity (or the revised issue price) multiplied by the number of complete years remaining to maturity ("*de minimis* market discount"). The revised issue price of a Note is its initial issue price increased by the amount of OID includible in the gross income of previous holders. Market discount on a Note will accrue, at the election of the holder, either ratably or at a constant yield to maturity. The U.S. Holder may elect to take

market discount into income as it accrues. This election to include market discount in income currently, once made, applies to all market discount obligations acquired in or after the first taxable year to which the election applies. It may not be revoked without the consent of the Internal Revenue Service. Rules similar to those applicable to Short-Term Notes payable in a foreign currency apply with respect to a Note with market discount payable in a foreign currency. A U.S. Holder may be required to defer deductions for interest expense attributable to debt incurred or continued to purchase a Note with market discount.

Premium

A U.S. Holder that purchases a Note for more than its stated redemption price at maturity may elect to amortize the bond premium. If a U.S. Holder makes such an election, the amount of interest on the Note otherwise required to be included in the U.S. Holder's income will be reduced each year by the amount of amortizable bond premium allocable to such year on a constant yield to maturity basis (except to the extent regulations may provide otherwise). If a Note is redeemable prior to maturity, the amount of amortizable bond premium will be determined with reference to the amount payable on the earlier redemption date if such determination results in a smaller premium attributable to the period ending on the earlier redemption date. Amortized bond premium will reduce the U.S. Holder's basis in the Note. An election to amortize bond premium will apply to certain other debt instruments that the U.S. Holder acquired at a premium, and the election may have different tax consequences depending on when the debt instruments were issued or acquired. Special rules apply to (i) certain Notes payable in or by reference to a foreign currency and (ii) certain Notes with contingent interest payments. A U.S. Holder should consult its tax adviser before making an election to amortize bond premium.

Interest Election

U.S. Holders on the accrual method or the cash method of accounting generally may elect to include all accrued interest on a Note in gross income using the constant yield to maturity method. The election applies to stated interest, acquisition discount, OID, *de minimis* OID, market discount and *de minimis* market discount, as adjusted by any amortizable bond premium or acquisition premium. If a U.S. Holder makes such an election and (a) the Note has amortizable bond premium, the U.S. Holder is deemed to have made an election to amortize bond premium or (b) the Note has market discount, the U.S. Holder is deemed to have made an election to include market discount in income currently. See "Premium" and "Market Discount" above. A U.S. Holder should consult its tax adviser before making this election.

Sale or Exchange of Notes

Except (i) to the extent that gain or loss is attributable to (a) accrued but unpaid interest or accrued market discount or (b) changes in the exchange rates in the case of a Foreign Currency Note, (ii) under the circumstances described above under "Original Issue Discount — Short-Term Notes" or "Market Discount" or (iii) with respect to certain Notes with contingent interest payments, a U.S. Holder generally will recognize capital gain or loss upon a sale, exchange or complete retirement of a Note equal to the difference between the amount realized and the U.S. Holder's adjusted basis in the Note. The gain or loss will be long-term gain or loss if the Note has been held for more than one year. The adjusted basis of a Note generally will equal its initial U.S. Dollar value cost (which, in the case of a Note purchased with foreign currency, will be the U.S. Dollar value of the purchase price on the date of the purchase) increased by any OID, market discount or acquisition discount with respect to the Note previously included in the U.S. Holder's gross income and reduced by the payments previously received on the Note, other than payments of qualified stated interest, and by any amortized premium. The amount realized on the sale or retirement of a Note for an amount of foreign currency will be the U.S. Dollar value of such amount on the date of sale or retirement. To the extent that such U.S. Dollar value differs from the U.S. Dollar value of the foreign currency amount at the spot rate on the day when the U.S. Holder acquired the Note, the U.S. Holder's gain or loss will be ordinary in character. Gain on sale or retirement of a Note by a U.S. Holder generally will be from sources within the United States, but loss other than foreign currency loss may be given a foreign source by reference to the source of interest income and OID on the Notes.

The tax consequences of a partial redemption of a Note will depend upon the price at which the U.S. Holder purchased the Note. A U.S. Holder that purchased a Note at a *de minimis* market discount or purchased a Note for more than its revised issue price, but less than its principal amount, will recognize capital gain equal to the difference between the principal prepayment and the U.S. Holder's adjusted basis in the prepaid portion of the Note. If a U.S. Holder purchased a Note at a market discount, the principal prepayment will be included in ordinary income to the extent of the accrued market discount on the Note, although it is possible in the case of a *pro rata* prepayment that the amount to be treated as ordinary income would not exceed accrued market discount attributable to the prepaid portion of the Note, in which case amounts attributable to unaccrued market discount allocable to the prepaid portion of the Note would be recognized as capital gain. If a U.S. Holder purchased a Note for more than its stated principal amount and has not elected to amortize bond premium, the U.S. Holder will recognize a capital loss equal to any amount by which the U.S. Holder's adjusted basis in the prepaid portion of the Note exceeds the amount of the principal prepayment. If the U.S. Holder has elected to amortize bond premium, all or part of such excess might be deductible as amortizable bond premium rather than as capital loss. Any capital gain or loss will be long-term gain or loss if the Note has been held for more than one year.

Any replacement of the Issuer as obligor on the Notes or the consolidation, amalgamation or merger of the Issuer with or into any other person, corporation or entity (as contemplated under the heading "Description of the Notes — Assumption of Obligations" and "— Consolidation, Merger and Sale of Assets" herein) may be considered for U.S. federal income tax purposes as an exchange of the Notes, resulting in recognition of taxable gain or loss to a U.S. Holder and certain other adverse tax consequences. Holders should consult their tax advisers in the event of any such replacement, consolidation, amalgamation or merger.

Dispositions of Foreign Currency. Foreign currency received as interest on a Note or on the sale or retirement of a Note will have a tax basis equal to its U.S. Dollar value at the time such interest is received or at the time of such sale or retirement. Foreign currency that is purchased will generally have a tax basis equal to its U.S. Dollar cost at the time of acquisition. Any gain or loss recognized on a sale or other disposition of foreign currency (including its use to purchase Notes or its exchange for U.S. Dollars) will be ordinary income or loss.

Indexed Notes. The tax treatment of an Indexed Note will depend on its particular terms and prospective purchasers should consult the tax disclosure in the relevant Pricing Supplement as well as their tax advisers.

Non-U.S. Holders

Subject to the discussion of backup withholding below, interest on a Note paid to a person that is not a U.S. Holder (a "non-U.S. Holder") will not be subject to U.S. withholding tax. In addition, interest on a Note will not be includible in the gross income of a non-U.S. Holder for U.S. federal income tax purposes, whether or not the non-U.S. Holder is engaged in a trade or business within the United States, unless the non-U.S. Holder is:

- (i) an insurance company organized as a corporation and carrying on a United States insurance business to which the interest is attributable, within the meaning of the Code, or
- (ii) an individual or corporation that has an office or other fixed place of business in the United States to which the interest is attributable, the interest is derived in the active conduct of a banking, financial or similar business within the United States or is received by a corporation the principal business of which is trading in stock or securities for its own account, and certain other conditions exist.

Ordinary income or loss recognized by a non-U.S. Holder in respect of changes in exchange rates will be U.S. source income or loss and will be includible in the gross income of the non-U.S. Holder if, using the rules generally applicable to determine whether income is effectively connected with a non-U.S. Holder's conduct of a trade or business in the United States, it is so effectively connected. Other gain or loss on the disposition of a Note will be includible in the gross income of the non-U.S. Holder if the gain or loss is effectively connected with the non-U.S. Holder's conduct of a trade or business in the United States or, in the case of an

individual, if the non-U.S. Holder is present in the United States for 183 days or more in the taxable year of the disposition and certain other conditions are met.

The Notes will not be includible for purposes of U.S. federal estate tax in the gross estate of a non-resident of the United States who was not a citizen of the United States at the time of death.

Information Reporting and Backup Withholding

Certain information reporting requirements on Internal Revenue Service Form 1099 may apply to payments of principal and premium, if any, and interest (including OID) on a Note made to certain U.S. noncorporate holders, in the case of interest, if such payments are made or are considered made in the United States (including payments made by wire transfer from outside the United States to an account maintained by the holder with the Trustee or any paying agent in the United States), and a backup withholding rate of 30% (subject to reduced rates through 2010) will apply to such payments if a U.S. Holder fails to provide an accurate taxpayer identification number or is notified by the Internal Revenue Service that it has failed to report all interest and dividends required to be shown on its U.S. federal income tax returns or fails to otherwise establish an exemption from such reporting or backup withholding. Nonresident alien individuals will generally be exempt from these reporting and withholding requirements if payments of principal, any premium or interest (including OID) are made to such alien outside the United States by the Company or another non-U.S. payor, but such alien may be required to comply with certification and identification procedures in order to prove the exemption if payment of principal, premium or interest is made or is considered made in the United States. Unless the holder certifies to its non-U.S. status or otherwise establishes an exemption, similar rules requiring reporting and withholding with respect to gross sales proceeds will apply to non-U.S. Holders who sell Notes through a U.S. branch of a broker, and information reporting will apply to non-U.S. Holders who sell Notes through (a) the non-U.S. branch of a U.S. broker or (b) a non-U.S. office of a broker that is a controlled foreign corporation for U.S. income tax purposes or that is a person 50% or more of whose income is effectively connected with a U.S. trade or business for a specified period.

Netherlands Taxation

In the opinion of KPMG Meijburg & Co, SIF No. 2's Dutch tax adviser, having regard to information given to them by the Company as to the intended management and operations of the business of SIF No. 2, under the law of The Netherlands as in effect on the date of the Information Memorandum, no deduction or withholding in respect of Netherlands taxation would be required to be made in respect of payments to a non-resident of The Netherlands by SIF No. 2 on the Notes issued by it in respect of principal of and interest on such Notes, provided that the Notes do not in fact function as equity of the Issuer, rather than as a loan, within the meaning of the Netherlands Corporate Income Tax Act 1969 as described below.

The following criteria should be applied for determining whether a loan functions, legally or in fact, as equity within the meaning of the Netherlands Corporate Income Tax Act 1969.

1. The value of the payments on the loan (e.g. interest) is entirely contingent on the profits of or on the profit distribution by the debtor or any of its affiliates and the loan has no repayment date or the repayment date is more than 10 years after the date on which the loan was taken out; or
2. The value of the payments on the loan (e.g. interest) is partly contingent on the profits of or on the profit distribution by the debtor or any of its affiliates. At the time the payment is agreed upon, the part of the payment that is not profit-related corresponds to less than half of the fair market interest rate applicable to loans with the same maturity period but for which the payment is not profit-related. The loan has no repayment date or the repayment date is more than 10 years after the date on which the loan was taken out; or
3. The liability in respect of the payments on the loan is contingent on the profits made or distributed by the debtor or any of its affiliates, while the value of the payment is not. The loan is subordinated and the loan has no repayment date or the repayment date is more than 50 years after the date on which the loan was taken out.

If any of these three abovementioned criteria are met, the payments on such loans (known as “hybrid loans”), as well as the depreciation of such loans, will not be tax deductible while the payment is subject to Dutch dividend withholding tax.

A Holder of any Note will not be subject to Netherlands taxes on income or capital gains in respect of any payment under the Notes issued by SIF No. 2 or in respect of any gain realized on the disposal or redemption thereof, provided that:

- (a) such Holder is not a resident or a deemed resident of The Netherlands; and
- (b) such Holder does not have a business or an interest in a business that is, in whole or in part, carried on through a permanent establishment or a permanent representative in The Netherlands and to which business or part of a business the Notes are attributable;

and, if the Holder is a legal person, an open limited partnership (*“open commanditaire vennootschap”*), another company with a capital divided in shares, or a special purpose fund,

- (c) such Holder does not have a substantial interest* in the share capital of SIF No. 2, or, if such Holder does have such an interest, such interest forms part of the assets of a business; and
- (d) such Holder does not have a deemed Netherlands business to which business the Instruments are attributable, such business including an entitlement to a share in the profits of an enterprise that is effectively managed in the Netherlands, other than by way of securities or through an employment contract, and to which enterprise the Instruments are attributable;

and, if the Holder is a natural person,

- (e) such Holder does not derive income and/or capital gains from activities in the Netherlands other than business income (as described under (b) above) to which activities the Notes are attributable, which activities include the use of that individual’s special knowledge or activities performed by that individual with respect to the Notes as a result of which such individual can make a return on the Notes that is in excess of the return on regular portfolio management (*belastbaar resultaat uit overige werkzaamheden in Nederland*), or employment activities in the Netherlands, or employment activities outside the Netherlands for remuneration that is subject to Netherlands payroll tax and social security contributions; and
- (f) such Holder or a person related to the Holder by law, contract, consanguinity or affinity to the degree specified in the tax laws of the Netherlands does not have, or is not deemed to have, a substantial interest* in the share capital of SIF No. 2.

No gift, estate or inheritance tax will arise in The Netherlands on a gift of a Note issued by SIF No. 2 by, or on the death of, a Holder who is not a resident or a deemed resident of The Netherlands, unless either:

- (i) a Holder dies within 180 days after having made a gift, while being at the moment of his death a resident or deemed resident in The Netherlands, or
- (ii) such Note is attributable to a business of such Holder carried on through a permanent establishment or a permanent representative in The Netherlands, which business the donor or the deceased Holder owned in whole or in part.

An individual of Netherlands nationality is deemed to be a resident of the Netherlands for the purposes of Netherlands gift and inheritance tax if he or she has been resided in the Netherlands at any time during the 10 years preceding the date of the gift or his or her death. An individual of any other nationality is deemed to

* Generally speaking, an interest in the share capital of SIF No. 2 should not be considered as a substantial interest if the Holder of such interest, and if the Holder is a natural person his spouse, registered partner, certain other relatives or certain persons sharing the Holder’s household, do not hold, alone or together, whether directly or indirectly, the ownership of, or certain rights over, shares or rights resembling shares representing five percent or more of the total issued and outstanding capital, or the issued and outstanding capital of any class of shares, of SIF No. 2.

be a resident of the Netherlands for the purposes of Netherlands gift tax only if he or she has been resided in the Netherlands at any time during the 12 months preceding the date of the gift.

There are no registration, stamp, capital, issue, transfer, sales, value added or other taxes, levies, imposts or charges of a similar nature of The Netherlands or any political subdivision or taxing authority thereof or therein, payable on or in connection with the documents as such or in connection with the arrangements contemplated thereby, or on the issue, subscription, initial distribution, or the alienation and transfer as such of the Notes, other than value added tax on the fees payable by the Issuer to any entrepreneur for services which are not explicitly exempt from Netherlands value added tax, such as management, administrative and similar activities, safekeeping of the Notes and the handling and verifying of documents.

United Kingdom Taxation

The following is a summary of certain aspects of the U.K. taxation treatment which applies at the date hereof in relation to the Notes. The comments do not deal with all of the U.K. tax aspects of acquiring, holding or disposing of the Notes but concentrate on those which are most likely to be relevant to Holders of Notes who are resident for tax purposes in the U.S. and are not taxpayers in the U.K. Prospective Holders should be aware that the particular terms of issue of any series of Notes as specified in the relevant Pricing Supplement may affect the tax treatment of that and other series of Notes. The following is a general guide and should be treated with appropriate caution. Holders who are in any doubt as to their tax position should consult their professional advisers.

A. *Withholding by U.K. Issuers — U.K. Source Interest*

1. Interest payable on Notes issued by Bank of Scotland or Treasury Services or any other Issuer which is resident in the U.K. for U.K. tax purposes may be payable without withholding or deduction on account of United Kingdom tax so long as, at the time of payment, the payer is a bank (meaning a person who has permission under Part 4 of the U.K. Financial Services and Markets Act 2000 to accept deposits (subject to certain exceptions) and certain other categories) and the interest is paid in the ordinary course of its business. According to U.K. Inland Revenue practice, interest on such Notes should be treated as paid in the ordinary course of a bank's business unless (inter alia) the issue of such Notes is regarded as relating to the capital structure of the bank. Therefore, interest paid on Subordinated Notes issued by Bank of Scotland or Treasury Services (or any other Notes issued by a bank) will not be regarded as paid in the ordinary course of a bank's business where the borrowing represented by such Notes conforms to any of the Tier 1, Tier 2 or Tier 3 definitions adopted by the Financial Services Authority, whether or not the borrowing actually counts towards Tier 1, Tier 2 or Tier 3 capital for regulatory purposes. Additionally, interest will not be regarded as paid in the ordinary course of business where the characteristics of the transaction giving rise to the interest are primarily attributable to an intention to avoid U.K. tax.
2. Where a Holder is resident in the United States for the purposes of the U.S./U.K. double taxation convention with respect to income and capital gains (the "U.S./U.K. Treaty") and does not have a permanent establishment in the U.K. and is the beneficial owner of the interest payments in question and certain other conditions are satisfied interest payments on the Notes held by the Holder may be made without withholding or deduction for or on account of U.K. income tax where (following an application by the Holder) the U.K. Inland Revenue have issued an authorization for the interest to be so paid. Treaty relief may be relevant in the case of Subordinated Notes issued by the Company and any other Notes falling outside the scope of the exemption referred to in 1 above. A Holder of such Notes can apply for the authorization referred to above by completing U.K. Inland Revenue form U.S./CORPORATION (in the case of companies) or U.S./INDIVIDUAL (in the case of individuals) and submitting the completed form to the U.S. Internal Revenue Service. Where such authorization has not been obtained and U.K. tax is actually withheld from payments under a Note but the Holder is entitled to exemption under the U.S./U.K. Treaty the Holder may be able to claim from the U.K. Inland Revenue a repayment of the tax so withheld.

3. Where payments of yearly interest (as defined in Section A.4. below) are payable to the person beneficially entitled to the income in respect of which the payments is made and that person is:
 - i. a company resident in the U.K.;
 - ii. a partnership each member of which is a company resident in the U.K. or;
 - iii. a company not resident in the U.K. for U.K. tax purposes but the nonresident company carries on a trade in the U.K. through a branch or agency and the payment falls to be brought into account in computing its UK chargeable profits; or
 - iv. effective only from October 2002, a body exempt from U.K. tax, who would otherwise have to reclaim the tax at a later stage;

then the payments may be made without deduction of U.K. withholding tax, subject to certain disapplying directions.

4. In all cases other than those falling within 1, 2 or 3 above interest payable on any Notes issued by the Company, Bank of Scotland or Treasury Services or any other Issuer which is resident in the U.K. for U.K. tax purposes ("U.K.-source interest" and "U.K. Notes" respectively) may be payable subject to deduction of U.K. income tax at the lower rate (currently 20%) subject to such relief as may be available under the provisions of any applicable double taxation treaty other than the U.S./U.K. Treaty. This withholding tax applies only to "yearly" interest. Interest will not normally be "yearly" for this purpose where it is payable on a Note issued for a term of less than one year and where the borrowing under the Note at no time forms part of a borrowing which is intended to have a total term of one year or more.

B. *Withholding by the Company Under the Guarantee*

5. If the Company is required to make a payment under any Guarantee given by it in respect of the obligations of any Issuer under any Notes the payment may be subject to U.K. withholding tax at a maximum rate of 22%. Such payments by the Company or Bank of Scotland may not be eligible for the exemptions described in A above. Relief may be available under the provisions of the U.S./U.K. Treaty or under any other applicable double taxation treaty.

C. *Withholding from Discount and Premium*

6. Notes may be issued at an issue price of less than 100% of their principal amount. Any discount element ("Discount") on any such Note may not constitute interest for U.K. withholding tax purposes and therefore may not be subject to any U.K. withholding tax (as applicable to interest) pursuant to the provisions outlined in paragraphs 1 to 5 inclusive above, but may be subject to reporting requirements as outlined in paragraph 12 below.
7. Where Notes are issued or may fall to be redeemed at a premium, as opposed to being issued at a discount, then payment of any such premium or part thereof may constitute a payment of interest. Payments of interest are subject to U.K. withholding tax as outlined above.

D. *U.K. Income Tax — Direct Assessment*

8. United Kingdom tax on interest payable to a person who is not resident in the United Kingdom is limited to any tax deducted at source, provided that the person does not have a "United Kingdom representative" for the purposes of Section 126 and Schedule 23 of the U.K. Finance Act 1995 to which the interest is attributable.
9. Holders should note that the provisions set out in this Offering Memorandum relating to the payment of additional amounts in respect of withholdings required to be made for taxes would not apply if the U.K. Inland Revenue sought to assess the person entitled to the relevant interest or Discount directly to U.K. tax thereon. Exemption from or reduction of such U.K. tax liability might be available under the terms of an applicable double taxation treaty.

E. U.K. Stamp Duty (“Stamp Duty”) and Stamp Duty Reserve Tax (“SDRT”)

10. There is a wide-ranging exemption from Stamp Duty and SDRT in relation to “loan capital”. Where that exemption applies, no Stamp Duty or SDRT is payable on the issue of any relevant Note or any transfer of, or on an agreement to transfer full legal and beneficial ownership of any such Note. However, the terms of certain Notes, specified in the applicable Pricing Supplement, may prevent them from qualifying for that exemption. This may occur, in particular, if (a) any Notes bear interest at more than a reasonable commercial rate on the nominal amount of the capital of such Notes, (b) a premium is payable on redemption of any Notes, (c) the amount of interest payable on any Notes depends to any extent on the results of any business or the value of any property, or (d) any Notes carry a right of conversion into shares or other securities, or to the acquisition of shares or other securities, including “loan capital” of the same description. Where there is no exemption there may be a charge to Stamp Duty and/or SDRT in respect of transfers or agreements to transfer such Notes. Persons who are in any doubt regarding the application of the “loan capital” exemption to any Notes should seek appropriate professional advice.

General

11. The above summary assumes that: —
- (a) the source of interest will follow the residence of the Issuer of the Notes in question — this may not necessarily be the case and, for example, interest on Notes issued by a non-U.K. resident but secured on U.K. property could have a U.K. source and be subject to the withholding tax rules set out in paragraphs 1 to 4 above;
 - (b) Notes are not held in a clearing system and are not quoted; the rules on withholding tax may be different for Notes which are held in a clearing system and/or quoted; and
 - (c) there will be no substitution of an Issuer. The above summary does not consider the tax consequences of any such substitution.
12. The references to “interest” and “principal” above mean “interest” and “principal” as understood in United Kingdom tax law. The statements above do not take account of any different definitions of “interest” or “principal” which may prevail under any other law or which may be adopted by the terms and conditions of the Notes or any other related documentation.

Reporting Requirements

Persons in the United Kingdom paying interest to or receiving interest on behalf of another person may be required to provide certain information to the United Kingdom Inland Revenue regarding the identity of the payee or the persons entitled to interest and, in certain circumstances, such information may be exchanged with tax authorities in other countries. These provisions may also apply, in certain circumstances, to payments made on redemption of any Notes, where the amount payable on redemption is greater than the issue price of the Notes.

Proposed European Union Directive on the Taxation of Savings

The Council of the European Union is currently considering proposals for a new directive regarding the taxation of savings income. Subject to a number of important conditions being met, it is proposed that a Member State will be required to provide to the tax authorities of another Member State details of payments of interest (or other similar income) paid by a person within its jurisdiction to an individual resident in that other Member State, subject to the right of certain Member States (namely Belgium, Luxembourg and Austria) to opt instead for a withholding system for a transitional period in relation to such payments. The proposed directive is not yet final, and may be subject to further amendment.

PLAN OF DISTRIBUTION

The Notes are being offered on a continuous basis for sale by the Issuers thereof through Morgan Stanley & Co. Incorporated, Credit Suisse First Boston LLC, J.P. Morgan Securities Inc., Lehman Brothers Inc., and Merrill Lynch, Pierce, Fenner & Smith Incorporated (“the Agents”), each of which has agreed to use its best efforts to solicit offers to purchase the Notes. An Issuer will pay the applicable Agent a commission which, depending on the maturity of the related Notes, will range from 0.125%, to 0.75% of the principal amount of any such Note sold through such Agent. Commissions with respect to Notes with maturities in excess of 30 years which are sold through an Agent will be negotiated between the relevant Issuer and such Agent at the time of such sale. An Issuer may also sell Notes to an Agent, as principal, at a discount from the principal amount thereof, and such Agent may later resell such Notes to investors and other purchasers at varying prices related to prevailing market prices at the time of sale as determined by such Agent. An Issuer may also sell Notes directly to, and may solicit and accept offers to purchase directly from, investors on its own behalf in those jurisdictions where it is authorized to do so.

In addition, the Agents may offer the Notes they have purchased as principal to other Agents. The Agents may sell Notes to any Agent at a discount. Unless otherwise indicated in the applicable Pricing Supplement, any Note sold to an Agent as principal will be purchased by such Agent at a price equal to 100% of the principal amount thereof less a percentage equal to the commission applicable to any agency sale of a Note of identical maturity, and may be resold by such Agent to investors and other purchasers from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price or at varying prices determined at the time of sale or may be resold to certain dealers as described above. After the initial public offering of Notes to be resold to investors and other purchasers on a fixed public offering price basis, the public offering price, concession and discount may be changed.

Each Issuer reserves the right to withdraw, cancel or modify the offer made hereby without notice and may reject orders in whole or in part whether placed directly with such Issuer or through an Agent. Each Agent will have the right, in its discretion reasonably exercised, to reject any offer to purchase Notes received by it, in whole or in part.

In connection with an offering of Notes purchased by one or more Agents as principal on a fixed offering price basis, such Agent(s) will be permitted to engage in transactions that stabilize the price of Notes. These transactions may consist of bids or purchases for the purpose of pegging, fixing or maintaining the price of Notes. If the Agent creates or the Agents create, as the case may be, a short position in Notes, that is, if it sells or they sell Notes in an aggregate principal amount exceeding that set forth in the applicable pricing supplement, such Agent(s) may reduce that short position by purchasing Notes in the open market. In general, purchase of Notes for the purpose of stabilization or to reduce a short position could cause the price of Notes to be higher than it might be in the absence of such purchases.

None of the Issuers, Guarantors or Agents makes any representation or prediction as to the direction or magnitude of any effect that the transactions described in the immediately preceding paragraph may have on the price of notes. In addition, none of the Issuers, Guarantors or Agents make any representation that the Agents will engage in any such transactions or that such transactions, once commenced, will not be discontinued without notice.

The Notes are not being registered under the Securities Act in reliance upon Regulation S under the Securities Act and the exemptions from registration provided by Rule 144A under the Securities Act and Section 4(2) of the Securities Act and Regulation D promulgated thereunder. The Notes are being offered hereby only (A) to QIBs in reliance on Rule 144A, (B) outside the United States to persons other than U.S. Persons (as defined in Regulation S) (“Regulation S Purchasers”) in offshore transactions in reliance upon Regulation S and (C) to institutional investors that qualify as “accredited investors” as defined in Regulation D promulgated under the Securities Act. The minimum principal amount of Notes which may be purchased for any account is (i) \$1,000 (or the equivalent thereof in another currency or composite currency) in the case of any sale pursuant to clauses (A) or (B) of the foregoing sentence and (ii) \$250,00 (or the equivalent thereof in another currency or composite currency) in the case of any sale pursuant to clause (C) of the foregoing sentence.

Prior to any issuance of Notes in reliance on Regulation S, each relevant Agent will be deemed to represent and agree that:

- (i) in relation to Notes which have a maturity of one year or more from the date of their issue and which are to be admitted to the Official List of the U.K. Listing Authority, it has not offered or sold and will not offer or sell any such Notes to persons in the United Kingdom prior to admission of such Notes to listing in accordance with Part VI of the Financial Services and Markets Act 2000 (the “FSMA”) except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended) or the FSMA;
- (ii) in relation to Notes which have a maturity of one year or more from the date of their issue and which are not to be admitted to the Official List of the U.K. Listing Authority, it has not offered or sold and, prior to the expiry of a period of six months from the issue date of such Instruments, will not offer or sell any such Notes to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended);
- (iii) in relation to any Notes which have a maturity of less than one year from the date of their issue,
 - (a) it is a person whose ordinary activities involve it in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of its business and (b) it has not offered or sold and will not offer or sell any Notes other than to persons:
 - (1) whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses; or
 - (2) who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses,

where the issue of the Notes would otherwise constitute a contravention of Section 19 of the FSMA by the relevant Issuer*1

- (iv) it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which Section 21(1) of the FSMA [does not apply to the relevant Issuer or HBOS as Guarantor or would not, if Bank of Scotland as Guarantor was not an authorised person, apply to Bank of Scotland as Guarantor]*2;

*1 This selling restriction does not apply if the Issuer is either Bank of Scotland or Treasury Services.

*2 Both Bank of Scotland and Treasury Services are authorised persons under the FSMA. Neither HBOS nor SIF No. 2 is an authorised person under the FSMA. The square-bracketed wording above at paragraph iv is appropriate where HBOS and Bank of Scotland jointly and severally guarantee an issue of Notes by SIF No. 2. Such wording shall be adapted to read as follows in the following circumstances:-

HBOS and Bank of Scotland jointly and severally guarantee an issue of Notes by Treasury Services:-

“... does not apply to HBOS as Guarantor or would not, if each of Treasury Services as Issuer and Bank of Scotland as Guarantor was not an authorised person, apply to Treasury Services as Issuer or Bank of Scotland as Guarantor”.

HBOS guarantees an issue of Notes by Bank of Scotland:-

“... does not apply to HBOS as Guarantor or would not, if Bank of Scotland as Issuer was not an authorised person, apply to Bank of Scotland as Issuer”.

HBOS makes an issue of Notes:-

“... does not apply to HBOS as Issuer”.

- (v) it has complied and will comply with all applicable provisions of the FSMA (and all rules and regulations made pursuant to the FSMA) with respect to anything done by it in relation to any Notes in, from or otherwise involving the United Kingdom; and
- (vi) with respect to offers and sales outside the United States, it will send to each distributor, dealer or person receiving a selling concession, fee or other remuneration that purchases Notes from them during the distribution compliance period (as defined in Regulation S) a confirmation or notice substantially to the following effect:

“The Notes covered hereby have not been registered under the U.S. Securities Act of 1933 (the “Securities Act”) and may not as a matter of U.S. law be offered and sold within the United States or to, or for the account or benefit of, U.S. persons (i) as part of their distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the offering and the closing date, except in either case in accordance with Regulation S (or Rule 144A, if available) under the Securities Act. Terms used above have the meaning given to them by Regulation S”.

Until the expiration of the period ending 40 days after the later of the commencement of the offering and the date of issue of the Notes, an offer or sale of Notes within the United States by a dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A under the Securities Act or pursuant to another exemption from Registration under the Securities Act. Furthermore, if any such Notes are sold within the United States or to, or for the account or benefit of, a U.S. person (as defined in Regulation S) pursuant to Rule 144A or pursuant to another exemption from registration under the Securities Act, DTC’s current procedures require that such person (i) must hold its interest in the Notes offshore through Euroclear or Clearstream, Luxembourg, as the case may be, until the expiration of the distribution compliance period (as defined in Regulation S) and (ii) upon the expiration of such distribution compliance period, certify that it bought such Notes pursuant to Rule 144A or pursuant to another exemption from registration under the Securities Act.

There is no undertaking to register the Notes hereafter and they cannot be resold except pursuant to an effective registration statement or an exemption from the registration requirements of the Securities Act. Each purchaser of the Notes offered hereby in making its purchase shall be deemed to have made the acknowledgments, representations and agreements as set forth under “Notice to Purchasers” contained on pages 2 and 3 hereof.

Each Issuer and the Company have, jointly and severally, agreed to indemnify the Agents against and to make contributions relating to certain liabilities, including liabilities under the Securities Act. The Agents may engage in transactions with, or perform services for, any Issuer or the Company in the ordinary course of business.

The Agents may from time to time purchase and sell Notes in the secondary market, but they are not obligated to do so, and there can be no assurance that there will be a secondary market for the Notes or liquidity in the secondary market if one develops. From time to time, the Agents may make a market in the Notes.

Some of the Agents or their affiliates have, directly or indirectly, performed investment and/or commercial banking or financial advisory services for HBOS or its affiliates, for which they may have received customary fees and commissions, and they expect to provide these services to HBOS and its affiliates in the future, for which they may also receive customary fees and commissions.

Notes issued by SIF No. 2 and any Notes issued by any other Issuer which are offered (as part of their initial distribution or by way of re-offering) in or from within The Netherlands (for which purposes “offerings upon issue in or from within The Netherlands” is to be construed in accordance with the provisions of and pursuant to the Dutch 1995 Act on the supervision of the securities trade (*Wet toezicht effectenverkeer 1995*)) will have a minimum denomination of €45,378.02 (or its equivalent in another currency), subject in all cases to changes in applicable legal or regulatory requirements.

The Notes issued in or from within The Netherlands by SIF No. 2 will be offered under the group financing exemption pursuant to Section 3 of the Dutch Exemption Regulation pursuant to the Act on the Supervision of the Credit System 1992. The issuance of Notes in or from within The Netherlands by any Issuer other than SIF No. 2 shall have to comply with the provisions of the Act on the Supervision of the Credit System 1992.

LEGAL MATTERS

The validity of the Notes and the Guarantee have been passed upon for the Issuers, Bank of Scotland and the Company by their United States counsel, Milbank, Tweed, Hadley & McCloy, Dashwood House, 69 Old Broad Street, London EC2M 1QS, England, their Netherlands counsel, De Brauw Blackstone Westbroek, London, 2nd Floor, Triton Court, 14 Finsbury Square, London EC2A 1BR, England, the Company's, Bank of Scotland's and Treasury Services' solicitors, Shepherd+ Wedderburn, Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ET, Scotland (upon whose opinion Milbank, Tweed, Hadley & McCloy and Cleary, Gottlieb, Steen & Hamilton have relied with respect to all matters of English and Scots law except certain matters relating to U.K. tax law in respect of which Cleary, Gottlieb, Steen & Hamilton has relied upon the opinion of KPMG Audit PLC, Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ET, Scotland). Certain legal matters relating to the Notes have been passed upon for the Agents by their U.S. counsel, Cleary, Gottlieb, Steen & Hamilton, City Place House, 55 Basinghall Street, London EC2V 5EH, England.

INDEPENDENT AUDITORS

The Consolidated Financial Statements of the Group as at December 31, 2002 appearing in this Offering Memorandum have been audited by KPMG Audit PLC, independent auditors, as stated in their report thereon appearing herein.

GLOSSARY

Set forth below are definitions, or the locations elsewhere of definitions, of some of the terms used in this Offering Memorandum.

"Business Day" when used with respect to any place of payment or any other particular location means any day which is not a Saturday or Sunday or a day on which banking institutions in that place of payment or other location are authorized or obligated by law to remain closed.

"Calculation Agent" means the agent appointed by an Issuer to calculate interest rates for Floating Rate Notes. Unless otherwise provided in a Pricing Supplement, the Calculation Agent will be the Paying Agent.

"Calculation Date" means the date on which the Calculation Agent is to calculate an interest rate with respect to a Floating Rate Note as specified in the fourth paragraph under the heading "Description of the Notes and the Guarantees — Interest — Floating Rate Notes."

"CD Rate" means the rate calculated as set forth under the heading "Description of the Notes and the Guarantees — Interest — Floating Rate Notes — CD Rate Notes," unless otherwise indicated in the applicable Pricing Supplement.

"CMT Rate" means the rate calculated as set forth under the heading "Description of the Notes and the Guarantees — Interest — Floating Rate Notes — CMT Rates Notes," unless otherwise indicated in the applicable Pricing Supplement.

"Commercial Paper Rate" means the rate calculated as set forth under the heading "Description of the Notes and the Guarantees — Interest — Floating Rate Notes — Commercial Paper Rate Notes," unless otherwise indicated in the applicable Pricing Supplement.

"Composite Quotations" means the daily statistical release entitled "Composite 3:30 P.M. Quotations for U.S. Government Securities," or any successor publication, published by the Federal Reserve Bank of New York.

"EURIBOR" means the rate calculated as set forth under the heading of "Description of Notes — Interest — Floating Rate Notes — EURIBOR Notes," unless otherwise indicated in the applicable Pricing Supplement.

“*Exchange Rate Agent*” means the agent appointed by an Issuer to convert principal and any premium and interest payments in respect of Foreign Currency Notes into U.S. dollars. Unless otherwise provided in a Pricing Supplement, the Exchange Rate Agent will be the Paying Agent.

“*Federal Funds Rate*” means the rate calculated as set forth under the heading “Description of the Notes and the Guarantees — Interest — Floating Rate Notes — Federal Funds Rate Notes,” unless otherwise indicated in the applicable Pricing Supplement.

“*Fixed Rate Note*” shall have the meaning set forth under the heading “Description of the Notes and the Guarantees — Interest — Fixed Rate Notes.”

“*Floating Rate Note*” shall have the meaning set forth under the heading “Description of the Notes and the Guarantees — Interest — Floating Rate Notes.”

“*H.15(519)*” means the weekly statistical release entitled “Statistical Release H.15(519), Selected Interest Rates,” or any successor publication, published by the Board of Governors of the Federal Reserve System.

“*H.15 Daily Update*” means the daily update of H.15(519), available through the world-wide-web site of the Board of Governors of the Federal Reserve Systems at <http://federalreserve.gov/releases/h15/update>, or any successor site or publication.

“*Index Maturity*” means, with respect to a Floating Rate Note, the period to maturity of the instrument or obligation on which the interest rate formula is based, as indicated in the applicable Pricing Supplement.

“*Initial Interest Rate*” means the rate at which a Floating Rate Note will bear interest from its date of issue to the first Interest Reset Date, as indicated in the applicable Pricing Supplement.

“*Interest Determination Date*” means the date as of which the interest rate for a Floating Rate Note is to be calculated, to be effective as of the following Interest Reset Date and calculated on the related Calculation Date (except in the case of LIBOR, which is calculated on the related LIBOR Interest Determination Date). See the third paragraph under the heading “Description of the Notes and the Guarantees — Interest — Floating Rate Notes” for the Interest Determination Dates for Floating Rate Notes. The Interest Determination Dates for any Floating Rate Note will also be indicated in the applicable Pricing Supplement.

“*Interest Reset Date*” means the date on which a Floating Rate Note will begin to bear interest at the variable interest rate determined as of the relevant Interest Determination Date. Unless otherwise specified in the applicable Pricing Supplement, the Interest Reset Date for a Floating Rate Note will be as specified in the second paragraph under the heading “Description of the Notes and the Guarantees — Interest — Floating Rate Notes”.

“*London Market Day*” means any day on which deposits in U.S. dollars are transacted in the London interbank market.

“*LIBOR*” means the rate calculated as set forth under the heading of “Description of Notes — Interest — Floating Rate Notes — LIBOR Notes,” unless otherwise indicated in the applicable Pricing Supplement.

“*Market Day*” means (a) with respect to any Note other than a LIBOR Note or a Foreign Currency Note, any Business Day in The City of New York, (b) with respect to LIBOR Notes only, any Business Day in London, England on which dealings in deposits in U.S. dollars are transacted in the London interbank market, (c) with respect to Foreign Currency Notes only, any Business Day in The City of New York that is also a Business Day in the financial center of the country of the Specified Currency or, with respect to Foreign Currency Notes denominated in euro, in Luxembourg and on which the Trans-European Automated Real Time Gross Settlement Express Transfer System (the “TARGET” System) is operating, and (d) any other Business Day specified in the applicable Pricing Supplement.

“*Market Exchange Rate*” for any Specified Currency means the noon buying rate in The City of New York for cable transfers for such Specified Currency as certified for customs purposes by the Federal Reserve Bank of New York.

“*Maturity*” when used with respect to any Note means the date on which the principal of such Note or an installment of principal becomes due and payable, whether at the Stated Maturity or by declaration of acceleration, call for redemption, exercise of option to require repayment or otherwise.

“*Original Issue Date*” shall have the meaning set forth in the fifth paragraph under the heading “Description of the Notes and the Guarantees — General.”

“*Prime Rate*” means the rate calculated as set forth under the heading “Description of the Notes and the Guarantees — Interest — Floating Rate Notes — Prime Rate Notes,” unless otherwise indicated in the applicable Pricing Supplement.

“*Principal Subsidiary*” means any subsidiary of the Company (a) whose total net assets or total net profits (after deducting all charges except taxation and excluding extraordinary items) (or, where the subsidiary of the Company in question itself has subsidiaries, calculated on a consolidated basis) represent not less than 10% of the total consolidated net assets or the total consolidated net profits (after deducting all charges except taxation and excluding extraordinary items) of the Company, all as calculated by reference to the then latest audited accounts of each such subsidiary (and its subsidiaries) and the then latest audited consolidated accounts of the Company; or (b) to which is transferred the whole or substantially the whole of the assets and undertaking of a subsidiary of the Company which immediately prior to such transfer was a Principal Subsidiary. A report by the independent public accountants or auditors of the Company that, in their opinion, a subsidiary of the Company is or is not a Principal Subsidiary shall, in the absence of manifest error, be conclusive and binding on the relevant Issuer, the Guarantor, the Trustee and the Holders of any series of Notes.

“*Program Exchange Rate*” for any Specified Currency means the Paying Agent’s London office’s spot rate of exchange for the sale in London of U.S. dollars for such Specified Currency on the date an Issuer agreed to issue the relevant Notes or such other amount as the Company (on behalf of itself and the Issuer) and the Agents may agree.

“*Redemption Price*” when used with respect to any Note to be redeemed, means the price at which it is to be redeemed pursuant to the Indenture and the applicable Pricing Supplement, exclusive of accrued and unpaid interest, if any.

“*Regular Record Date*” means, in respect of any Interest Payment Date, the fifteenth day next preceding such Interest Payment Date.

“*Reuters Screen U.S.PRIME1 Page*” means the display designated as page “U.S.PRIME1” on the Reuters Monitor Money Rates Service (or such other page as may replace the U.S.PRIME1 page on that service for the purpose of displaying prime rates or base lending rates of major U.S. banks).

“*Special Record Date*” means, in respect of interest which is payable, but not punctually paid or duly provided for, on any Interest Payment Date, such date as shall be determined by an Issuer.

“*Specified Currency*” shall have the meaning set forth in the first paragraph under the heading “Special Provisions Relating to Foreign Currency Notes — General.”

“*Spread*” means the number of basis points specified in the applicable Pricing Supplement as being applicable to the interest rate for a particular Floating Rate Note.

“*Spread Multiplier*” means the percentage specified in the applicable Pricing Supplement as being applicable to the interest rate for a particular Floating Rate Note.

“*Stated Maturity*” when used with respect to any Note or any installment of principal or interest thereon, means the date specified in such Note as the fixed date on which the principal of such Note or such installment of principal or interest is due and payable.

“*Treasury Rate*” means the rate calculated as set forth under the heading “Description of the Notes and the Guarantees — Interest — Floating Rate Notes — Treasury Rate Notes,” unless otherwise indicated in the applicable Pricing Supplement.

CONSOLIDATED FINANCIAL STATEMENTS

The following audited financial statements, together with the report thereon report of KPMG Audit Plc, with page references amended as appropriate, are included in this Offering Memorandum.

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Directors' Accounting Responsibilities

The following statement, which should be read in conjunction with the Independent Auditors' Report on page F-3, enables shareholders to distinguish the respective responsibilities of the Directors and the Auditors in relation to the accounts.

Company law requires the Directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the Company and of the Group and of the profit or loss for that period. In preparing those accounts, the Directors are required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;

- State whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts;
- Prepare the accounts on the going concern basis unless it is inappropriate to presume that the Company and the Group will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the accounts comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Independent Auditors' Report to the Members of HBOS plc

We have audited the accounts on pages F-4 to F-51. We have also audited the information in Section 3 of the Report of the Board of the HBOS plc Annual Report and Accounts 2002 in relation to remuneration policy and practice.

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

Respective responsibilities of directors and auditors

The directors are responsible for preparing the Annual Report and Accounts and the Report of the Board in relation to remuneration policy and practice. As described on page 64 of the HBOS plc Annual Report and Accounts 2002, this includes responsibility for preparing the accounts in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of the Financial Services Authority, and by our profession's ethical guidance.

We report to you our opinion as to whether the accounts give a true and fair view and whether the accounts and the part of the Report of the Board in relation to remuneration policy and practice to be audited have been properly prepared in accordance with the Companies Act 1985.

We also report to you if, in our opinion, the directors' report is not consistent with the accounts, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the Group is not disclosed.

We review whether the statement on pages 62 and 63 of the HBOS plc Annual Report and Accounts 2002 reflects the Company's compliance with the seven provisions of the Combined Code specified for our review by the Listing Rules, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and Accounts, including the corporate governance statement and the unaudited part of the Report of the Board in relation to remuneration policy and practice, and consider whether it is consistent with the audited accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the accounts.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts and the part of the Report of the Board in relation to remuneration policy and practice to be audited. It also includes an assessment of the significant estimates

and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion:

- the accounts give a true and fair view of the state of affairs of the Company and the Group as at 31 December 2002 and of the profit of the Group for the year then ended; and
- the accounts and the part of the Report of the Board in relation to remuneration policy and practice to be audited have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
Edinburgh
24 February 2003

Accounting Policies

Accounting Convention

The accounts have been prepared under the historical cost convention in compliance with the special provisions of Part VII of the Companies Act 1985 applicable to banking groups modified by the revaluation of items held for trading purposes and the revaluation of investment properties. The accounts have been prepared in accordance with applicable accounting standards and pronouncements of the Urgent Issues Task Force ("UITF") and in accordance with applicable Statements of Recommended Practice being those issued by the British Bankers' Association and the Finance and Leasing Association.

Accounting policies are reviewed regularly to ensure they are the most appropriate to the circumstances of the Group for the purposes of giving a true and fair view.

Changes in Accounting Policy

In accordance with the approach now adopted by other banking groups, the Group is using unsmoothed asset values (market value at 31 December) for the purposes of projecting future cash flows attributable to the shareholder in respect to long-term assurance business. Previously, these projections were based on smoothed asset values. The cumulative impact of this change of policy relating to previous years has been recognised in the accounts as a prior year adjustment and, accordingly, the prior year results have been restated.

The cumulative impact of this change of accounting policy was to reduce income from long-term assurance business and profit before tax by £203 million (2001 – £320 million) partially offset by an increase of £56 million (2001 – £nil) resulting from a reduction in the risk discount rate from 9% to 8.5%. The taxation charge reduced by £49 million (2001 – £92 million) partially offset by the tax effect on the risk discount rate of £15 million (2001 – £nil). The value of the Group's reserves reduced in total at 31 December 2001 by £190 million and minority interests (equity) by £10 million (2000 – increase of £28 million to the Group's reserves). The effect of this change in accounting policy is disclosed in Note 29.

In the current year, the Group implemented Financial Reporting Standard ("FRS") 19 "Deferred Tax". The cumulative impact on the taxation charge relating to previous years has been recognised in the accounts as a prior period adjustment and the prior year results have been restated. The effect of implementing this new accounting

standard was to reduce the taxation on profit on ordinary activities by £11 million (2001 – £10 million), increase the profit on ordinary activities after taxation by £11 million (2001 – £10 million) and increase the value of the Group's reserves at 31 December 2001 by £135 million (2000 – £125 million). This is mainly due to the recognition in full of a deferred tax asset on the general provision for bad and doubtful debts.

UITF 33 "Obligations in capital instruments" was also implemented in the current year. This required reclassification of certain capital instruments from minority and other interests (non-equity) to undated loan capital. The impact was to re-classify £297 million (2001 – £297 million) of perpetual securities within the consolidated balance sheet from capital and reserves to liabilities. Within the consolidated profit and loss account £22 million (2001 – £18 million) of interest on preferred securities was recognised as interest payable rather than minority interests (non-equity).

Basis of Consolidation

i. Basis of Preparation

The merger of Bank of Scotland Group and Halifax Group was completed on 10 September 2001 and was accounted for using the merger accounting principles set out in FRS 6 "Acquisitions and Mergers". The 2001 results were presented as if the Group had been established throughout that accounting period.

ii. Consolidation

The Group's accounts include the audited results of the Company and its subsidiary undertakings. The accounts of all principal subsidiary undertakings are made up to 31 December. The value of the long-term assurance business attributable to shareholders and the assets and liabilities attributable to policyholders are presented separately on the consolidated balance sheet from those of other businesses in order to reflect the different nature of the shareholders' and policyholders' interests therein.

iii. Associated Undertakings and Joint Ventures

The Group's share in associated undertakings is stated in the consolidated balance sheet at the Group's share of their net tangible assets plus attributable goodwill. The attributable share of results of associated undertakings, generally based on audited accounts, is included in consolidated profit using the equity method of accounting. Joint ventures

in which the Group has a long-term interest and shares control under a contractual agreement with other parties are accounted for using the gross equity method.

iv. Goodwill

The excess of the fair value of purchase consideration over the fair value of net assets at the date of acquisition of subsidiary undertakings, associated undertakings, joint ventures and other businesses arising on acquisitions after 31 December 1997 is capitalised. This goodwill is amortised by equal instalments over its estimated useful life, normally 20 years.

Goodwill arising on acquisitions prior to 1 January 1998 was written off to reserves in the year in which it arose and has not been reinstated, as permitted by FRS 10 "Goodwill and Intangible Assets". On the disposal of subsidiary undertakings and other businesses any related goodwill charged directly to reserves prior to 1 January 1998 is reinstated and included in the calculation of the profit or loss on disposal.

Goodwill carried in the consolidated balance sheet is subject to impairment review when events or changes in circumstances indicate that the carrying amount may not be recoverable and is written down by the amount of any impairment loss identified in the year. Impairment charges, if any, are included within goodwill amortisation.

Long-term Assurance Business

The Group accounts for the income from its long-term assurance business using the embedded value basis. The income represents the change in the surplus attributable to the Group, including minority interests, and the net present value of the in-force business. The value is a prudent estimate of the net present value of future cash flows attributable to the shareholders, based on the market value of the assets at 31 December, using assumptions which reflect experience and a long term outlook for the economy and then discounting at an appropriate risk discount rate.

General Insurance Business

The Group both underwrites and acts as intermediary in the sale of general insurance products. For each general insurance policy underwritten, premiums net of refunds are credited to other operating income over the duration of the insurance policy. Premiums received relating to future accounting periods are deferred as accruals and

deferred income and credited to other operating income when earned.

The cost of claims notified but not settled and claims incurred but not reported at the balance sheet date are estimated and provided for. Estimates are based upon an assessment of the likely costs taking account of all known facts. Where the outcome of outstanding cases is unclear, statistical techniques are used which take into account the cost of recent similar claim settlements. Claims equalisation provisions are calculated in accordance with relevant legislation and guidance.

Where the Group acts as intermediary, commission income net of a provision for expected future policy cancellations is credited to fees and commissions at the commencement of each insurance policy.

Loans and Advances

Loans and advances are held at cost less provisions.

Specific provisions are made for advances that are recognised to be bad or doubtful. Specific provisions are assessed on a case by case basis or, where this is not practical, as part of a portfolio of similar advances using loan loss estimation models. A general provision, to cover advances that are latently bad or doubtful, but not yet identified as such, is also maintained based on loan loss estimation models. The models reflect the historical loan loss experience relevant to the particular market segment or product and include adjustments for economic and business climate factors and management experience.

Provisions made during the year are charged to the profit and loss account, net of recoveries. If the collection of interest is considered doubtful, it is suspended and excluded from interest income in the profit and loss account. Provisions and suspended interest are written off to the extent that there is no longer any realistic prospect of recovery.

Securitisation

Loans and advances to customers include advances that are subject to non-returnable finance arrangements following securitisation of portfolios of mortgages and other advances. The principal benefits of these advances were acquired from the Group by special purpose securitisation companies which fund their purchase primarily through the issue of floating rate notes. In accordance with FRS 5, "Reporting the Substance of Transactions", the proceeds of these note issues are shown deducted from the securitised assets on the face of the balance sheet.

Finance Leases, Instalment Credit and Operating Leases

Assets leased to customers which transfer substantially all the risks and rewards of ownership to the customer are classified as finance leases and, together with instalment credit agreements, are recorded within loans and advances to customers or loans and advances to banks. The net investment in finance leases and instalment credit agreements represents total minimum payments less gross earnings allocated to future periods. Obligations under leases with third party finance lessors are included in customer accounts.

All other assets leased to customers are classified as operating leases. These assets are separately disclosed in the balance sheet and are recorded at cost less aggregate depreciation.

Income from finance leases and instalment credit agreements is credited to interest receivable using an actuarial method to give a constant periodic return on the net cash investment. Operating lease rentals are recognised in the profit and loss account on a straight line basis with depreciation charged using an actuarial method to give a constant periodic return on the net cash investment.

Unguaranteed residual values in respect of both finance lease and operating lease assets are reviewed regularly and any impairments identified are charged to operating expenses.

Debt Securities

(i) Debt securities and other fixed interest securities held for trading are included at market value with gains or losses included in dealing profits. The difference between the cost and market value of securities held for trading is not disclosed as its determination is not practicable.

(ii) Debt securities and other fixed interest securities held for the longer term are included at cost less amounts written off and adjusted for the amortisation of premiums or discounts arising on purchase of investments redeemable at fixed dates. Such premiums or discounts are taken to interest receivable on a straight line basis over the period to redemption. The use of a straight line basis does not result in a material difference to the amount of amortisation taken to interest receivable compared to the amortisation had a level gross yield basis been used. Gains or losses on realisation are recorded in net operating income as they arise.

(iii) Debt securities sold subject to repurchase agreements are retained within the balance

sheet where the Group retains substantially all of the risks and rewards of ownership. Funds received under these arrangements are included within deposits by banks or customer accounts. Conversely, debt securities acquired under commitments to resell are not recognised in the balance sheet as debt securities where substantially all the risks and rewards do not pass to the Group. In this case, the purchase price is included within loans and advances to banks or loans and advances to customers. The difference between sale and repurchase prices for such transactions is reflected in the profit and loss account over the lives of the transactions, within interest payable or interest receivable as appropriate.

Equity Shares

Equity shares are stated at cost less amounts written off. Income from listed equity shares is credited to other operating income on the ex-dividend date and from unlisted equity shares on an equivalent basis.

Investment Properties

Investment properties are accounted for in accordance with Statement of Standard Accounting Practice ("SSAP") 19, "Accounting for Investment Properties" and are revalued annually to open market value. Changes in market value are reflected in the revaluation reserve except when an impairment is deemed to be permanent, when the loss is charged directly against the current year's profit.

No depreciation is provided in respect of investment properties. This treatment is a departure from the requirements of the Companies Act 1985 which requires all properties to be depreciated. However, the Directors consider that these properties are not held for consumption but for investment and that to depreciate them would not give a true and fair view. The amount of depreciation which might otherwise have been charged cannot be separately identified or quantified as it is not practical to assess the estimated useful lives for investment properties.

Tangible Fixed Assets and Depreciation

Freehold land is not depreciated. Freehold and leasehold property, other than freehold investment properties, is stated at cost and depreciated over 50 years or the length of the lease term if shorter. Improvements to leasehold properties with unexpired lease terms of 50 years or less are stated at cost and are depreciated in equal instalments over the lesser of the remaining life of the lease or eight years. Premiums are amortised over the period of the lease.

Accounting Policies continued

The cost of equipment, including fixtures and fittings, vehicles and computer hardware, less estimated residual value, is written off in equal instalments over the expected lives of the assets, generally between three and fifteen years. Software development costs which lead to the creation of a definable software asset, subject to a de minimis limit, are capitalised and depreciated over their expected lives, generally four years.

Provision is made for the diminution in value of any tangible fixed asset where impairment is identified. The resulting net book value of the asset is written off over its remaining expected economic life. Impairment charges are included within operating expenses.

Taxation

Deferred tax is recognised, without discounting, in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date, except as otherwise required by FRS 19.

Dated and Undated Loan Capital

Dated and undated loan capital is included at the nominal value adjusted for premiums, discounts and expenses, all of which are amortised evenly over the period to redemption or reset. This does not result in a material difference to the amount of amortisation had a level gross yield basis been used.

Fees and Commissions Receivable

Arrangement fees and commissions receivable for the continuing servicing of loans and advances are recognised on the basis of work done. Those receivables in respect of bearing risk, including premiums received by the Group on high loan to value mortgages, are recognised on a straight line basis over the expected period of the advance or risk exposure. Other fees are recognised when receivable.

Mortgage Incentives

All costs associated with mortgage incentive schemes are charged in full in the year in which the expense is incurred.

Retirement Benefits

The cost of providing retirement pensions and related benefits is charged against profits on a systematic basis over the employees' service lives in accordance with SSAP 24 "Accounting for pension costs".

Foreign Currencies

Assets and liabilities and profit and loss

accounts are translated at the rates of exchange ruling on the balance sheet date or at the forward exchange rate, as appropriate. Exchange differences arising on the translation of foreign equity investments are taken to reserves except to the extent that they are offset by corresponding differences arising on the translation of related borrowing. All other exchange differences are included in dealing profits.

Collateral and Netting

The Group nets loans, deposits and derivative transactions where it enters into master agreements (occasionally collateralised) with counterparties to ensure that if an event of default occurs all amounts outstanding with these counterparties will be settled on a net basis. Where the master agreements are collateralised, the collateral will take the form of a lien over the counterparty's assets thereby enabling the Group to claim on these assets in respect of existing and future liabilities.

Derivatives

Derivative financial instruments used for trading and non-trading purposes include interest rate swaps, cross currency swaps, futures, options, forward rate agreements and caps, floors and collars.

(i) Trading derivatives, which include customer driven and proprietary transactions and hedges thereof, are carried in the accounts at fair value with gains or losses included in dealing profits. The fair value is based on quoted market prices. Where representative market prices are not available, the fair value is determined from appropriate financial models using the actual or modelled cash flows. Fair value adjustments are made where appropriate, to cover credit risk, liquidity risk and future administrative costs.

(ii) Non-trading derivatives, which are used primarily as a risk management tool for hedging interest rate and foreign exchange rate risk arising on on-balance sheet assets and liabilities, are accounted for on an accruals basis reflecting the treatment of the underlying items being hedged.

In order to qualify as a hedge, a derivative must effectively reduce any risk inherent in the hedged item from potential movements in interest rates, exchange rates and market values. Changes in the market value of the derivative must be highly correlated with changes in the market value of the underlying hedged item over the life of the hedge contract. Gains and losses on instruments used for hedging purposes are

not recognised until the exposure that is being hedged is itself recognised. Where a hedge transaction is terminated early, any profit or loss is spread over the remaining life of the underlying asset or liability being hedged. In other circumstances, where the underlying item subject to the hedge is extinguished, the hedge transaction is measured at fair value and any profit or loss is recognised immediately.

Consolidated Profit and Loss Account

For the year ended 31 December 2002

	Notes	2002 £ million	2001 Restated £ million
Interest receivable			
Interest receivable and similar income arising from debt securities		882	1,426
Other interest receivable and similar income		15,809	14,689
		16,691	16,115
Interest payable		(11,921)	(11,960)
Net interest income		4,770	4,155
Fees and commissions receivable		2,157	1,921
Fees and commissions payable		(672)	(517)
Dealing profits	1	154	82
Income from long-term assurance business	3(iii), 29	233	150
Other operating income		904	743
Net operating income (all from continuing operations)	1	7,546	6,534
Administrative expenses	2, 3(i)	(3,128)	(2,967)
Depreciation and amortisation			
Tangible fixed assets		(259)	(260)
Operating lease assets		(289)	(210)
Goodwill amortisation		(86)	(68)
		(634)	(538)
Operating expenses		(3,762)	(3,505)
General insurance claims		(79)	(68)
Provisions for bad and doubtful debts	18	(832)	(608)
Amounts written off fixed asset investments	19, 20	(24)	(21)
Operating profit (all from continuing operations)		2,849	2,332
Before exceptional items		3,002	2,479
Exceptional items	3	(153)	(147)
Share of operating profits of joint ventures		8	20
Share of operating profits of associated undertakings		27	16
Profit on disposal of business	4	25	
Merger costs – exceptional	3(ii)		(76)
Profit on ordinary activities before taxation		2,909	2,292
Before exceptional items		3,062	2,515
Exceptional items	3	(153)	(223)
Tax on profit on ordinary activities	10	(835)	(663)
Profit on ordinary activities after taxation		2,074	1,629
Before exceptional items		2,186	1,811
Exceptional items	3	(112)	(182)
Minority interests (equity)		(35)	(67)
(non-equity)		(123)	(94)
Profit attributable to shareholders		1,916	1,468
Dividends	11		
Ordinary		1,140	993
Preference		37	37
		1,177	1,030
Retained profit of the year	12	739	438
Underlying earnings per share	13	56.1p	47.7p
Basic earnings per share	13	50.6p	40.5p
Diluted earnings per share	13	50.2p	40.1p

It is estimated that Group profit on ordinary activities before taxation and retained profit of the year calculated solely on a historical cost basis would not differ materially from those stated in the Consolidated Profit and Loss Account above.

The statement of accounting policies on pages F-4 to F-6 and the notes on pages F-12 to F-51 form part of these accounts.

Consolidated Balance Sheet

As at 31 December 2002

	Notes	2002 £ million	2001 Restated £ million
Assets			
Cash and balances at central banks		1,373	1,150
Items in course of collection		1,093	983
Treasury bills and other eligible bills	14	5,964	4,071
Loans and advances to banks	15	11,838	12,929
Loans and advances to customers		240,879	201,034
Less: non-returnable finance	16	(6,564)	(3,141)
	16	234,315	197,893
Debt securities	19	44,324	42,449
Equity shares	20	223	224
Interest in joint ventures	21(i)		
Share of gross assets		3,674	2,214
Share of gross liabilities		(3,393)	(2,002)
		281	212
Interest in associated undertakings	21(ii)	172	134
Intangible fixed assets	23	1,434	1,245
Tangible fixed assets	24	1,671	1,627
Operating lease assets	25	2,625	2,042
Other assets	26	7,434	4,205
Prepayments and accrued income		1,458	2,241
Long-term assurance business attributable to shareholders	29	3,544	3,065
		317,749	274,470
Long-term assurance assets attributable to policyholders	29	37,331	37,601
Total Assets		355,080	312,071
Liabilities			
Deposits by banks	30	45,637	30,449
Customer accounts	31	150,221	140,516
Debt securities in issue	32	80,771	69,528
Notes in circulation		821	737
Corporate taxation		232	69
Dividends payable	11	754	679
Other liabilities	33	8,912	5,153
Accruals and deferred income		4,486	5,167
Provisions for liabilities and charges			
Deferred taxation	34(i)	648	489
Other provisions	34(ii)	232	252
		880	741
Subordinated liabilities	35		
Dated loan capital		5,690	4,966
Undated loan capital		3,437	2,957
		9,127	7,923
		301,841	260,962
Capital and Reserves			
Called up share capital	36		
Ordinary shares		946	892
Preference shares (non-equity)		400	400
		1,346	1,292
Share premium account	37	1,292	27
Other reserves	37	496	492
Profit and loss account	37	10,635	9,602
Shareholders' funds (including non-equity interests)	38	13,769	11,413
Minority interests (equity)		436	405
Minority and other interests (non-equity)	39	1,703	1,690
		15,908	13,508
		317,749	274,470
Long-term assurance liabilities attributable to policyholders		37,331	37,601
Total Liabilities		355,080	312,071

Consolidated Balance Sheet

As at 31 December 2002

	Notes	2002 £ million	2001 £ million
Memorandum Items	40		
Contingent liabilities			
Acceptances and endorsements		157	202
Guarantees and assets pledged as collateral security		2,672	2,133
		2,829	2,335
Commitments			
Other commitments		49,024	37,272

Approved by the Board on 24 February 2003 and signed on its behalf by:

Lord Stevenson
Chairman

A J Hobson
Chairman of Audit Committee

J R Crosby
Chief Executive

M H Ellis
Group Finance Director

The statement of accounting policies on pages F-4 to F-6 and the notes on pages F-12 to F-51 form part of these accounts.

Company Balance Sheet

As at 31 December 2002

	Notes	2002 £ million	2001 £ million
Fixed Assets			
Investments			
Shares in Group undertakings	22	10,040	1,301
Own shares	27	17	5
		10,057	1,306
Current Assets			
Debtors			
Amounts owed by Group undertakings		4,910	974
Dividends receivable		3,821	679
Other debtors		40	7
		8,771	1,660
Current Liabilities			
Creditors: Amounts falling due within one year			
Amounts owed to Group undertakings		8,657	27
Dividends payable	11	754	679
Accruals		13	2
Other liabilities	33	322	4
		9,746	712
Net Current (Liabilities)/Assets		(975)	948
Total Assets Less Current Liabilities			
		9,082	2,254
Creditors: Amounts falling due after more than one year			
Subordinated liabilities	35		
Dated loan capital		515	
Undated loan capital		2,131	902
		2,646	902
Net Assets		6,436	1,352
Capital and Reserves			
Called up share capital	36		
Ordinary shares		946	892
Preference shares (non-equity)		400	400
		1,346	1,292
Share premium account	37	1,292	27
Profit and loss account	37	3,798	33
Shareholders' Funds	38	6,436	1,352

Approved by the Board on 24 February 2003 and signed on its behalf by:

Lord Stevenson
ChairmanA J Hobson
Chairman of Audit CommitteeJ R Crosby
Chief ExecutiveM H Ellis
Group Finance Director

The statement of accounting policies on pages F-4 to F-6 and the notes on pages F-12 to F-51 form part of these accounts.

Consolidated Statement of Total Recognised Gains and Losses

For the year ended 31 December 2002

	2002 £ million	2001 Restated £ million
Profit attributable to shareholders	1,916	1,468
Exchange translation	4	(6)
Total recognised gains and losses in the year	1,920	1,462
Prior year adjustment on the implementation of FRS 19	135	
Prior year adjustment in respect of the use of unsmoothed asset values	(190)	
Total recognised gains and losses since last annual report	1,865	

Consolidated Cash Flow Statement

For the year ended 31 December 2002

	Notes	2002 £ million	2001 Restated £ million
Net cash (outflow)/inflow from operating activities	48	(994)	635
Merger costs – exceptional			(76)
Dividends received from joint ventures		48	16
Dividends received from associated undertakings		2	
Returns on investments and servicing of finance	49(i)	(700)	(638)
Taxation		(445)	(860)
Capital expenditure and financial investment	49(ii)	2,199	(1,076)
Acquisitions and disposals	49(iii)	(114)	(738)
Equity dividends paid		(782)	(837)
Net cash outflow before financing		(786)	(3,574)
Financing	49(iv)	2,543	2,697
Increase/(decrease) in cash	51	1,757	(877)

The statement of accounting policies on pages F-4 to F-6 and the notes on pages F-12 to F-51 form part of these accounts.

Notes on the Accounts

1. Net Operating Income

	2002 £ million	2001 Restated £ million
Net operating income includes:		
Mortgage incentives	(1,106)	(1,027)
Interest payable on subordinated liabilities	(518)	(485)
Dealing profits		
Foreign exchange	59	44
Interest related	95	38
Finance lease rental income	726	671
Operating lease rental income	468	369
General insurance premium income	320	265
Profit on sale of investment securities	37	92
Dividend income from equity shares	6	7

Dealing profits arise from the Group's trading book. The types of instrument in which the Group trade are as set out in Note 41.

2. Administrative Expenses

	Notes	2002 £ million	2001 £ million
Administrative expenses (excluding exceptional items) includes:			
Staff costs	5	1,552	1,425
Property rentals		128	135
Hire of equipment		25	24

The Group operates Inland Revenue approved Savings-Related Share Option Schemes and relies on the exemption under UITF Abstract 17 and accordingly no cost has been recognised on the grant of Savings-Related Share Options.

3. Exceptional Items

Exceptional items include the following:

(i) Included within administrative expenses, exceptional costs have been charged as follows:-

	Notes	2002 £ million	2001 £ million
HBOS merger integration costs	(a)	(153)	(132)
Equitable Life integration costs	(b)		(42)
		(153)	(174)
Tax effect		41	49

(a) The HBOS merger integration costs cover the costs of integrating and reorganising Bank of Scotland Group and Halifax Group following the merger.

(b) The Equitable Life integration costs relate to expenses incurred during the integration of The Equitable sales force, acquired on 1 March 2001 into the new Halifax Equitable structure together with other ancillary integration costs associated with the transaction.

(ii) Merger costs of £76 million (tax £nil) in 2001 comprise the deal costs incurred in connection with the merger of Bank of Scotland Group and Halifax Group.

(iii) Included within income from long-term assurance business in 2001 is an exceptional credit of £27 million (tax £8 million) arising from St. James's Place Capital plc's share of profits from an arrangement to transfer Life Assurance Holding Corporation Ltd's ("LAHC") investment management business to Aberdeen Asset Management plc. LAHC is an associated undertaking of St. James's Place Capital plc.

4. Profit on Disposal of Business

On 27 November 2002, the Bank of Scotland, a subsidiary undertaking of HBOS plc, disposed of its merchant services business for £25 million, generating a gain of £25 million.

5. Staff

	2002 Number	2001 Number
The average number of persons employed by the Group during the year was:-		
Full time	48,180	47,979
Part time	15,802	14,869
	63,982	62,848

	2002 £ million	2001 £ million
The aggregate remuneration payable to those employees comprises:-		
Wages and salaries	1,531	1,432
Social security costs	126	112
Other pension costs (Note 9)	92	73
Other post retirement benefits (Note 9)	2	2
	1,751	1,619
Less: long-term assurance business staff costs	(199)	(194)
Staff costs charged to administrative expenses	1,552	1,425

Staff costs in respect of long-term assurance business are not charged to administrative expenses but are taken into account in determining the increase in the net present value of the in-force long-term assurance business.

6. Directors' Remuneration

	2002 £000	2001 £000
Total emoluments	7,118	6,581
Total potential pre-tax gains on share options exercised	1	1,195
Highest paid Director – emoluments	1,027	994
– potential pre-tax gains on share options exercised	Nil	1,195
– accrued pension entitlement per annum	349	296

Retirement benefits accrued to 8 Directors under pension schemes in the year to 31 December 2002.

The figures for the year to 31 December 2001 include the emoluments of the Directors of Bank of Scotland and Halifax Group plc who were appointed to the Board of HBOS plc.

A detailed analysis of Directors' emoluments, pension entitlements, share interests and share options is given on pages 47 to 61 in the Report of the Board in relation to remuneration policy and practice.

7. Auditors' Remuneration

The aggregate remuneration of KPMG Audit Plc and its associates for audit and other services (excluding VAT) is analysed below. KPMG Audit Plc were the auditors of both Halifax Group and Bank of Scotland Group for 2002 and 2001, and since 5 June 2001 have been the auditors of HBOS plc.

	Within UK £ million	Outwith UK £ million	2002 Total £ million	Within UK £ million	Outwith UK £ million	2001 Total £ million
Group						
Statutory audits	3.1	0.6	3.7	2.9	0.5	3.4
As auditors or reporting accountants	3.3	0.3	3.6	3.4	0.1	3.5
	6.4	0.9	7.3	6.3	0.6	6.9
Accounting, advisory and consultancy	2.8	0.1	2.9	6.6	0.6	7.2
Tax advisory	0.8	0.2	1.0	0.5	0.3	0.8
Merger and acquisitions	0.5		0.5	8.1		8.1
	10.5	1.2	11.7	21.5	1.5	23.0

In respect of the Company, statutory audit fees include £10,000 (2001 – £10,000), fees as auditors or reporting accountants were £181,000 (2001 – nil) and fees in respect of the merger were £76,000 (2001 – nil). All fees are within the UK.

Notes on the Accounts continued

7. Auditors' Remuneration continued

Non-audit fees include £0.7 million which has been capitalised by the Group in the year ended 31 December 2002 (2001 – £2.0 million). The level of fees were greater in 2001 primarily reflecting work conducted in connection with the merger of Bank of Scotland Group and Halifax Group and the acquisition of the operating assets, salesforce and unit-linked and certain non-profit business of The Equitable.

The Group's policy in relation to the appointment of the external auditors for other work is explained in the Corporate Governance Statement on pages 62 and 63 of the HBOS plc Annual Report and Accounts 2002.

8. Operating Leases

			Group	
	2002 Property £ million	2002 Other £ million	2001 Property £ million	2001 Other £ million
There are commitments to make payments in the following year in respect of non-cancellable operating leases which expire:-				
within 1 year	3	2	3	3
between 1 and 5 years	19	35	18	13
after 5 years	106	2	106	3
	128	39	127	19

9. Pension Costs

The Group operates several pension schemes. The principal schemes are the Halifax Retirement Fund and the Bank of Scotland 1976 Pension Scheme (together, "the Schemes"), which are funded schemes. These Schemes cover 76 per cent of the Group's pensionable employees, and provide defined benefits based on final pensionable salary. The assets of the Schemes are held in Trust Funds which are independent of the Group's own assets.

In determining the level of contributions required to be made to the Schemes and the relevant charges to the Group's profit and loss account, the Group has been advised by Watson Wyatt LLP, Actuaries and Consultants. The most recently published formal valuation of the Halifax Retirement Fund took place as at 31 March 2000; a formal valuation of the Bank of Scotland 1976 Pension Scheme was carried out as at 31 December 2001. The financial assumptions are derived based upon the economic conditions prevailing at the date of valuation. The different assumptions between the two Schemes are as a consequence of their differing valuation dates. The main financial assumptions adopted for these calculations were as follows:-

	Halifax Retirement Fund Rates per annum	Bank of Scotland 1976 Pension Scheme Rates per annum
Future price inflation	3.00 per cent	2.50 per cent
Return on new investments	7.25 per cent	6.60 per cent
Return on existing investments	5.75 per cent	6.00 per cent
Increases in earnings ¹	4.50 per cent	3.50 per cent
Increases in pensions ²	3.00 per cent	2.50 per cent

Notes:-

1. In addition to the general assumed rate of salary increases, there is a separate assumed salary scale of increases due to promotions and increasing seniority.

2. The pension increase is on the excess over the Guaranteed Minimum Pension.

The pension costs for accounting purposes have been calculated using the same assumptions as those adopted for the formal valuations. The following disclosures are based on these assumptions using the projected unit method of valuation:-

	Halifax Retirement Fund	Bank of Scotland 1976 Pension Scheme
Effective date of valuation	31/3/2000	31/12/2001
Market value of assets	£2,148m	£1,409m
Asset cover level	119 per cent	98 per cent
Regular pension charge (as a percentage of pensionable salaries)	16.75 per cent	15.90 per cent

9. Pension Costs continued

The asset cover levels disclosed in the previous table represent the ratios of the respective Schemes' assets to the value of the benefits that had accrued to members and pensioners at the valuation dates after allowing for expected future increases in earnings and pensions.

The regular pension charge for the Halifax Retirement Fund is inclusive of employee contributions which were increased from 3% to 4% of pensionable salaries from 1 May 2002. These charges have been adjusted by spreading surplus assets or shortfalls in each of the Schemes over the average future working lifetimes of the memberships (15 years for the Halifax Retirement Fund and 16 years for the Bank of Scotland 1976 Pension Scheme) by fixed capital instalments plus interest on the reducing balances. These elements, together with interest on the opening balance sheet positions result in a charge of £12 million (2001 – £15 million) in respect of the Halifax Retirement Fund and £54 million (2001 – £30 million) in respect of the Bank of Scotland 1976 Pension Scheme. Included within the Bank of Scotland 1976 Pension Scheme charge is an exceptional charge of £1 million.

Contributions to the Schemes of £72 million were paid over the period. As contributions differed from the amount charged in the Profit and Loss Account a pension prepayment of £35 million (2001 – £25 million) in respect of the Halifax Retirement Fund and a provision of £82 million (2001 – £78 million) for future contributions in respect of the Bank of Scotland 1976 Pension Scheme is included in the Balance Sheet. This leads to a net provision of £47 million (2001 – £53 million). The Group currently contributes to the Halifax Retirement Fund at a rate of 4% of pensionable salaries, and to the Bank of Scotland 1976 Pension Scheme at a rate of 16.6% of pensionable salaries.

The current pension cost for the Halifax Retirement Fund under SSAP 24 is likely to increase in 2003, when the next formal triennial valuation is performed, reflecting, inter alia, a deterioration in stock market conditions.

The Bank of Scotland 1976 Pension Scheme was closed to new members on 30 September 2002. With effect from 1 October 2002 all new members of staff will be eligible to join The HBOS Group Money Purchase Scheme.

The pension costs charged in the Profit and Loss Account include £27 million (2001 – £28 million) relating to schemes other than the Schemes. These costs are net of an amount of £7 million in respect of The Equitable Pension and Life Assurance Scheme ('The Equitable Pension Scheme') which The Equitable is obliged to reimburse to the Group.

Other Post-Retirement Benefits

The Group also provides post-retirement health care benefits and concessionary rate mortgages for certain pensioners and dependent spouses. An independent actuarial review as at 31 December 2002 estimated the present value of the accumulated other post-retirement benefit obligations at £38 million for the Group (2001 – £37 million). The main additional financial assumption used was that over the long-term the rate of increase in health care costs would be 7.25% per annum, being 4.25% per annum higher than the rate of inflation. The charge for the year ended 31 December 2002 for other post-retirement benefits was £2 million (2001 – £2 million). Included in provisions for liabilities and charges is £35 million (2001 – £33 million) which represents the accrued amount for other post-retirement benefits.

FRS 17

Under the transitional arrangements of FRS 17 the Group continues to account for retirement benefits in accordance with SSAP 24 as detailed above. The following additional disclosures under FRS 17 are required by way of narrative only.

The actuarial valuations used in assessing the FRS 17 disclosures are:-

- the Halifax Retirement Fund valuation as at 31 March 2000
- the Bank of Scotland 1976 Pension Scheme valuation as at 31 December 2001

These are the principal schemes for the Group but additional FRS 17 disclosure has been provided for all other defined benefit schemes within the Group. These are detailed below under the heading "Other Schemes".

For the Schemes and Other Schemes, each actuarial valuation is updated by qualified actuaries, principally Watson Wyatt LLP, to take account of the requirements of FRS 17 and to assess the assets and liabilities of the schemes as at 31 December 2002. Scheme assets are stated at their market value at 31 December 2002.

The liabilities of the Schemes under FRS 17 were calculated using the Projected Unit method using the following financial assumptions:-

	Rates per annum 31 December 2001	Rates per annum 31 December 2002
Future price inflation	2.5 per cent	2.4 per cent
Discount rate	6.0 per cent	5.8 per cent
Increases in earnings ¹	3.5 per cent	3.4 per cent
Increases in pensions ²	2.5 per cent	2.4 per cent

Notes:-

1. In addition to the general assumed rate of salary increases, there is a separate assumed salary scale of increases due to promotions and increasing seniority.
2. The pension increase is on the excess over the Guaranteed Minimum Pension. Pensions which are guaranteed to increase at a rate of 3.0 per cent per annum have been assumed to increase at 3.0 per cent.

Notes on the Accounts continued

9. Pension Costs continued

The Schemes are closed to new entrants. Under the Projected Unit method, the current service cost will increase as members of the Schemes approach retirement.

The liabilities of the Other Schemes under FRS 17 were calculated using the Projected Unit method using the following financial assumptions:-

	Rates per annum 31 December 2001	Rates per annum 31 December 2002
Future price inflation	2.5 per cent	2.4 per cent
Discount rate	6.0 per cent	5.8 per cent
Increases in earnings	3.5 per cent	3.4 per cent
Increases in pensions	2.5 per cent	2.4 per cent

The above rates apply to all Other Schemes with the exception of the schemes within Bank of Scotland (Ireland) Ltd, which are not significant.

The assets of the Schemes and the expected rates of return were:-

	Long-term expected rate of return per annum at 31 December 2001	Value at 31 December 2001 £ million	Long-term expected rate of return per annum at 31 December 2002	Value at 31 December 2002 £ million
Equities	7.75 per cent	2,715	8.50 per cent	2,157
Bonds	5.25 per cent	305	5.00 per cent	269
Property	6.50 per cent	88	6.80 per cent	82
Cash	4.50 per cent	88	3.80 per cent	84
Total market value of assets		3,196		2,592
Present value of liabilities of the Schemes		3,194		3,546
Surplus/(Deficit) in the Schemes		2		(954)
Deferred tax asset				286
Net pension asset/(liability)		2		(668)

The assets of the Other Schemes and the expected rates of return were:-

	Long-term expected rate of return per annum at 31 December 2001	Value at 31 December 2001 £ million	Long-term expected rate of return per annum at 31 December 2002	Value at 31 December 2002 £ million
Equities	7.75 per cent	365	8.50 per cent	314
With-profits investments	6.25 per cent	114	5.80 per cent	79
Bonds	5.25 per cent	76	5.00 per cent	124
Property	6.50 per cent	13	6.80 per cent	19
Cash	4.50 per cent	12	3.80 per cent	33
Total market value of assets		580		569
Present value of liabilities of the Other Schemes		607		751
Deficit in the Other Schemes		(27)		(182)
Deferred tax asset		8		55
Net pension liability		(19)		(127)

The above rates apply to all Other Schemes with the exception of the schemes within Bank of Scotland (Ireland) Ltd, which are not significant.

The movement in the surplus/(deficit) in the Schemes and Other Schemes ("Group Schemes") during the year can be analysed as follows:-

	Year ended 31 December 2002		
	The Schemes £ million	Other Schemes £ million	Total £ million
Surplus/(Deficit) in the Group Schemes at beginning of year	2	(27)	(25)
Contributions paid	72	42	114
Current service cost	(128)	(22)	(150)
Past service cost	(16)	(6)	(22)
Other finance income	46	4	50
Actuarial loss	(930)	(173)	(1,103)
Deficit in the Group Schemes at end of year	(954)	(182)	(1,136)

9. Pension Costs continued

Components of defined benefit cost for the year 2002

Analysis of amount that would be charged to operating profit

Year ended 31 December 2002

	The Schemes £ million	Other Schemes £ million	Total £ million
Current service cost	128	22	150
Past service cost	16	6	22
Total that would be charged to operating profit	144	28	172

Analysis of amount that would be credited to other finance income

Interest on pension scheme liabilities	188	36	224
Expected return on assets in pension scheme	(234)	(40)	(274)
Net amount that would be credited to other finance income	(46)	(4)	(50)
Total potential profit and loss charge before deduction for tax	98	24	122

Analysis of amounts that would be recognised in Statement of Total Recognised Gains and Losses (STRGL)

Year ended 31 December 2002

	The Schemes £ million	Other Schemes £ million	Total £ million
Loss on assets	829	163	992
Experience loss/(gain) on liabilities	7	(8)	(1)
Loss on change of assumptions (financial and demographic)	94	18	112
Total potential loss recognised in STRGL before tax	930	173	1,103

History of experience gains and losses

Year ended 31 December 2002

	The Schemes	Other Schemes	Total
Loss on scheme assets			
Amount (£ million)	829	163	992
% of scheme assets at end of year	32%	29%	31%
Experience loss/(gain) on scheme liabilities			
Amount (£ million)	7	(8)	(1)
% of scheme liabilities at end of year	0%	1%	0%
Total potential loss recognised in STRGL before tax			
Amount (£ million)	930	173	1,103
% of scheme liabilities at end of year	26%	23%	26%

Included within Other Schemes is The Equitable Pension Scheme. At 31 December 2002, under FRS 17, a deficit of £51 million and a profit and loss charge of £14 million would arise. The Equitable is, however, obliged to reimburse the Group for certain excess costs of funding this scheme. The contributions to Other Schemes referred to above are those paid by the Group and do not take account of amounts to be reimbursed by The Equitable.

Other Post-Retirement Benefits

An independent actuarial review as at 31 December 2002 estimated the present value of the accumulated other post-retirement benefit obligations under FRS 17 at £40 million (2001 – £40 million) for the Group. There are no assets backing these obligations, and hence the notional balance sheet provision under FRS 17 is also £40 million (2001 – £40 million). The notional charge in relation to these benefits amounted to £3 million. The main additional financial assumption used was that over the long-term the rate of increase in health care costs would be 5.8% per annum, which is in line with the discount rate.

Notes on the Accounts continued

10. Taxation

	2002 £ million	2001 Restated £ million
UK Corporation Tax at 30 per cent (2001 – 30 per cent)	519	429
Relief for overseas taxation	(17)	(12)
	502	417
Tax relating to change in value of long-term assurance business (Note 29)	51	23
	553	440
Overseas taxation	107	97
Share of joint ventures' taxation	12	11
Share of associated undertakings' taxation	5	4
Total current corporation tax	677	552
Deferred taxation (Note 34(i))	158	111
Tax on profit on ordinary activities	835	663

The tax assessed for the year is lower than the standard rate of corporation tax in the UK (30 per cent). The differences are explained below:-

	2002 £ million	2001 Restated £ million
Profit on ordinary activities before taxation	2,909	2,292
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 30 per cent (2001 – 30 per cent)	873	688
Effects of:-		
Expenses not deductible for tax purposes	50	69
Capital allowances in excess of depreciation	(154)	(139)
Net effect of differing tax rates overseas	(28)	(9)
Book gains covered by capital losses/indexation	(5)	(8)
Deductible interest on innovative tier 1 capital	(33)	(23)
Differing tax rates for life assurance business	(3)	(9)
Expenditure qualifying for capital allowances	6	16
Amounts written off fixed asset investments	10	3
Tax deductible contributions to Qualifying Employee Share Trust	(4)	(9)
Other timing differences	(18)	(13)
Adjustments in respect of previous periods	(15)	(6)
Others	(2)	(8)
Current corporation tax charge for year	677	552

11. Dividends

	2002 £ million	2001 £ million
Preference dividends paid	25	25
payable	12	12
	37	37
Ordinary dividend		
Interim dividend of 9.80p per ordinary share (2001 – 9.30p)	370	330
Proposed final dividend of 19.60p per ordinary share (2001 – 18.70p)	742	667
Adjustments	28	(4)
	1,140	993
	1,177	1,030

Of the adjustment in 2002, £32 million results from the 2001 final dividend payable in respect of the 172.5 million ordinary shares issued by means of a share placing which took place subsequent to the dividends being accrued but before the ex-dividend date.

The other adjustment in 2002 of £4 million (2001 – £2 million) results from the waiver of dividends by the QUEST (Note 27(b)) which took place subsequent to the dividends being accrued but before the ex-dividend date.

The remaining adjustment in 2001 of £2 million reflects a credit for dividends declared on unclaimed Halifax Group plc ordinary shares that were sold by Halifax Group plc in 2001. The dividends accrued on these shares were not required to be paid.

12. Retained Profit

	2002 £ million	2001 Restated £ million
The profit of the Group has been retained by		
HBOS plc	3,494	43
Subsidiary undertakings	(2,723)	390
	771	433
Associated undertakings and joint ventures	(32)	5
	739	438

By virtue of the exemption contained within Section 230 of the Companies Act 1985, the Profit and Loss Account of the Company is not presented.

Following the transfer of certain Halifax Group plc subsidiary undertakings, a dividend of £3.2 billion was payable from Halifax Group plc to HBOS plc.

13. Earnings per Ordinary Share

Basic and diluted earnings per Ordinary Share are based upon Group profit attributable to Ordinary Shareholders of £1,879 million (2001 restated – £1,431 million). The underlying earnings per Ordinary Share are based upon Group profit attributable to Ordinary Shareholders (before exceptional items and goodwill amortisation but after tax) of £2,083 million (2001 restated – £1,687 million). For the basic and underlying earnings per Ordinary Share the weighted average number of 25p Ordinary Shares of 3,716 million (2001 – 3,536 million) is used and for the diluted earnings per Ordinary Share the weighted average number of actual and potential 25p Ordinary Shares of 3,743 million (2001 – 3,568 million) is used. Group profit attributable to Ordinary Shareholders equals profit attributable to shareholders of £1,916 million (2001 restated – £1,468 million) less preference dividends of £37 million (2001 – £37 million). The weighted average number of actual and potential Ordinary Shares in issue is detailed below:-

	2002 Number million	2001 Number million
Actual weighted average number of shares in issue	3,716	3,536
Adjustment for weighted average number of shares on which options have been granted but not yet exercised	27	32
Potential weighted average number of shares in issue	3,743	3,568

The calculation of the underlying earnings per Ordinary Share, noted below, has been included to enable shareholders to assess the underlying trading performance.

	2002 pence	2001 Restated pence
Basic earnings per share	50.6	40.5
Exceptional items	3.0	5.1
Goodwill amortisation	2.5	2.1
Underlying earnings per share	56.1	47.7

14. Treasury Bills and Other Eligible Bills

	2002		2001	
	Book Value £ million	Market Value £ million	Book Value £ million	Market Value £ million
Investment securities				
Treasury bills and similar securities	3,704	3,707	2,602	2,600
Other eligible bills	302	303	448	451
	4,006	4,010	3,050	3,051
Other securities				
Treasury bills and similar securities	1,118	1,118	57	57
Other eligible bills	840	840	964	964
	1,958	1,958	1,021	1,021
	5,964	5,968	4,071	4,072

Notes on the Accounts continued

14. Treasury Bills and Other Eligible Bills continued

The movement on treasury bills and other eligible bills held for investment purposes was as follows:-

	£ million
At 1 January 2002	3,050
Exchange translation	28
Additions	12,615
Disposals	(11,750)
Amortisation	63
At 31 December 2002	4,006
Aggregate unamortised discounts net of premiums at 31 December 2002	30

15. Loans and Advances to Banks

	2002 £ million	Group 2001 £ million
Repayable on demand or at short notice	3,159	1,625
Other loans and advances repayable		
in 3 months or less excluding on demand or at short notice	6,551	9,191
1 year or less but over 3 months	1,776	1,741
5 years or less but over 1 year	282	185
over 5 years	70	187
	11,838	12,929

16. Loans and Advances to Customers

	2002 £ million	Group 2001 £ million
Repayable on demand or at short notice	18,469	16,679
Other loans and advances repayable		
in 3 months or less excluding on demand or at short notice	24,008	18,296
1 year or less but over 3 months	11,514	10,057
5 years or less but over 1 year	34,613	27,582
over 5 years	147,876	127,171
Gross loans and advances to customers*	236,480	199,785
Provisions for bad and doubtful debts (Note 18)	(2,024)	(1,769)
Interest in suspense	(141)	(123)
Loans and advances to customers	234,315	197,893

* Net of securitised loans and advances to customers.

At 31 December 2002, there were gross loans and advances to customers of £4,588 million (2001 – £3,280 million) outstanding from associated undertakings and joint ventures.

Loans and advances to customers include finance lease receivables of £4,287 million (2001 – £3,900 million). Assets acquired in the year for letting under finance leases amounted to £1,047 million (2001 – £1,005 million).

16. Loans and Advances to Customers continued

The Group's gross lending exposure is analysed below.

	2002 £ million	2001 £ million
Agriculture, forestry and fishing	1,096	1,038
Energy	1,591	1,598
Manufacturing industry	5,836	5,654
Construction and property	20,591	15,053
Hotels, restaurants and wholesale and retail trade	8,410	5,930
Transport, storage and communication	5,107	4,736
Financial	6,867	6,716
Other services	12,788	9,850
Individuals		
Home mortgages	147,470	127,636
Other personal lending	16,560	13,874
Overseas residents	10,164	7,700
Gross loans and advances to customers*	236,480	199,785

* Net of securitised loans and advances to customers.

Loans and advances to customers which have been securitised are shown below. These meet the criteria set out in FRS 5 "Reporting the Substance of Transactions", for a linked presentation format.

		At 31 December 2002		At 31 December 2001	
	Assets securitised	Gross assets securitised £ million	Non- returnable finance £ million	Gross assets securitised £ million	Non- returnable finance £ million
SWAN Trust	Mortgages	150	150	204	204
Mound Financing (No 1) PLC	Mortgages	750	748	750	748
Mound Financing (No 2) PLC	Mortgages	750	748	750	748
Melrose Financing No 1 plc	Corporate Loans	1,500	1,444	1,500	1,441
Permanent Financing (No 1) PLC	Mortgages	3,479	3,474		
		6,629	6,564	3,204	3,141

These special purpose companies, all of which are ultimately beneficially owned by charitable trusts, have been funded primarily through the issue of floating rate notes. Neither HBOS plc nor its subsidiary undertakings will support any losses that may be suffered by the noteholders in accordance with the terms of the notes. When all liabilities to the noteholders have been discharged, any proceeds from assets in addition to the non-returnable amounts already received in the securitisation companies accrue to HBOS plc or its subsidiary undertakings.

Neither HBOS plc nor its subsidiary undertakings have the right or obligation to repurchase any securitised advance unless it has been in breach of warranty.

The HBOS Group undertakings and third parties have entered into a number of interest rate swaps with the securitisation undertakings, the intention of which is to swap all or part of the interest flows from customers into variable rate interest flows to match the variable rate interest payable to the noteholders.

In June 2002, £3,479 million of mortgage loans were securitised through Permanent Financing (No 1) PLC.

In aggregate the securitisation undertakings had net interest income of £8.8 million (2001 – £3.7 million); operating expenses of £6.3 million (2001 – £1.5 million); provisions for bad and doubtful debts of £2.5 million (2001 – £0.2 million); resulting in a profit for the year of £nil (2001 – £2.0 million).

17. Non-performing Assets

The aggregate gross non-performing loans and advances is £4,206 million (2001 – £4,072 million) including £1,192 million (2001 – £1,125 million) of advances on which interest is being held in suspense. Net of provisions and interest in suspense, non-performing loans and advances amount to £2,041 million (2001 – £2,180 million).

Notes on the Accounts continued

18. Provisions for Bad and Doubtful Debts

	Group		
	Specific £ million	General £ million	Total £ million
At 1 January 2002	1,102	667	1,769
New provisions less releases	833	37	870
Amounts written off	(618)		(618)
Exchange movements	4	(1)	3
Cumulative provisions as at 31 December 2002	1,321	703	2,024
New provisions less releases	833	37	870
Recoveries of amounts previously written off	(38)		(38)
Net charge to profit and loss account	795	37	832

19. Debt Securities

	2002				2001			
	Issued by Public Bodies £ million	Issued by Others £ million	Total £ million	Market Value £ million	Issued by Public Bodies £ million	Issued by Others £ million	Total £ million	Market Value £ million
Group								
Investment securities								
Listed								
British Government Securities	521		521	524	378		378	384
Others	1,318	14,086	15,404	15,402	2,096	10,992	13,088	13,144
Unlisted								
Certificates of deposit issued by banks and building societies		1,962	1,962	1,963		5,138	5,138	5,152
Others	266	7,015	7,281	7,207	1,221	9,395	10,616	10,623
Total investment securities	2,105	23,063	25,168	25,096	3,695	25,525	29,220	29,303
Other securities								
Listed	486	1,826	2,312	2,312	1,454	397	1,851	1,851
Unlisted		16,844	16,844	16,844	229	11,149	11,378	11,378
	2,591	41,733	44,324	44,252	5,378	37,071	42,449	42,532
of which:-								
maturing within 1 year			21,426				22,189	
1 year and over			22,898				20,260	
			44,324				42,449	

The movement on debt securities held as investment securities is as follows:-

	Group		
	Amortised Cost £ million	Aggregate amount written off £ million	Book Value £ million
At 1 January 2002	29,243	(23)	29,220
Exchange translation	(379)		(379)
Additions	19,676		19,676
Amortisation	6		6
Disposals	(23,352)		(23,352)
Amount written off		(3)	(3)
At 31 December 2002	25,194	(26)	25,168
Aggregate unamortised premium at 31 December 2002	6		6

Debt securities include securities with a market value of £662 million (2001 – £1,077 million) for the Group sold subject to agreement to repurchase.

19. Debt Securities continued

Debt securities include securities pledged as collateral of £12,416 million (2001 – £7,323 million).

Debt securities include asset backed securities of £9,320 million (2001 – £7,670 million) which have been sold by subsidiaries of the Company to bankruptcy remote special purpose vehicles, funded by the issue of commercial paper on terms whereby the rewards and some of the risks of the portfolio have been retained by HBOS Treasury Services plc. The securitisation does not qualify for linked presentation under FRS 5 and the asset backed securities have therefore been retained on the Group balance sheet with commercial paper being included within debt securities in issue (Note 32).

20. Equity Shares

	Listed				Unlisted	
	Cost £ million	Aggregate amount written off £ million	Book Value £ million	Cost £ million	Aggregate amount written off £ million	Total Book Value £ million
Investment Securities						
Group						
At 1 January 2002	64		64	171	(11)	224
Exchange translation	1		1	(1)	(1)	
Fair value adjustments	(10)		(10)			(10)
Additions	11		11	58		69
Disposals	(7)		(7)	(32)	(32)	(39)
Amounts written off		(2)	(2)		(19)	(21)
At 31 December 2002	59	(2)	57	196	(30)	223

The total value of investments as at 31 December 2002 for the Group was £274 million (2001 – £285 million) including £96 million (2001 – £114 million) in respect of listed equity shares.

21. Interests in Joint Ventures and Associated Undertakings

(i) Joint Ventures

	Group				
	Acquired Book Value £ million	Equity Adjustments £ million	Share of Net Tangible Assets £ million	Goodwill £ million	Book Value £ million
At 1 January 2002 – Restated	151	(49)	102	110	212
Acquisitions and subscriptions of capital	120		120		120
Disposals		1	1		1
Equity accounting adjustments		(46)	(46)	(6)	(52)
At 31 December 2002	271	(94)	177	104	281

Interests in joint ventures have been restated to reflect the impact of the joint venture entities adopting FRS 19. The effect has been to increase equity adjustments and reduce book value at 1 January 2002 by £4 million.

(ii) Associated Undertakings

	Group				
	Acquired Book Value £ million	Equity Adjustments £ million	Share of Net Tangible Assets £ million	Goodwill £ million	Book Value £ million
At 1 January 2002	127	7	134		134
Acquisitions and subscriptions of capital	21		21		21
Disposals	(3)		(3)		(3)
Equity accounting adjustments		20	20		20
At 31 December 2002	145	27	172		172

All the interests in joint ventures and associated undertakings are unlisted.

The main joint ventures and associated undertakings are listed in Note 54 on page F-49.

Notes on the Accounts continued

22. Shares in Group Undertakings

	Banks £ million	Others £ million	Total £ million
At cost at 1 January 2002	734	567	1,301
Subscriptions of capital	1,250	600	1,850
Transfers from Group Undertakings	2,570	4,319	6,889
At cost at 31 December 2002	4,554	5,486	10,040

With effect from 1 January 2002, Halifax Group plc's insurance and investment subsidiary undertakings were transferred to an intermediate insurance holding company, HBOS Insurance & Investment Group Limited ("HBOS IIG"). On 1 July 2002, all Halifax Group plc's subsidiary undertakings comprising, inter alia, Halifax plc, HBOS IIG and Halifax Share Dealing Limited, were transferred at book value to HBOS plc.

The main subsidiary undertakings of HBOS plc are listed in Note 55 on page F-50.

23. Intangible Fixed Assets

	Goodwill £ million
Cost	
At 1 January 2002	1,372
Exchange translation	1
Fair value adjustments (Note 50)	22
Additions (Note 50)	259
Other movements	(7)
At 31 December 2002	1,647
Amortisation and provisions for impairment	
At 1 January 2002	127
Amortisation charged in year	86
At 31 December 2002	213
Net Book Value	
At 31 December 2002	1,434
At 31 December 2001	1,245

Goodwill on acquisitions is capitalised and amortised by equal instalments over its estimated useful life, which, for all material acquisitions, is 20 years.

Other movements relate to cash distributions from the acquisition of the business of Birmingham Midshires Building Society in April 1999 which have not been claimed and reverted back to Halifax plc in July 2002 under the terms of the transfer document. This is a reduction in the cost of investment.

24. Tangible Fixed Assets

	Cost or Valuation £ million	Depreciation £ million	Group Book Value £ million
Property			
At 1 January 2002	1,303	(418)	885
Exchange translation	(1)		(1)
Additions	93		93
Disposals	(86)	11	(75)
Depreciation for year		(46)	(46)
At 31 December 2002	1,309	(453)	856
of which:-			
Investment properties at valuation:-			
Freehold			39
Other properties at cost less depreciation:-			
Freehold			673
Long leasehold			49
Short leasehold			95
			856
Occupied for own activities			689
Equipment			
At 1 January 2002	1,726	(984)	742
Exchange translation	(1)		(1)
Additions	298		298
Disposals	(57)	46	(11)
Depreciation for year		(213)	(213)
At 31 December 2002	1,966	(1,151)	815
Total tangible fixed assets at 31 December 2002	3,275	(1,604)	1,671
Total tangible fixed assets at 31 December 2001	3,029	(1,402)	1,627
Equipment includes amounts acquired under finance leases	32	(31)	1

Included within Group tangible fixed assets are assets in the course of construction amounting to £87 million (2001 – £89 million) which are not depreciated until the assets are brought into use.

The investment properties were valued by C B Hillier Parker, Chartered Surveyors, as at 31 December 2002, on the basis of open market value in accordance with the Appraisal and Valuation Manual of The Royal Institution of Chartered Surveyors. The valuation amount equated to the original historic cost as at 31 December 2002. The Group had no investment properties as at 31 December 2001.

Notes on the Accounts continued

25. Operating Lease Assets

Assets leased to customers include the following amounts in respect of operating lease assets:-

	Group
	£ million
Cost	
At 1 January 2002	2,486
Additions	1,287
Disposals	(578)
At 31 December 2002	3,195
Aggregate depreciation	
At 1 January 2002	(444)
Charge for the year	(289)
Disposals	163
At 31 December 2002	(570)
Net Book Value at 31 December 2002	2,625
Net Book Value at 31 December 2001	2,042

The Group's unguaranteed residual value exposure in respect of operating lease assets, assuming disposal at the end of the lease term, is as follows:-

	Group	
	2002	2001
	£ million	£ million
On operating lease assets where the unguaranteed residual value is expected to be recovered in:-		
1 year or less	14	17
2 years or less but over 1 year	8	7
5 years or less but over 2 years	73	79
over 5 years	346	330
	441	433

26. Other Assets

	Group	
	2002	2001
	£ million	£ million
Own shares (Note 27)	17	5
Positive market values of trading derivative contracts	6,014	2,813
Other assets	1,403	1,387
	7,434	4,205

27. Own Shares

Included in other assets are own shares held as follows:-

(a) No.1 Employee Share Ownership Trust

The No.1 Employee Share Ownership Trust administers shares conditionally granted to Executive Directors and other executives under the HBOS plc Long-term Executive Bonus Plan and to former Halifax Executive Directors and other former Halifax executives under the Halifax Group plc Long-term Executive Bonus Scheme. The Trust also administers shares which have been conditionally granted to Executive Directors, other executives and employees under the HBOS plc Annual Bonus Plan and the former Halifax Group plc Annual Bonus Plan.

Interest free loans have been provided by HBOS plc to the Trust to allow shares to be purchased in the market to satisfy these share grants. The cost of the shares conditionally awarded is being charged to the profit and loss account on a straight line basis over the performance period.

At 31 December 2002, 8.6 million HBOS plc ordinary shares (2001 – 2.1 million) were held by the Trustee and included in the balance sheet of HBOS plc. The shares, with a nominal value of 25p each, had a total market value at that date of £56 million (2001 – £17 million). Under the terms of the Trust, dividends on these shares are waived. At 31 December 2002 all these shares had been conditionally granted.

(b) HBOS plc Qualifying Employee Share Ownership Trust (the "HBOS QUEST")

The HBOS QUEST operates in conjunction with the HBOS Sharesave Scheme and the former savings-related share schemes operated by Bank of Scotland and Halifax Group plc.

Halifax QUEST held 14,626,075 HBOS ordinary shares and on 12 June 2002, HBOS plc purchased these ordinary shares from the Trustees of the Halifax QUEST for a consideration of £1,000. On that date, these shares were cancelled and HBOS plc issued the same number of ordinary shares, at their nominal value of 25p per share, to the HBOS QUEST. These ordinary shares held by the HBOS QUEST are included within own shares in the balance sheet at nil value.

At 31 December 2002, the HBOS QUEST held 13.5 million HBOS plc ordinary shares (2001 – 14.6 million) with a market value of £89 million (2001 – £116 million).

Under the terms of the Trust Deed, dividends are required to be waived on the shares held by the HBOS QUEST.

28. Capital and Other Commitments

	Group	
	2002 £ million	2001 £ million
Commitments in respect of capital expenditure on fixed assets, authorised but not provided for in the accounts, for which contracts have been entered into	17	25
Included in other liabilities are net obligations under finance leases payable as follows:-		
1 year or less	7	8
5 years or less but over 1 year	7	14

Commitments for which contracts have been placed in relation to operating lease assets were £161 million (2001 – £251 million).

Notes on the Accounts continued

29. Long-term Assurance Business

The Group has now adopted the more generally accepted approach of using unsmoothed asset values for the purposes of determining the net present value of in-force business. Previously, smoothed asset values were used. The cumulative impact of this change of accounting policy relating to previous years has been recognised in the accounts as a prior year adjustment and accordingly, the prior year results have been restated. The effect of this change of policy on this year's results and the prior year comparative is disclosed below.

	Revised accounting basis		Previous accounting basis*	
	2002 £m	2001 Restated £m	2002 £m	2001 £m
Consolidated Profit and Loss Account:-				
Income from long-term assurance business	233	150	380	470
Profit on ordinary activities before taxation	2,909	2,292	3,056	2,612
Tax on profit on ordinary activities	(835)	(663)	(869)	(755)
Profit on ordinary activities after taxation	2,074	1,629	2,187	1,857
Consolidated Balance Sheet:-				
Long term assurance business attributable to shareholders	3,544	3,065	3,857	3,265

* The balances shown under the previous accounting basis for 2002 are based on a risk discount rate of 9%.

The principal economic assumptions are reviewed annually and are as follows:-

	2002 %	2001 %
Risk discount rate (net of tax)	8.5	9.4
Return on equities (net of tax credits)	7.5	7.5
Return on Gilts (gross of tax)	5.0	5.0
Expense inflation	3.0	3.0

In-force business is defined as all live policies where the first premium has been paid. For traditional with profits business, the surplus attributable to the Group equates to one ninth of the bonuses declared in any year. The level of assumed future bonuses is calculated by projecting the portfolio of with profits business forward and applying reversionary and terminal bonus rates so as to exhaust the projected surplus of assets attributable to with profit policyholders. For all other business, the entire surplus is attributable to the Group.

The income from long-term assurance business is calculated as follows:-

	2002 £ million	2001 Restated £ million
Closing value of Group's interest in long-term assurance business including minority interests	3,544	3,065
Opening value of Group's interest in long-term assurance business including minority interests	(3,065)	(2,428)
Increase in value of long-term assurance business	479	637
Transfers to long-term assurance business	(309)	(254)
Acquisitions		
Long-term assurance business of The Equitable (Note 50(a))	12	(277)
Long-term assurance business of St. James's Place Capital plc		21
Income after tax from long-term assurance business	182	127
Tax relating to long-term assurance business (Note 10)	51	23
Income before tax from long-term assurance business	233	150

29. Long-term Assurance Business continued

Income before tax from long-term assurance business may be analysed as follows:-

	2002 £ million	2001 Restated £ million
Contribution from new business	120	55
Contribution from existing business	366	308
Investment earnings	69	51
Income before tax from long-term assurance business based on long term assumptions	555	414
Changes to economic assumptions	90	60
Short-term fluctuations in investment returns	(412)	(324)
Income before tax from long-term assurance business	233	150

The long-term assurance assets comprise:-

	2002 £ million	2001 Restated £ million
Investments attributable to policyholders		
Fixed interest securities	5,893	5,334
Stocks, shares and collective investments	9,420	10,935
Properties	2,191	2,103
Assets held to cover linked liabilities	16,267	16,566
Mortgages and loans	12	16
Deposits	3,308	2,658
Total investments attributable to policyholders	37,091	37,612
Net assets attributable to shareholders	1,823	1,421
Value of in-force policies	1,721	1,644
Other policyholder net current assets/(liabilities)	240	(11)
Total long-term assurance assets	40,875	40,666
Long-term assurance business attributable to shareholders	3,544	3,065
Long-term assurance assets attributable to policyholders	37,331	37,601
	40,875	40,666

The figures for 2001 in the tables above have been restated to reflect the change in accounting policy for long-term assurance business.

Derivatives (options and futures) are used for efficient portfolio management of the long-term assurance business and to match obligations to policyholders. These derivatives are included within investments above at market value.

Insurance companies and insurance groups report their income from long-term assurance business on the "Modified Statutory Solvency Basis" ("MSSB") in accordance with the Statement of Recommended Practice issued by the Association of British Insurers which is only applicable to the accounts of such companies and groups. Under this approach, the profit reported is the surplus or deficit calculated for statutory solvency purposes with prescribed adjustments to technical provisions and the deferral of certain costs of acquiring business.

Notes on the Accounts continued

29. Long-term Assurance Business continued

The Group's income from long-term assurance business under this alternative basis is set out below:-

	2002 £ million	2001 £ million
Premiums	8,924	8,251
Reinsurance premiums from The Equitable unit-linked and non-profit business		4,106
Investment income	1,139	1,211
Other income	21	206
	10,084	13,774
Claims	(4,354)	(3,378)
Change in technical provisions	(1,546)	(3,167)
Change in technical provisions from The Equitable unit-linked and non-profit business		(4,106)
Expenses	(1,178)	(990)
Unrealised losses on investments	(4,814)	(4,213)
Other charges	(29)	(44)
Tax attributable to long-term business	157	199
Transfer from the fund for future appropriations	1,605	1,803
Balance on the technical account – long-term business	(75)	(122)
Tax credit/(charge) attributable to balance on the technical account – long-term business	5	(22)
Income in shareholders' fund	(44)	14
Expenses in shareholders' fund	(19)	(33)
Deficit before tax from long-term assurance business on a modified statutory solvency basis	(133)	(163)
Tax	(6)	35
Deficit after tax from long-term assurance business on a modified statutory solvency basis	(139)	(128)

The balance sheet in respect of long-term assurance business prepared on a modified statutory solvency basis can be summarised as follows:-

	2002 £ million	2001 £ million
Assets		
Investments	22,713	23,199
Assets held to cover linked liabilities	16,267	16,566
Other assets	1,739	1,507
Total Assets	40,719	41,272
Liabilities		
Shareholders' funds	2,498	2,410
Fund for future appropriations		2,009
Linked liabilities	16,267	16,566
Other technical provisions	21,064	19,526
Other creditors	890	761
Total Liabilities	40,719	41,272
Long-term assurance assets attributable to shareholders on a modified statutory solvency basis	2,498	2,410
Long-term assurance assets attributable to policyholders on a modified statutory solvency basis	38,221	38,862
	40,719	41,272

29. Long-term Assurance Business continued

The embedded value of the Group's interest in long-term assurance business can be reconciled to the long-term assurance assets attributable to shareholders on a modified statutory solvency basis as follows:-

	2002 £ million	2001 Restated £ million
Embedded value of long-term assurance business	3,544	3,065
Value of in-force business	(1,141)	(1,047)
Other differences:-		
Deferred acquisition costs	596	646
Adjustments to net asset values	(331)	(254)
Short-term fluctuations in investment returns	(170)	
Long-term assurance assets attributable to shareholders on a modified statutory solvency basis	2,498	2,410

Profits calculated using MSSB use the same long-term assumptions as required to assess the regulatory solvency but with certain prescribed accounting adjustments. Because of the conservative nature of the current solvency regulations, a major failing of MSSB is that new business is normally reported as a loss in the year of sale.

30. Deposits by Banks

	2002 £ million	Group 2001 £ million
Repayable on demand	14,704	8,440
Repayable		
3 months or less but not repayable on demand	22,066	16,267
1 year or less but over 3 months	8,725	5,632
5 years or less but over 1 year	63	44
over 5 years	79	66
	45,637	30,449
Amounts above include:-		
Associated undertakings	352	444

31. Customer Accounts

	2002 £ million	Group 2001 £ million
Repayable on demand	123,262	116,715
Repayable		
3 months or less but not repayable on demand	19,022	18,961
1 year or less but over 3 months	6,326	3,917
5 years or less but over 1 year	1,371	876
over 5 years	240	47
	150,221	140,516
Amounts above include:-		
Associated undertakings	31	9
Joint ventures	72	29

Notes on the Accounts continued

32. Debt Securities in Issue

	Group	
	2002 £ million	2001 £ million
Bonds and Medium Term Notes		
Repayable		
1 year or less, or on demand	4,120	8,668
2 years or less but over 1 year	8,230	3,552
5 years or less but over 2 years	6,530	3,699
over 5 years	2,733	2,546
	21,613	18,465
Other Debt Securities		
Repayable		
3 months or less	47,339	38,584
1 year or less but over 3 months	11,761	12,202
2 years or less but over 1 year	54	206
5 years or less but over 2 years		67
over 5 years	4	4
	59,158	51,063
Total Debt Securities in Issue	80,771	69,528

Bonds and Medium Term Notes includes £303 million (2001 – £320 million) secured on advances to customers and certain other assets of the Group.

Other Debt Securities includes £9,286 million (2001 – £7,711 million) in respect of commercial paper issued to fund the purchase of asset backed securities by special purpose vehicles (Note 19). During 2002, the Group securitised a portfolio of mortgage advances which, under FRS 5 "Reporting the Substance of Transactions" is not available for linked presentation and therefore the funding from this securitisation of £300 million is included in Bonds and Medium Term Notes. The portfolio of mortgage advances continues to be reported in Loans and Advances to Customers (Note 16).

33. Other Liabilities

	Group		Company	
	2002 £ million	2001 £ million	2002 £ million	2001 £ million
Negative market values of trading derivative contracts	6,263	2,580		
Unclaimed shares	279	286	279	
Short positions in government debt securities		615		
Other liabilities	2,370	1,672	43	4
	8,912	5,153	322	4

Unclaimed shares comprise the net sale proceeds of certain Halifax Group plc ordinary shares which, following the Halifax Group restructuring which took effect on 1 June 1999, represented Halifax plc ordinary shares. These shares were issued to meet claims for Halifax plc ordinary shares from qualifying members of Halifax Building Society and others following the transfer of business from Halifax Building Society to Halifax plc in 1997. This liability also includes the related unclaimed dividends up to the date of sale and the unclaimed capital payments arising from the Halifax Group restructuring in 1999. These amounts are being held on behalf of the persons who would have been entitled to claim the shares before they were sold. Following the internal reorganisation on 1 July 2002, responsibility for these balances was assumed by HBOS plc.

34. Provisions for Liabilities and Charges

	Group
	2002
	£ million
(i) Deferred Taxation	
At 1 January 2002 as previously stated	628
Prior year adjustment	(139)
At 1 January 2002 – Restated	489
Charge in year (Note 10)	158
Other movements	1
At 31 December 2002	648

	2002		2001	
	Provided for in Accounts £ million	Full Potential Liability £ million	Provided for in Accounts Restated £ million	Full Potential Liability Restated £ million
Deferred taxation comprises:-				
Group				
Capital allowances:-				
on assets leased to customers	718	718	574	574
on other assets	50	50	37	37
General provisions	(196)	(196)	(185)	(185)
Other timing differences	76	76	63	63
	648	648	489	489

	Group				
	Pensions Review Provision £ million	Pensions and Other similar Obligations £ million	HBOS Integration Provision £ million	Other Provisions £ million	Total £ million
(ii) Other Provisions					
At 1 January 2002	23	138	65	26	252
Charge for year		63	153		216
Utilised in year	(11)	(54)	(170)	(1)	(236)
At 31 December 2002	12	147	48	25	232

The pensions review provision has been established to cover estimated administrative costs and compensation payable in connection with Phases 1 and 2 of the Pensions Review and the FSAVC Review. In 2001 a £41 million provision to cover direct and indirect costs arising from the Pensions Review was included in the long-term assurance liabilities attributable to policyholders.

Of the provision for pensions and other similar obligations, £35 million relates to post-retirement benefits (2001 – £33 million).

Other provisions include property related costs on surplus leased space.

Notes on the Accounts continued

35. Subordinated Liabilities

	Group		Company
	2002	2001	2002
	£ million	£ million	£ million
Dated Loan Capital			
€51.1 million 8.30% Notes 2002		31	
US\$300 million 8.80% Notes 2004	186	207	
£400 million 8.75% Subordinated Notes 2006	400	400	
US\$150 million 8.85% Notes 2006	93	103	
£75 million 9.125% Subordinated Notes 2006	75	75	
£60 million 9.00% Instruments 2006	60	60	
A\$100 million Callable Notes 2007		35	
€650 million 4.75% Subordinated bonds 2009	423	397	
US\$500 million Floating rate subordinated step-up callable notes 2009	310	345	
€500 million 5.50% Instruments 2009	325	305	
£75 million Floating rate subordinated notes 2009	75	75	
US\$500 million Notes 2010	310	344	
£75 million Floating Rate Instruments 2010	75	75	
US\$150 million Notes 2011	93	103	
€7 million Floating Rate Notes 2011	5	4	
€750 million Subordinated Fixed Rate Notes 2012	488		
US\$450 million Subordinated Floating Rate Notes 2012	279		
£200 million Floating rate step-up callable subordinated notes 2012	200	200	
€12.8 million 6.25% Instruments 2012	8	8	
A\$75 million Callable Notes 2012	26		
€1,000 million Subordinated callable fixed/floating rate instruments 2013	651	611	
€325 million 6.125% Notes 2013	212	198	
£250 million 11% Subordinated bonds 2014	250	250	
£150 million 10.5% Subordinated bonds 2018	150	150	
£250 million 6.375% Instruments 2019	250	250	
£500 million 9.375% Subordinated bonds 2021	500	500	
€400 million 6.45% Eurodated Floating subordinated guaranteed bonds 2023	261	251	
£245 million 7.881% Subordinated Extendable Maturity Notes 2048			245
€415 million Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048			270
Unamortised Premiums, Discounts and Issue Costs	(15)	(11)	
	5,690	4,966	515
Repayable:-			
in 1 year or less		31	
in more than 1 year but not more than 5 years	814	845	
in more than 5 years	4,876	4,090	515
	5,690	4,966	515

No repayment, for whatever reason, of dated loan capital prior to its stated maturity and no purchase by the relevant subsidiary undertaking of its loan capital may be made without the consent of the Financial Services Authority. On a winding up of the relevant company, 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 that company 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.

On 29 October 2002, Bank of Scotland issued €600 million Subordinated Fixed Rate Notes 2012 at an issue price of 99.812% of the principal amount. The Notes bear interest at a fixed rate 5.5% per annum. On 25 November 2002 Bank of Scotland issued a further €150 million at an issue price of 101.611% of the principal amount plus €610,274 representing 27 days accrued interest for the period from and including 29 October 2002 to 25 November 2002.

On 22 November 2002, Bank of Scotland issued US\$450 million Subordinated Floating Rate Notes 2012 at an issue price of 99.663% of the principal amount. The Notes bear interest at 3 months US\$-LIBOR-BBA plus 0.50% per annum until 22 November 2007 at which time the interest rate becomes 3 month US\$-LIBOR-BBA plus 1.00% per annum. Bank of Scotland has the option to redeem these Notes on 23 November 2007.

On 10 December 2002, a subsidiary of the Company issued A\$75 million Callable Notes 2012. The Notes bear interest at the three month Australian bank bill rate plus 0.75% per annum. The issuer has the option to redeem the Notes at par after 10 December 2007.

35. Subordinated Liabilities continued

The £245 million 7.881% Subordinated Extendable Maturity Notes 2048 and the €415 million Fixed to Floating Rate Extendable Maturity Notes 2048 were issued to HBOS Sterling Finance (Jersey) L.P. (formerly Halifax Group Sterling Finance (Jersey) L.P.) and HBOS Euro Finance (Jersey) L.P. (formerly Halifax Group Euro Finance (Jersey) L.P.) respectively by Halifax Group plc as subordinated notes. HBOS Sterling Finance (Jersey) L.P. and HBOS Euro Finance (Jersey) L.P. have issued preferred securities of equivalent amount. Halifax Group plc, HBOS plc and the Trustee for the holders of the Notes agreed with the consent of the holders of the Notes, to enter into supplemental trust deeds that have, inter alia, made both issues of Notes the obligation of HBOS plc effective on 1 July 2002. These are included in minority and other interests (non-equity) in the Consolidated Balance Sheet (Note 39).

	Group		Company	
	2002	2001	2002	2001
	£ million	Restated £ million	£ million	£ million
Undated Loan Capital				
£600 million Fixed to Floating Rate Undated Subordinated Notes			600	600
€500 million Fixed to Floating Rate Undated Subordinated Notes	325	305	325	305
£300 million Perpetual Regulatory tier One Securities	300	300		
£300 million 7.5% Undated Subordinated Step-up Notes	300	300	300	
JPY 42.5 billion 3.50% Undated Subordinated Yen Step-up Notes	222	223	222	
US\$300 million Reset Notes	186	207		
£200 million Perpetual Notes	200	200		
£200 million 7.375% Undated Subordinated Guaranteed Bonds	200	200		
€300 million Floating Rate Undated Subordinated Step-up Notes	195	183	195	
US\$250 million Floating Rate Primary Capital Notes	155	172		
£150 million Instruments	150	150		
£150 million Instruments	150	150		
JPY 17 billion Instruments	99	110		
£100 million Instruments	100	100		
£100 million 12% Perpetual Subordinated Bonds	100	100		
£100 million 8.75% Perpetual Subordinated Bonds	100	100		
£75 million 13.625% Perpetual Subordinated Bonds	75	75		
JPY 9 billion Instruments	47	47		
£50 million 9.375% Perpetual Subordinated Bonds	50	50		
£500 million 5.75% Undated Subordinated Step-up Notes	500		500	
Unamortised Premiums, Discounts and Issue Costs	(17)	(15)	(11)	(3)
	3,437	2,957	2,131	902

No exercise of any redemption option or purchase by the relevant company of any of its undated loan capital may be made without the consent of the Financial Services Authority. On a winding up of the Company or subsidiary undertaking, 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 Company or subsidiary undertaking 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.

On 28 November 2002, HBOS plc issued £500 million Undated Subordinated Step-up Notes at an issue price of 99.415% of their principal amount. The Notes bear interest at 5.75% per annum annually in arrear to 28 November 2025 and thereafter at a rate per annum equal to the sum of the 5 year benchmark Gilt rate.

The £600 million Fixed to Floating Rate Undated Subordinated Notes were issued to HBOS Capital Funding LP by the Company. HBOS Capital Funding LP has issued preferred securities of equivalent amount. These are included in minority and other interests (non-equity) in the Consolidated Balance Sheet (Note 39).

On 28 February 2001, £300 million Perpetual Regulatory tier One Securities were issued through Bank of Scotland. These qualify as Tier 1 regulatory capital. A £150 million Series A Issue has a fixed coupon of 7.286% to 2016 and a Series B Issue of £150 million has a fixed coupon of 7.281% to 2026. Thereafter, if not redeemed on their respective dates, for each Issue the coupon will be reset and will be further reset at five yearly intervals. There is an option to settle the coupon payment through the issue of Ordinary Shares. Coupon payments may be deferred but the Bank of Scotland may not declare or pay dividends on any of its Ordinary Shares whilst any coupon payments are deferred. UITF 33 was implemented during 2002 which required these securities to be reclassified from minority and other interests (non-equity) to undated loan capital. Comparative amounts have been restated to reflect this change.

The £300 million 7.5% Undated Subordinated Step-up Notes, were issued by Halifax Group plc on 26 May 2000. Halifax Group plc, HBOS plc and the Trustee for the holders of the Notes agreed, with the consent of the holders of the Notes, to enter into a supplemental trust deed that has, inter alia, made the Notes the obligation of HBOS plc effective on 1 July 2002. Interest on these Notes is payable annually in arrears on 26 May until 2016 at the rate of 7.5% per annum and, for each period of five years thereafter, annually in arrears on 26 May at the rate per annum equal to the sum of the five year benchmark Gilt rate plus 3.45%. HBOS plc has the option to redeem these Notes on 26 May 2016 and on each fifth anniversary thereafter.

Notes on the Accounts continued

35. Subordinated Liabilities continued

The JPY 42.5 billion 3.50% Undated Subordinated Yen Step-up Notes, were issued by Halifax Group plc on 28 February 2001. Halifax Group plc, HBOS plc and the Trustee for the holders of the Notes agreed, with the consent of the holders of the Notes to enter into a supplemental trust deed that has, inter alia, made the Notes the obligation of HBOS plc effective on 1 July 2002. Interest on these Notes is payable half yearly in arrear on 28 February and 28 August until 28 February 2031 at the rate of 3.50% per annum and thereafter at the rate of 6 month JPY LIBOR plus a margin of 2.09% per annum. HBOS plc has the option to redeem these Notes on 28 February 2011, on 28 February 2031 and on each coupon payment date thereafter.

The €300 million Floating Rate Undated Subordinated Step-up Notes, were issued by Halifax Group plc on 26 May 2000. Halifax Group plc, HBOS plc and the Trustee for the holders of the Notes agreed, with the consent of the holders of the Notes, to enter into a supplemental trust deed that has, inter alia, made the Notes the obligation of HBOS plc effective on 1 July 2002. Interest on these Notes is payable on 26 May, 26 August, 26 November and 26 February each year until 26 August 2010 at the rate of 3 month EURIBOR plus a margin of 1.20% per annum and from and including 26 August 2010 at the rate of 3 month EURIBOR plus a margin of 2.30% per annum. HBOS plc has the option to redeem these Notes on 26 August 2010 and on each interest payment date thereafter.

36. Share Capital

	Ordinary Shares 25p each £ million	9 ¹ / ₄ % Non- Cumulative Irredeemable Preference Shares £1 each £ million	9 ³ / ₄ % Non- Cumulative Irredeemable Preference Shares £1 each £ million	Other Preference Shares	
				Sterling £ million	Euro € million
Authorised					
At 31 December 2002 and 31 December 2001	1,185	375	125	1,204	1,500
Allotted, called up and fully paid					
At 1 January 2002	892	300	100		
Issued by means of a share placing	43				
Issued under employee share schemes and in lieu of dividends	11				
At 31 December 2002	946	300	100		

Other sterling preference shares include 200 million 6.125 per cent. Non-Cumulative Redeemable Preference Shares of £1 each, 1,000 million Sterling Preference Shares of £1 each, 250,000 8.117 per cent. Non-Cumulative Perpetual Preference Shares Class A of £10 each and 150,000 7.754 per cent. Non-Cumulative Perpetual Preference Shares Class B of £10 each.

Between 5 and 7 March 2002, 172.5 million Ordinary Shares of 25p each were issued at a price of £7.40 per share, raising proceeds (net of expenses) of £1,258 million.

The Group operates a number of share option plans and savings-related share option plans for both executives and employees.

At 31 December 2002, options to acquire 40.6 million ordinary shares were outstanding under HBOS plc option plans and former Halifax option plans. These options are exercisable at a range of prices from £6.68 to £8.28 at various dates up to 14 April 2008. At 31 December 2002, options to acquire 6.2 million ordinary shares were outstanding under the former Bank of Scotland executive stock option schemes. These options are exercisable at a range of prices from £1.89 to £7.13 at various dates up to 16 October 2010.

At 31 December 2002, options to acquire 51.5 million ordinary shares were outstanding under savings-related share option plans. These options are exercisable at a range of prices from £2.08 to £5.98 at various dates up to 31 December 2010.

During the year, a total of 8.0 million shares were issued on the exercise of options for a consideration of £39 million.

37. Reserves

	Share Premium £ million	Other Reserves £ million	Profit and Loss Account £ million
Group			
At 1 January 2002 as previously stated	27	492	9,657
Prior year adjustments			(55)
At 1 January 2002 – Restated	27	492	9,602
Reserves capitalised	(9)		
Premium arising on the issue of new shares	1,251		
Dividends retained on account of share dividends			283
Exchange translation		4	
Contribution to Employee Share Trust	23		(12)
Release of employee options granted under Company share ownership plans			23
Retained profit			739
At 31 December 2002	1,292	496	10,635
Company			
At 1 January 2002	27		33
Reserves capitalised	(9)		
Premium arising on the issue of new shares	1,251		
Dividends retained on account of share dividends			283
Contribution to Employee Share Trust	23		(12)
Retained profit			3,494
At 31 December 2002	1,292		3,798

The Group profit and loss account reserve at 31 December 2002 includes £589 million (2001 restated – £566 million) not presently available for distribution. This represents mainly the excess of retained profits on an embedded value basis over those available for distribution.

The cumulative amount of positive goodwill on acquisitions of subsidiary undertakings written off in the Group reserves is £574 million (2001 – £574 million) and in respect of joint ventures and associated undertakings £nil (2001 – £nil).

The Share Dividend Plan, which was offered as an alternative to the cash dividend to shareholders, resulted in £267 million relating to the December 2001 final dividend and £16 million relating to the June 2002 interim dividend being retained by HBOS plc and added to reserves.

38. Reconciliation of Shareholders' Funds

	Group		Company	
	2002 £ million	2001 Restated £ million	2002 £ million	2001 £ million
Profit attributable to shareholders	1,916	1,468	4,671	1,073
Dividends	(1,177)	(1,030)	(1,177)	(1,030)
Other recognised gains and losses	4	(6)		
Dividends retained on account of share/stock dividends	283	24	283	
Contribution to Employee Share Trust	(12)	(30)	(12)	(10)
Release/(charge) of employee options granted under company share ownership plans	23	(36)		
Ordinary capital subscribed	1,319	309	1,319	919
Preference capital subscribed				400
Reserve arising on sale of unallocated shares		23		
	2,356	722	5,084	1,352
Shareholders' Funds at 1 January as previously stated	11,468	10,538	1,352	
Prior year adjustments	(55)	153		
Shareholders' Funds at 1 January – Restated	11,413	10,691	1,352	
Shareholders' Funds at 31 December	13,769	11,413	6,436	1,352
of which:-				
Attributable to non-equity interests	400	400	400	400
Attributable to equity interests	13,369	11,013	6,036	952
	13,769	11,413	6,436	1,352

Notes on the Accounts continued

39. Minority and Other Interests (Non-equity)

The principal minority and other interests (non-equity) are set out below.

	2002 £ million	2001 Restated £ million
£600 million preferred securities	600	600
£250 million preferred securities	250	250
£150 million preferred securities	150	150
£245 million preferred securities	245	245
€415 million preferred securities	270	257
£198 million non-cumulative preference shares	198	198
	1,713	1,700
Less: unamortised issue costs	(10)	(10)
	1,703	1,690

On 28 November 2001, £600 million Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A were issued through HBOS Capital Funding LP. These qualify as Tier 1 regulatory capital. These are perpetual securities and are not subject to any mandatory redemption provisions. They are redeemable in 2018, or each fifth anniversary thereafter, at the option of the general partner. The securities have a fixed coupon of 6.461% to 2018. Thereafter, if not redeemed, the coupon will be reset.

During 2000, the £250 million and £150 million preferred securities were issued by a subsidiary undertaking of Bank of Scotland.

During 1999, the £245 million and €415 million Guaranteed Non-voting Non-cumulative Preferred Securities were issued by subsidiary undertakings of the Halifax Group.

During 1999, non-cumulative preference shares were issued by Halifax plc, as part of the consideration to acquire the business of the Birmingham Midshires Building Society.

40. Memorandum Items

The contract amounts noted below indicate the volume of business outstanding at the balance sheet date in respect of contingent liabilities and commitments undertaken for customers. They do not reflect the underlying credit and other risks, which are significantly lower.

	2002 Contract Amount £ million	2001 Contract Amount £ million
Group		
Contingent Liabilities		
Acceptances and endorsements	157	202
Guarantees and assets pledged as collateral security		
Guarantees and irrevocable letters of credit	2,672	2,133
	2,829	2,335
Commitments		
Other commitments		
Short-term trade related transactions	129	202
Undrawn formal standby facilities, credit lines and other commitments to lend		
up to and including 1 year	35,634	26,298
over 1 year	13,261	10,772
	49,024	37,272
Company		
Contingent Liabilities		
Guarantees and assets pledged as collateral security		
Guarantees provided to subsidiary companies	525	
	525	

41. Derivatives

The Group uses interest rate swaps, forward foreign exchange contracts and other derivative instruments to hedge and reduce the interest rate and currency exposures that are inherent in any banking business. Trading transactions are either customer driven and generally matched or are carried out for proprietary trading purposes within limits approved by the Board.

The Group has entered into derivative contracts as noted below. The notional principal amounts and fair values of these derivatives (excluding internal trades) are analysed between non-trading and trading activity. Fair value is the amount at which instruments could be exchanged in an arm's-length transaction.

	2002			2001		
	Notional Principal Amount £ million	Year End Fair Value Asset £ million	Fair Value Liability £ million	Notional Principal Amount £ million	Year End Fair Value Asset £ million	Liability £ million
Group						
Non-Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	411	8	11	1,653	24	12
Cross currency swaps	32,414	556	843	13,264	450	513
	32,825	564	854	14,917	474	525
Interest Rate Related Contracts						
Interest rate swaps	28,980	979	598	62,447	1,076	987
Forward rate agreements				734		1
Options	558	4	1	183	6	3
Futures	2,678	1	1	2,838		4
	32,216	984	600	66,202	1,082	995
Equity and Commodity Related Contracts						
Options and swaps	535	10	31	520	21	14
Total Non-Trading Derivatives	65,576	1,558	1,485	81,639	1,577	1,534

The Company held non-trading derivatives with a notional principal amount of £2,420 million (2001 – £nil). The Company's non-trading derivatives with a positive fair value was an asset of £118 million (2001 – £nil) and with a negative fair value was a liability of £7 million (2001 – £nil).

	2002			2001		
	Notional Principal Amount £ million	Year End Fair Value Asset £ million	Fair Value Liability £ million	Notional Principal Amount £ million	Year End Fair Value Asset £ million	Liability £ million
Group						
Trading						
Exchange Rate Related Contracts						
Forward foreign exchange	49,471	682	1,674	49,887	327	441
Cross currency swaps	142	5	7	78	1	1
Options	12,728	9	9	483	3	3
	62,341	696	1,690	50,448	331	445
Interest Rate Related Contracts						
Interest rate swaps	214,096	3,168	3,390	184,125	1,415	1,508
Forward rate agreements	9,856	2	2	6,323	3	3
Options	45,840	130	185	31,364	89	61
Futures	190,017	49	74	80,591	22	60
	459,809	3,349	3,651	302,403	1,529	1,632
Equity and Commodity Related Contracts						
Options and swaps	563	37	28	323	11	5
Total Trading Derivatives	522,713	4,082	5,369	353,174	1,871	2,082
Total Group Derivatives	588,289	5,640	6,854	434,813	3,448	3,616

Notes on the Accounts continued

41. Derivatives continued

The residual maturity of 'over the counter' (OTC) and non-margined exchange traded contracts was as follows:-

	2002		2001	
	Notional Principal Amount £ million	Replace- ment Cost £ million	Notional Principal Amount £ million	Replace- ment Cost £ million
Group				
Contracts maturing:-				
in 1 year or less	198,933	1,239	223,122	1,724
in more than 1 year but not more than 5 years	128,890	1,727	91,187	782
in more than 5 years	67,771	2,624	37,075	920
	395,594	5,590	351,384	3,426

Credit Risk Analyses

Counterparties of the Group's derivative transactions are primarily financial institutions. An institutional and geographical analysis of replacement cost, based on the location of the office writing the business, is shown below:-

	Group	
	2002 £ million	2001 £ million
Institutional		
Financial Institutions	4,516	3,094
Non-financial Institutions	1,074	332
	5,590	3,426
Geographical		
UK	5,411	3,190
Rest of World	179	236
	5,590	3,426

The Group's objectives and policies in managing the risks that arise in connection with the use of financial instruments are set out on pages 38 to 42 of the Financial Review and Risk Management report of the HBOS plc Annual Report and Accounts 2002.

42. Fair Value of Financial Assets and Financial Liabilities

Fair values of financial assets and financial liabilities are based on market prices where available, or are estimated using other valuation techniques. Where they are short-term in nature or reprice frequently, fair value approximates to carrying value.

Derivatives held for trading purposes as disclosed in Note 41 are carried at fair values. Derivatives held for non-trading purposes are accounted for in the same way as the underlying transaction being hedged. Fair values are based on market prices where available, or are estimated using other valuation techniques.

The following table shows the carrying amount and the fair values of financial assets and liabilities analysed between trading and non-trading:-

	2002				2001 Restated			
	Assets		Liabilities		Assets		Liabilities	
	Carrying Amount £ million	Fair Value £ million	Carrying Amount £ million	Fair Value £ million	Carrying Amount £ million	Fair Value £ million	Carrying Amount £ million	Fair Value £ million
Group								
Non-Trading								
Treasury bills and other eligible bills	4,006	4,010			3,050	3,051		
Debt securities	25,168	25,096			29,220	29,303		
Equity shares	223	274			224	285		
Debt securities in issue			80,524	81,130			69,162	66,961
Dated loan capital			5,690	6,436			4,966	5,709
Undated loan capital			3,437	3,937			2,957	3,027
Preference shares			400	571			400	577
Minority and other interests (non-equity)			1,703	1,918			1,690	1,902
Derivatives	302	1,558	299	1,485	1,298	1,577	979	1,534
Total Non-Trading	29,699	30,938	92,053	95,477	33,792	34,216	80,154	79,710
Trading								
Treasury bills and other eligible bills	1,958	1,958			1,021	1,021		
Loans and advances to banks	1,348	1,348			463	463		
Loans and advances to customers	709	709			480	480		
Debt securities	19,156	19,156			13,229	13,229		
Other assets	63	63			165	165		
Debt securities in issue			247	247			366	366
Deposits by banks			11,650	11,650			6,649	6,649
Customer accounts			2,309	2,309			1,991	1,991
Other liabilities			66	66			946	946
Derivatives	4,082	4,082	5,369	5,369	1,871	1,871	2,082	2,082
Total Trading	27,316	27,316	19,641	19,641	17,229	17,229	12,034	12,034

Fair values in respect of non-trading financial assets and liabilities are disclosed only where there is a liquid and active market.

Fair value information is not provided for items that do not meet the definition of a financial instrument or for certain other financial instruments, including sundry short-term debtors and creditors. The fair value information presented does not therefore represent the fair value of the Group as a going concern at 31 December 2002.

Notes on the Accounts continued

43. Hedges

Gains and losses on instruments used for hedging are not recognised until the exposure that is being hedged is itself recognised. Unrecognised gains and losses on instruments used for hedging, and the movements therein, are as follows:-

	2002		
	Gains £ million	Losses £ million	Total Net Gains/(Losses) £ million
Group			
Unrecognised gains and losses on hedges at 1 January 2002	825	1,101	(276)
Gains and losses arising in previous years that were recognised in the year ended 31 December 2002	263	744	(481)
Gains and losses arising before 1 January 2002 that were not recognised in the year ended 31 December 2002	562	357	205
Gains and losses arising in the year ended 31 December 2002 that were not recognised in that year	719	854	(135)
Unrecognised gains and losses on hedges at 31 December 2002	1,281	1,211	70
of which:-			
Gains and losses expected to be recognised in the year ended 31 December 2003	336	603	(267)
Gains and losses expected to be recognised after 31 December 2003	945	608	337
	2001		
	Gains £ million	Losses £ million	Total Net Gains/(Losses) £ million
Group			
Unrecognised gains and losses on hedges at 1 January 2001	877	1,262	(385)
Gains and losses arising in previous years that were recognised in the year ended 31 December 2001	421	771	(350)
Gains and losses arising before 1 January 2001 that were not recognised in the year ended 31 December 2001	456	491	(35)
Gains and losses arising in the year ended 31 December 2001 that were not recognised in that year	369	610	(241)
Unrecognised gains and losses on hedges at 31 December 2001	825	1,101	(276)
of which:-			
Gains and losses expected to be recognised in the year ended 31 December 2002	233	663	(430)
Gains and losses expected to be recognised after 31 December 2002	592	438	154

44. Interest Rate Sensitivity Gap

The tables below summarise the repricing profiles of the Group's assets and liabilities.

As at 31 December 2002

	Not more than 3 months £ million	Over 3 months but not over 6 months £ million	Over 6 months but not over 1 year £ million	Over 1 year but not over 5 years £ million	Over 5 years £ million	Non-interest bearing £ million	Trading £ million	Total £ million
Assets								
Treasury bills and other eligible bills	3,803	78	14	111			1,958	5,964
Loans and advances to banks	8,870	742	217	83	77	501	1,348	11,838
Loans and advances to customers	187,012	6,784	8,351	25,979	4,503	977	709	234,315
Debt securities and equity shares	20,132	1,399	547	1,740	1,054	519	19,156	44,547
Other assets	1,283	122	203	482	232	18,700	63	21,085
	221,100	9,125	9,332	28,395	5,866	20,697	23,234	317,749
Liabilities								
Deposits by banks	32,012	(16)	1,890	23	10	68	11,650	45,637
Customer accounts	132,961	3,701	3,715	5,789	207	1,539	2,309	150,221
Debt securities in issue	60,406	13,542	4,066	955	1,553	2	247	80,771
Other liabilities	99		1	13	8	15,898	66	16,085
Subordinated liabilities	1,594	155		940	6,438			9,127
Minority interests and shareholders' funds					1,702	14,206		15,908
Internal funding of trading business	(4,467)	(2,822)	(1,865)	(150)	342		8,962	
	222,605	14,560	7,807	7,570	10,260	31,713	23,234	317,749
On-balance sheet gap	(1,505)	(5,435)	1,525	20,825	(4,394)	(11,016)		
Non-trading derivatives	2,996	7,683	(3,484)	(10,886)	3,691			
Net interest rate repricing gap 2002	1,491	2,248	(1,959)	9,939	(703)	(11,016)		
Cumulative gap 2002	1,491	3,739	1,780	11,719	11,016			

Notes on the Accounts continued

44. Interest Rate Sensitivity Gap continued

As at 31 December 2001
Restated

	Not more than 3 months £ million	Over 3 months but not over 6 months £ million	Over 6 months but not over 1 year £ million	Over 1 year but not over 5 years £ million	Over 5 years £ million	Non-interest bearing £ million	Trading £ million	Total £ million
Assets								
Treasury bills and other eligible bills	2,001	948	9	92			1,021	4,071
Loans and advances to banks	9,772	1,542	462	169	26	495	463	12,929
Loans and advances to customers	150,282	5,732	4,110	27,040	9,893	356	480	197,893
Debt securities and equity shares	19,550	5,023	1,589	2,102	729	451	13,229	42,673
Other assets	224	221	215	589	684	11,993	2,978	16,904
	181,829	13,466	6,385	29,992	11,332	13,295	18,171	274,470
Liabilities								
Deposits by banks	19,943	1,951	1,196	27	18	665	6,649	30,449
Customer accounts	127,404	2,465	2,840	3,779	150	1,887	1,991	140,516
Debt securities in issue	52,011	9,435	4,317	1,441	1,952	6	366	69,528
Other liabilities			1	20		8,999	3,526	12,546
Subordinated liabilities	1,268	203		785	5,667			7,923
Minority interests and shareholders' funds						13,508		13,508
Internal funding of trading business	(5,639)						5,639	
	194,987	14,054	8,354	6,052	7,787	25,065	18,171	274,470
On-balance sheet gap	(13,158)	(588)	(1,969)	23,940	3,545	(11,770)		
Non-trading derivatives	6,598	(746)	(1,372)	(9,305)	4,825			
Net interest rate repricing gap 2001	(6,560)	(1,334)	(3,341)	14,635	8,370	(11,770)		
Cumulative gap 2001	(6,560)	(7,894)	(11,235)	3,400	11,770			

All derivative instruments which alter the interest bases of the non-trading portfolio of assets and liabilities are reflected in the above tables.

45. Trading Value at Risk

The Group's Value at Risk (VaR) methodology of estimating potential losses arising from the Group's exposure to market risk is explained on page 41 of the Financial Review and Risk Management report of the HBOS plc Annual Report and Accounts 2002. The Group's trading market risk exposure for the year ended 31 December 2002 is analysed below.

			Exposure					
	As at 31 December 2002 £ million	As at 31 December 2001 £ million	Average		Highest		Lowest	
			2002 £ million	2001 £ million	2002 £ million	2001 £ million	2002 £ million	2001 £ million
Total Value at Risk	7.9	13.8	11.1	8.0	14.8	21.4	7.4	0.8

For all significant exposures VaR has been calculated on a daily basis.

46. Non-trading Currency Exposure

Structural currency exposures arise from the Group's investments in overseas subsidiaries, branches and other investments and are noted in the table below.

	2002			2001		
Functional currency of the operation	Net investments in overseas operations £ million	Borrowing taken out to hedge the net investments £ million	Remaining structural currency exposure £ million	Net investments in overseas operations £ million	Borrowing taken out to hedge the net investments £ million	Remaining structural currency exposure £ million
US Dollar	222	185	37	114	85	29
Euro	304	190	114	212	56	156
Australian Dollar	371	315	56	307	281	26
Other	2	2		2	2	
Total	899	692	207	635	424	211

As at 31 December 2002 and 31 December 2001 there are no material net currency exposures in the non-trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses for the reason set out on page 41 of the Financial Review and Risk Management report.

47. Assets and Liabilities in Foreign Currencies

	Group	
	2002 £ million	2001 £ million
The aggregate amounts of assets and liabilities denominated in currencies other than sterling were:-		
Assets	73,420	59,932
Liabilities	115,484	82,912

The above figures do not reflect the Group's exposure to foreign exchange, which is significantly lower as it is hedged by off-balance sheet instruments.

48. Reconciliation of Operating Profit to Net Cash (Outflow)/Inflow from Operating Activities

	2002 £ million	2001 Restated £ million
Group operating profit	2,849	2,332
Decrease in accrued income and prepayments	806	395
Decrease in accruals and deferred income	(684)	(876)
Provision for bad and doubtful debts	832	608
Depreciation and goodwill amortisation	634	538
Amortisation of (discounts)/premiums on debt securities	(6)	51
Income from long-term assurance business	(233)	(150)
Interest on subordinated liabilities	518	485
Profit on sale of investment securities	(37)	(92)
Gain on sale of fixed assets	(14)	(7)
Provisions for liabilities and charges	216	171
Provisions utilised	(236)	(93)
Provisions against debt securities and equity shares	24	21
Exchange differences	384	(194)
Other non-cash movements		14
Net cash inflow from trading activities	5,053	3,203
Net increase in notes in circulation	84	84
Net increase in items in course of collection	(110)	(229)
Net increase in treasury and other eligible bills	(1,893)	(875)
Net increase in loans and advances to banks and customers	(34,879)	(21,979)
Net increase in deposits by banks and customer accounts	24,893	16,370
Net increase in debt securities in issue	11,243	15,850
Net increase in other assets	(3,217)	(1,320)
Net increase in other liabilities	3,759	2,233
Net increase in other debt securities	(5,927)	(12,702)
Net cash (outflow)/inflow from operating activities	(994)	635

Notes on the Accounts continued

49. Gross Cash Flows

	Notes	2002 £ million	2001 Restated £ million
(i) Returns on investments and servicing of finance			
Interest paid on subordinated liabilities		(515)	(474)
Preference dividends paid		(37)	(37)
Dividends paid to minority shareholders in subsidiary undertakings		(148)	(127)
		(700)	(638)
(ii) Capital expenditure and financial investment			
Transfers to long-term assurance business		(309)	(254)
Purchase of investment securities		(19,745)	(64,169)
Sale and maturity of investment securities		23,428	64,370
Purchase of property and equipment		(391)	(390)
Sale of property and equipment		100	99
Movement in own shares		(12)	1
Purchase of operating lease assets		(1,287)	(1,305)
Sale of operating lease assets		415	572
		2,199	(1,076)
(iii) Acquisitions and disposals			
Investment in subsidiary undertakings			(700)
Investment in associated undertakings, joint ventures and business interests		(141)	(69)
Disposal of associated undertakings, joint ventures and business interests		27	31
		(114)	(738)
(iv) Financing			
Issue of ordinary shares	52	1,319	275
Issue of subordinated liabilities	52	1,287	1,892
Issue of preferred securities			594
Minority interest acquired		24	4
Minority interest disposed		(9)	(5)
Repayments of subordinated liabilities	52	(66)	(33)
Contribution to Employee Share Trust		(12)	(30)
		2,543	2,697

50. Acquisitions and Disposals

(a) Equitable Life Assurance Society ("The Equitable")

On 1 March 2001, the Halifax Group acquired the operating assets, sales force and unit-linked and non-profit business of The Equitable for £508 million (including costs of acquisition of £8 million). Net assets with a preliminary fair value of £341 million were acquired, creating a balance of goodwill on the acquisition of £167 million.

The acquisition method of accounting has been adopted and the results of the acquired operations have been consolidated in full from that date.

On 11 January 2002, The Equitable's guaranteed annuity rate and non-guaranteed annuity rate policyholders voted in favour of a scheme of arrangement to compromise their respective claims against the with-profits fund. Following Court approval the scheme became effective on 8 February 2002. As a result of this, in accordance with the terms of the acquisition, Halifax plc (a subsidiary of HBOS plc) agreed to waive unconditionally the repayment of £250 million of loans advanced by it to The Equitable under a fully collateralised loan facility of £251 million, which was granted in 2001. The amount waived has been treated as additional goodwill.

As a result of the compromise scheme having become effective prior to 1 March 2002, in accordance with the terms of the acquisition, the HBOS Group is obliged to pay up to a further £250 million depending on the extent to which certain new business sales and profitability targets are achieved in 2003 and 2004 by the distribution channel acquired from The Equitable. No provision has been made at 31 December 2002 for this contingent consideration because it is not currently expected that any payment will be made.

In accordance with FRS 7, "Fair Values in Acquisition Accounting", preliminary fair value adjustments were made and were disclosed in the accounts for the year ended 31 December 2001. The principal adjustment required reflects the fact that, as a mutual life assurance society, The Equitable did not prepare accounts on an embedded value basis. A preliminary fair value adjustment for £277 million was therefore made, being an estimate of the value of acquired in-force business. Following a review of the preliminary fair value adjustments, the value of acquired in-force business has been adjusted from £277 million to £265 million. This revised value is reflected in the table below. As a result of this, the preliminary fair value of net assets acquired has been reduced by £12 million to £329 million and the balance of goodwill on acquisition has increased to £429 million. The other accounting policy and revaluation adjustments are not individually material.

The following table summarises the effects of this acquisition:-

	Acquired book value £ million	Revaluation adjustments £ million	Accounting policy adjustments £ million	Total fair value adjustments £ million	Fair value to the Group £ million
Long-term assurance business attributable to shareholders			265	265	265
Long-term assurance assets attributable to policyholders	4,106				4,106
Other assets	149		10	10	159
Total assets	4,255		275	275	4,530
Long-term assurance liabilities attributable to policyholders	4,106				4,106
Other liabilities	84	12	(1)	11	95
Total liabilities	4,190	12	(1)	11	4,201
Net assets	65	(12)	276	264	329
Goodwill					429
Consideration					758
Satisfied by:-					
Cash					500
Waiver of loan					250
Acquisition costs					8
					758

The goodwill arising on acquisition, prior to the waiver of the loans referred to above, is being amortised over a period of 20 years to reflect the strategic rationale of the acquisition and the period over which the economic benefits associated with the goodwill are expected to arise. The additional goodwill arising in 2002 is being amortised over a period equivalent to the balance of the period of 20 years over which the original goodwill is being amortised.

Notes on the Accounts continued

50. Acquisitions and Disposals continued

(b) On 16 February 2001, Bank of Scotland acquired 99.99% of the share capital of ICC Bank plc, which is based in Ireland. The remaining equity was acquired during that year. The consideration of £227 million inclusive of fees and expenses was satisfied partly in cash raised from the proceeds of a placing of Bank of Scotland stock and partly by stock issued. Net assets with a preliminary fair value of £163 million were acquired, creating a balance of goodwill on the acquisition of £64 million.

In accordance with FRS 7, preliminary fair value adjustments were made and disclosed in the accounts for the year ended 31 December 2001. The principal fair value adjustment reflects the revaluation of debt securities and equity shares to market value. A preliminary fair value adjustment for £33 million was therefore made. Following a review of the preliminary fair value adjustment, the value of net assets acquired has been adjusted from £163 million to £153 million. This revised value is reflected in the table below. As a result of this, the balance of goodwill on acquisition has increased to £74 million. The other accounting policy and revaluation adjustments are not individually material.

The following table summarises the effects of this acquisition:-

	Acquired book value £ million	Revaluation adjustments £ million	Accounting policy adjustments £ million	Total fair value adjustments £ million	Fair value to the Group £ million
Loans and advances to banks and customers	2,239	(4)		(4)	2,235
Debt securities and equity shares	233	29		29	262
Other assets, prepayments and accrued income	41		(1)	(1)	40
Total assets	2,513	25	(1)	24	2,537
Deposits by banks, customer accounts and debt securities in issue	2,255				2,255
Other liabilities, accruals and deferred income and other provisions	48				48
Subordinated liabilities	78	1		1	79
Minority interests	2				2
Total liabilities	2,383	1		1	2,384
Net assets	130	24	(1)	23	153
Goodwill					74
Consideration					227
Satisfied by:-					
Cash					193
Shares issued at fair value					34
					227

(c) During the year a further £8 million of goodwill arose from the acquisition of minorities (2001 – £26 million including fair value adjustments to previous acquisitions).

(d) There were no material disposals in the years to 31 December 2002 or 2001 other than disclosed in Note 4.

51. Analysis of the Balances of Cash as shown in the Balance Sheet

	As at 1 January 2002 £ million	Cashflow £ million	As at 31 December 2002 £ million	As at 1 January 2001 £ million	Cashflow £ million	As at 31 December 2001 £ million
Cash and balances at central banks	1,150	223	1,373	1,252	(102)	1,150
Loans and advances to other banks repayable on demand	1,625	1,534	3,159	2,400	(775)	1,625
	2,775	1,757	4,532	3,652	(877)	2,775

The Group maintains balances with the Bank of England which, at 31 December 2002, amounted to £881 million (2001 – £732 million).

52. Analysis of the Changes in Financing During the Year

	2002		2001	
	Share Capital (including Premium) £ million	Loan Capital £ million	Share Capital (including Premium) £ million	Loan Capital Restated £ million
At 1 January	1,319	7,923	1,278	5,985
Effect of foreign exchange differences		(17)		
Acquisitions				79
Shares issued as part payment for the acquisition of ICC Bank plc			34	
Proceeds of capital issues (including premium) – ordinary shares	1,319		275	
Issue of subordinated liabilities		1,287		1,892
Repayments of subordinated liabilities		(66)		(33)
Non-cash movement				
Transfer of share premium to other reserves			(268)	
At 31 December	2,638	9,127	1,319	7,923

53. Related Party Transactions

In the year ended 31 December 2002, the Group provided both administration and processing services to Sainsbury's Bank plc. The amounts in respect of administration and processing services payable to the Group during the year were £28 million (2001 – £19 million), of which £4 million was outstanding at the year end (2001 – £6 million).

During the year, IBM United Kingdom (Systems Operations) Limited, a non consolidated subsidiary, provided to the Group systems operations services. The amounts in respect of these services payable by the Group during the year were £147 million (2001 – £116 million), of which £5 million was outstanding at the year end (2001 – £11 million). On 19 August 2002 the Group served notice of contract severance to IBM United Kingdom (Systems Operations) Limited. There is a one year notice period contained in the contract.

54. Main Joint Ventures and Associated Undertakings

	Nature of Business	Issued Share and Loan Capital		Group's Interest	Statutory Accounts Made up to	Principal Area of Operations
Incorporated in the UK						
Joint Ventures:-						
Centrica Personal Finance Limited	Finance	ordinary loan	£3,000,002 £4,500,000	50.0% 50.0%	December 2002	UK
RFS Limited	Finance	ordinary	£6,000,006	50.0%	December 2002	UK
Lex Vehicle Leasing (Holdings) Ltd and its subsidiaries	Vehicle Leasing	ordinary	£16,900,002	50.0%	December 2002	UK
Halifax Cetelem Credit Ltd	Consumer Credit	ordinary	£34,000,000	50.0%	December 2002	UK
esure Holdings Ltd and its subsidiaries	Insurance	ordinary	£3,330,000	70.0%	December 2002	UK
Associated Undertaking:-						
Sainsbury's Bank plc	Banking	ordinary loan	£130,000,000 £25,000,000	45.0% 45.0%	February 2002*	UK

* The accounts of Sainsbury's Bank plc have been equity accounted in the Group's consolidated accounts on the basis of accounts prepared for the year to 31 December 2002.

All the above are held by subsidiary undertakings.

The Group also holds 100% of the preference shares issued by esure Holdings Ltd and 50% of the preference shares issued by Lex Vehicle Leasing (Holdings) Ltd.

Notes on the Accounts continued

55. Main Subsidiary Undertakings

	Company's Interest in Ordinary Share Capital and Voting Rights	Principal Business	Incorporated
The Governor and Company of the Bank of Scotland and subsidiaries, including	100%†	Banking, financial and related services	UK
HBOS Treasury Services PLC	100%	Banking	UK
Bank of Western Australia Ltd	56.8%	Retail and commercial banking	Australia
CAPITAL BANK plc	100%*	Banking and personal finance	UK
Halifax plc	100% ^o	Banking	UK
Halifax Share Dealing Ltd	100%	Execution only stockbroking	UK
HBOS Insurance & Investment Group Ltd and subsidiaries, including	100%	Investment holding	UK
Halifax General Insurance Services Ltd	100%	General insurance brokerage	UK
Clerical Medical Investment Group Ltd	100%	Life assurance	UK
Halifax Financial Services Ltd	100%	Financial services	UK
Halifax Investment Funds Management Ltd	100%	OEIC management	UK
Insight Investment Management Ltd	100%	Investment management	UK
Halifax Unit Trust Management Ltd	100%	Unit trust management	UK
St. James's Place Capital plc	60%	Financial services	UK

† HBOS plc holds 100% of the issued preference share capital.

* Bank of Scotland holds 100% of the issued preference share capital.

^o HBOS plc holds 75% of the issued preference share capital.

56. Transactions with Directors, Officers and Connected Persons

The aggregate amounts outstanding at 31 December 2002 in respect of loans and credit cards which were made available by the Group for persons who are, or were during the year, Directors and officers of HBOS plc and their connected persons were:-

	Number	Aggregate amount outstanding £000
Loans	11	2,377
Credit card accounts	12	49

57. Segmental Analysis

Business Sector

The Group reports through five divisions: Retail, Insurance & Investment, Business, Corporate, Treasury, plus BankWest and Group Items.

	Profit before Tax and Exceptional items £ million	Exceptional items £ million	2002 Profit before Tax £ million	Profit before Tax and Exceptional items Restated £ million	Exceptional items £ million	2001 Profit before Tax Restated £ million
Retail	1,426	(28)	1,398	1,205	(25)	1,180
Insurance & Investment	589	(6)	583	472	(22)	450
Business	307	(16)	291	306	(9)	297
Corporate	681		681	523	(1)	522
Treasury	231	(9)	222	169	(2)	167
BankWest	75		75	80		80
Group Items	(247)	(94)	(341)	(240)	(164)	(404)
	3,062	(153)	2,909	2,515	(223)	2,292

57. Segmental Analysis continued

	Net Assets		Total Assets	
	2002	2001	2002	2001
	£ million	Restated £ million	£ million	Restated £ million
Retail	4,959	4,250	161,470	138,887
Insurance & Investment	3,900	2,753	43,491	42,759
Business	1,294	1,176	26,694	21,954
Corporate	2,590	2,259	50,889	38,823
Treasury	784	764	64,000	61,866
BankWest	242	211	8,536	7,782
	13,769	11,413	355,080	312,071

Geographical

The table below analyses the Group results and assets by the geographical area in which the business is generated. The geographical analysis is prepared in accordance with the location of the relevant company or branch.

	2002			2001		
	UK	Rest	Group	UK	Rest	Group
	£ million	of World	Total	Restated	of World	Total
		£ million	£ million	£ million	Restated	Restated
					£ million	£ million
Interest receivable	15,444	1,247	16,691	14,961	1,154	16,115
Fees and commissions receivable	1,988	169	2,157	1,789	132	1,921
Dealing profits	146	8	154	77	5	82
Income from long-term assurance business	131	102	233	89	61	150
Other operating income	700	204	904	720	23	743
Gross income	18,409	1,730	20,139	17,636	1,375	19,011
Operating profit before exceptional items	2,552	450	3,002	2,195	284	2,479
Share of operating profits of joint ventures	19	(11)	8	25	(5)	20
Share of operating profits of associated undertakings	19	8	27	13	3	16
Profit on disposal of business	25		25			
Exceptional items	(153)		(153)	(223)		(223)
Group profit before taxation	2,462	447	2,909	2,010	282	2,292
Total assets	326,949	27,678	354,627	289,233	22,492	311,725
Joint ventures			281			212
Associated undertakings			172			134
Group total assets			355,080			312,071
Net assets (excluding minority interests)	12,226	1,543	13,769	10,306	1,107	11,413

58. Post Balance Sheet Events

On 31 January 2003, Insight Investment Management Ltd, a subsidiary of HBOS plc, acquired Rothschild Asset Management for consideration of £61 million. A review of the preliminary fair values of the net assets acquired is currently being undertaken.

ANNEX A TO THE CONSOLIDATED FINANCIAL STATEMENTS

Differences Between U.K. and U.S. Generally Accepted Accounting Principles

The Company prepares its consolidated financial statements in accordance with the U.K. Companies Act 1985, as applicable to banking groups, and U.K. GAAP. Such principles may vary from U.S. GAAP. Set out below are the principal accounting and disclosure differences between U.K. GAAP and U.S. GAAP. The Company has not quantified the effect of differences between U.K. GAAP and U.S. GAAP, nor prepared consolidated financial statements under U.S. GAAP, nor undertaken a reconciliation of U.K. GAAP and U.S. GAAP financial statements. Had the Company undertaken any such quantification or preparation or reconciliation, other potentially significant accounting and disclosure differences may have come to its attention which are not identified below. Accordingly, the Company does not provide any assurance that the differences identified below represent all the principal differences between U.K. GAAP and U.S. GAAP.

Deferred Taxation

Recognition is given to deferred taxation arising from timing differences to the extent that, and at the estimated rates at which, future taxation is expected to become payable.

Under U.S. GAAP, a deferred tax asset or provision is recognized in full for all temporary differences using the liability method. A valuation allowance is raised against any deferred tax asset where it is more likely than not that the asset, or part thereof, will not be realized.

Pension Costs

Pension fund liabilities are assessed by independent professionally qualified actuaries, normally at triennial valuations and at intervening dates if considered necessary. In accordance with the requirements of Statement of Standard Accounting Practice No 24 ("SSAP 24"), pension costs are charged against profits using actuarial valuation methods intended to spread the pension cost evenly over the average service periods of the current employees in the schemes. Under this standard the actuarial cost for the year of providing pensions for applicable persons employed by the Group during the year is charged against profits. SSAP 24 permits this charge to be reduced by offsetting any actuarial surpluses within the relevant pension schemes.

U.S. GAAP requires that the projected benefit obligation is matched against the market value of the plan's assets and other unrecognized actuarial gains and losses in determining the pension cost for the year. Certain variations from regular cost are allocated in equal amounts over the average remaining service lives of employees.

Proposed Final Dividend

The Company records the proposed final dividend, which is declared after the last day of February each year, in the period to which it relates.

Under U.S. GAAP, dividends are recorded in the period in which they are declared.

Equipment Leased to Customers

The Group credits leasing income and income from installment credit agreements, to profit by spreading interest and charges over the period of repayment in proportion to the net cash investment, taking into account tax payments and receipts associated with the lease. Leases are classified as finance leases when the substance of the agreement is that of a finance transaction and the lessee substantially assumes all of the risks and benefits relating to the asset. All other leases are classified as operating leases. Operating leased assets are depreciated over their useful lives such that, for each asset, rentals less depreciation are recognized at a constant periodic rate of return on the net cash invested in the leased asset.

Under U.S. GAAP, income from equipment leased to customers is recognized by amortizing the unearned income, residual asset value and investment tax credits over the life of the lease, using a method which results in a level rate of return on investment. No account is taken of the tax flows generated by the

lease. Leases are classified as capital leases when any of the criteria under Statement of Financial Accounting Standards No. 13 "Accounting for Leases" are met. Operating leased assets are depreciated such that the depreciation charge is at least equal to that which would have arisen on a straight line basis.

Goodwill

In accordance with U.K. GAAP prevailing at that time, goodwill arising on acquisitions prior to March 1, 1998 was written off to reserves in the year in which it arose. These amounts will continue to be charged to the profit and loss account on a subsequent disposal of the business to which they relate.

To reflect current U.K. GAAP, goodwill arising on acquisitions after March 1, 1998 is capitalized and included within Intangible Fixed Assets. Goodwill is amortized by equal installments over its estimated useful life as stated. Impairment charges are included within operating profit.

Under Statement of Financial Accounting Standard ("SFAS") No. 142, goodwill acquired after June 30, 2001 should be capitalized and should not be amortized. Under the transition rules of SFAS No. 142, goodwill acquired before June 30, 2001 should continue to be amortized over its expected useful life, generally no longer than 20 years, until December 31, 2001. All goodwill will cease to be amortized from December 31, 2001. Annual impairment tests should be performed and an impairment loss recognized if the carrying value is not recoverable.

Debt Securities and Equity Shares

The Group includes debt securities (and other fixed interest securities) held for dealing at market value and includes gains or losses within interest receivable in the profit and loss account. Debt securities (and other fixed interest securities) held for continuing use are included at cost less amounts written off and adjusted for the amortization of premiums or discounts arising on purchase of investments redeemable at fixed dates. Such premiums or discounts are taken to revenue evenly over the period to redemption and gains or losses on realization of such securities are taken to revenue as "Profit on sale of investment securities" as they arise. Equity shares are stated at cost less amounts written off.

U.S. GAAP require disclosure of debt securities and equity shares within one of three categories: (i) held to maturity; (ii) available for sale; and (iii) trading. Held to maturity securities are measured at amortized cost and include those securities where a positive intent and ability to hold the securities to maturity exists. Trading securities are those securities bought principally with a view to selling them in the near term and are measured at fair value with unrealized holding gains and losses included in earnings. Available for sale securities are those not classified as either held to maturity or trading securities and include those securities where there is an absence of intent and ability to hold them to maturity. Such securities are measured at fair value with unrealized holding gains and losses excluded from earnings and reported (net of applicable taxes and minority interests) in a separate component of other comprehensive income within stockholders funds. Foreign exchange gains or losses on foreign currency denominated available for sale securities are also excluded from earnings and recorded as part of the same separate component of stockholders' funds.

Acceptances

Acceptances outstanding and the matching customers' liabilities are not reflected in the consolidated balance sheet, but are disclosed as memorandum items below the consolidated balance sheet.

Under U.S. GAAP, acceptances outstanding and the matching customers' liabilities are reflected in the consolidated balance sheet.

Loan Origination Fees

Certain loan origination fees, in respect of services provided, are recognized in the profit and loss account on the basis of work done. Fees receivable in respect of bearing risk are recognized over the period of the advance or risk exposure. Mortgage incentive costs are charged to the profit and loss account as they are incurred.

Under U.S. GAAP, certain loan origination costs and loan origination fees, to the extent they are not offset by related direct costs, are deferred and amortized through the profit and loss account over the life of the loan.

Stock Based Compensation

Equity based instruments, such as share options, issued under compensation plans are accounted for within the share capital and share premium accounts on the balance sheet when exercised.

U.S. GAAP encourages companies to account for equity based instruments issued under compensation plans at their fair value, measured at the date at which the instruments are granted. U.S. GAAP also permits the intrinsic value-based method of accounting under which the compensation cost, being the excess, if any, of the quoted market price of the stock at grant date over the exercise price, must be recognized in the profit and loss account over the vesting period. On the balance sheet this is offset by a corresponding adjustment to share premium.

Fair Value of Financial Instruments

Under U.K. GAAP, the Company is not required to provide disclosure of the fair values of its financial instruments for the three fiscal years ended December 31, 2001, although certain disclosures are made regarding the market value of debt and equity securities and the replacement cost of off-balance sheet contracts.

Under U.S. GAAP, Statement of Financial Account Standards No. 107 “Disclosures about Fair Values of Financial Instruments” requires disclosure of the estimated fair values of certain financial instruments, both on-balance sheet and off-balance sheet, where it is practicable to do so.

Foreign Exchange

Under U.K. GAAP, foreign currency earnings of overseas entities may be translated using period-end exchange rates.

Under U.S. GAAP, foreign currency earnings must be translated using the average exchange rate prevailing for each period.

Profit and Loss Presentation

Under U.K. GAAP, the following amounts are shown separately in the profit and loss account: “Provision for contingent liabilities and commitments”, “Amounts written off fixed asset investments” and “Profit on sale of investment securities and tangible fixed assets”.

Under U.S. GAAP, “Provisions for contingent liabilities and commitments” are classified as “Operating expenses”, “Amounts written off fixed asset investments” are classified as “Other operating expenses” and “Profit on sale of investment securities and tangible fixed assets” are classified as “Other operating income”.

Cash Flow Presentation

Under U.K. GAAP, “Cash Flow” represents increases or decreases in “Cash”. “Cash” comprises cash in hand and repayable on demand overdrafts.

Under U.S. GAAP, “Cash” represents increases or decreases in cash or cash equivalents which include short term, highly liquid investments with original maturities less than 90 days, and excludes overdrafts.

Under U.K. GAAP, the principal headings of a Cash Flow statement are “Net cash flow from operating activities”, “Dividends received from joint ventures”, “Dividends received from associated undertakings”, “Returns on investment and servicing of finance”, “Taxation”, “Capital expenditure and financial investment”, “Acquisitions and disposals” and “Financing”.

Under U.S. GAAP, cash flows are disclosed under the following headings: “Cash flow from operating activities”, “Investing activities” and “Financing activities”.

EXHIBIT A — HOLDER/TRANSFEROR/AGENT TRANSFER CERTIFICATE

HBOS plc
The Governor and Company of the Bank of Scotland
HBOS Treasury Services PLC
Scotland International Finance No. 2 B.V.
c/o Citibank, N.A. as Paying Agent
5, Carmelite Street
London EC4Y 0PA England

Dear Sirs:

[This is to advise you] *[that the undersigned is the holder] [of a transfer] of [Specified Currency] [U.S.\$] _____ aggregate principal amount of _____% [Zero Coupon] [Senior/Subordinated] Medium-Term Notes Due _____ (the “Notes”) of [Issuer] [unconditionally and irrevocably guaranteed [on a subordinated basis] by [HBOS plc]/[The Governor and Company of the Bank of Scotland]]] *[in definitive form, certificate no(s). _____].

*[The undersigned wishes to hold [Specified Currency] [U.S.\$] _____ aggregate principal amount of the Notes in book entry form through the facilities of The Depository Trust Company, subject to the terms of the relevant Indenture. Accordingly, the undersigned has delivered herewith certificate no(s) _____ representing [Specified Currency] [U.S.\$] _____ aggregate principal amount of the Notes for cancellation in accordance with the terms of the relevant Indenture].

[The Notes are presently registered as follows:

Name:

Address:

Taxpayer ID Number:

The Notes would be registered as follows:

Name:

Address:

Taxpayer ID Number:]

The undersigned, in the case of (a) or (b) below, represents and warrants to you that, to the best of its knowledge or, in the case of (c) below, confirms that:

[(a) the new beneficial owner is acquiring the Notes in a transaction in accordance with Regulation S under the Securities Act; or]**

[(b) *[it] [the new beneficial owner] is a “Qualified Institutional Buyer” as defined in Rule 144A under the Securities Act to whom notice has been given that the transfer is being made in reliance on Rule 144A [and in the case of this clause (b),] the Notes [hereby transferred] are to be registered in the name of The Depository Trust Company or its nominee, Cede & Co.]**

[(c) ***it is an Agent that is a party to the Amended and Restated Private Placement Agreement dated April 30, 2003, as amended, relating to the Notes; the transfer of the Notes to the person described above is in compliance with the provisions of Section 6 of such Private Placement Agreement; and such person (or if such person is a nominee, each beneficial owner of such Notes) has been informed that the Notes may only be transferred in conformity with the restrictions on transfer set forth in the Notes and the relevant Indenture referred to therein.]

Name of *[Holder] [Transferor]*** [Agent]

By: _____
Name
Title

* Applies only to holders of Notes which are Qualified Institutional Buyers wishing to exchange definitive Notes for beneficial interests in the Global Note held by The Depository Trust Company.

** Does not apply to transfers of Notes through an Agent to an accredited investor approved by such Agent.

*** Applies only to transfers of Notes through an Agent to an accredited investor approved by such Agent.

EXHIBIT B — TRANSFEREE CERTIFICATE

HBOS plc (“HBOS”)
The Governor and Company of the Bank of Scotland (the “Bank”)
HBOS Treasury Services PLC
Scotland International Finance No. 2 B.V.
c/o Citibank, N.A., as Paying Agent
5, Carmelite Street
London EC4Y 0PA England

Dear Sirs:

We hereby request that the [Specified Currency] [U.S.\$] aggregate principal amount of
% [Zero Coupon] [Senior/Subordinated] Medium-Term Notes Due (the “Notes”) of
[Issuer] (the “Issuer”) [unconditionally and irrevocably guaranteed [on a subordinated basis] by
[HBOS]/[the Bank]] having [an Original Issue Date] [Original Issue Dates] of be
registered in the name set forth below. We hereby acknowledge, represent and agree that:

(1) We understand and acknowledge that the Notes have not been and will not be registered under the Securities Act of 1933, as amended (the “Securities Act”) or any other applicable securities law, and may not be offered, sold, transferred, pledged, encumbered or otherwise disposed of unless either registered pursuant to, or in a transaction exempt from registration under, the Securities Act and any other applicable securities law.

(2)(X) We are an institutional investor that is an “accredited investor” within the meaning of subparagraph (a)(1), (2), (3) or (7) of Rule 501 under the Securities Act (an “Accredited Investor”) that is purchasing for its own account or that is a bank (as defined in Section 3(a)(2) under the Securities Act) or a savings and loan association or other institution (as described in Section 3(a)(5)(A) under the Securities Act) that is purchasing as a fiduciary for the account of one or more institutional investors (each an “institutional account”) or (Y) we are an Accredited Investor other than a bank (as so defined) or a savings and loan association or other institutions (as so described) that is purchasing for one or more institutional accounts, each of which is an Accredited Investor. We have such knowledge and experience in financial and business matters that we are capable of evaluating the merits and risks of purchasing the Notes. We are aware that we (or any institutional account) may be required to bear the economic risk of an investment in each Note for an indefinite period of time, and we (or such institutional account) are able to bear such risk for an indefinite period. We are purchasing the Notes for our own account, or for one or more institutional accounts for which we are acting as a fiduciary or agent, in a minimum principal amount of U.S.\$250,000 (or the equivalent thereof in another currency or composite currency) for each such account, in each case for investment, and not with a view to, or for offer or sale in connection with, any distribution thereof, subject to the disposition of our property or the property of such institutional account or accounts being at all times within our or their control and subject to our or their ability to resell such Notes pursuant to Rule 144A, Regulation S or other exemption from registration available under the Securities Act. We agree on our own behalf and on behalf of any institutional account for which we are purchasing Notes to offer, sell or otherwise transfer such Notes (A) only in minimum principal amounts of U.S.\$1,000 (or \$250,000 in the case of any offer, sale or transfer to an Accredited Investor) (or, in each case, the equivalent thereof in another currency or composite currency) and (B) prior to the date which is two years after the later of (i) the original issue date of such Notes and (ii) the last date on which the Issuer, the Bank or any affiliate of the Issuer or the Bank was the beneficial owner of such Notes (or any predecessor of such Notes) only (a) to the Issuer, the Bank or an Agent that is party to the Private Placement Agreement dated August 21, 1992, as amended (an “Agent”), (b) to a person we reasonably believe is a qualified institutional buyer (a “QIB”) that is purchasing for its own account or for the account of a QIB to whom notice has been given that the transfer is being made in reliance on Rule 144A, (c) pursuant to the exemption from the registration requirements of the Securities Act provided by either Rule 144A or Regulation S thereunder, (d) to an institutional investor which is an “accredited investor” as defined in Regulation D of the Securities Act, (e) through an Agent to an institutional investor that is an accredited investor approved by such Agent, or (f) pursuant to an exemption

from such registration requirements as confirmed in an opinion of counsel satisfactory to the Issuer and the Bank, subject in each of the foregoing cases to any requirement of law that the disposition of our property or of the property of such institutional account or accounts be at all times within our or their control. In order to effectuate the foregoing restrictions on resales and other transfers of the Notes, if any resale or other transfer is proposed to be made (other than to the Issuer or the Bank or pursuant to an effective registration statement) prior to three years after the later of the original issue date and the last date on which the Issuer, the Bank or any affiliate of the Issuer or the Bank was the beneficial owner of any such Note (or any predecessor of such Notes) either (a) we shall deliver to the Trustee a certificate substantially in the form of Annex A to each Note in the case of a transfer proposed to be made in compliance with Rule 144A or Regulation S under the Securities Act, (b) the transferee shall deliver to the Trustee a certificate substantially in the form of Annex B attached to each Note in the case of a transfer to an “accredited investor” as defined in Regulation D under the Securities Act, (c) the Agent shall deliver to the Trustee a certificate substantially in the form of Annex A to each Note in the case of a transfer through an Agent to an institutional investor that is an “accredited investor” (as so defined) approved by such Agent, provided that such accredited investor shall forthwith deliver to the Trustee a certificate substantially in the form of Annex B attached to each Note or (d) we shall provide the Issuer and the Bank with an opinion of counsel satisfactory to the Issuer and the Bank to ensure compliance with the provisions of the Securities Act.

(3) We acknowledge that the Issuer, the Bank, the Agents and others will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements and agree that, if any of the acknowledgments, representations or warranties made by us are no longer accurate, we shall promptly notify the Issuer of such Notes, the Bank and the Agent through which we purchased any Notes. If we are acquiring any Notes as a fiduciary or agent for one or more institutional accounts, we represent that we have sole investment discretion with respect to each such account and that we have full power to make the foregoing acknowledgments, representations and agreements on behalf of each such account.

(4) The Notes should be registered as follows:

Name:

Address:

Taxpayer ID Number:

Name of Transferee

By _____
Name:
Title:

OFFERING MEMORANDUM SUPPLEMENT

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\$750,000,000

HBOS plc

as Issuer

6.00% SUBORDINATED NOTES DUE 2033

OFFERING MEMORANDUM SUPPLEMENT
(To OFFERING MEMORANDUM DATED
APRIL 30, 2003)

OCTOBER 24, 2003

LEHMAN BROTHERS
MERRILL LYNCH & Co.
MORGAN STANLEY