

21st January 2010

Dear Complainant

**Complaint against the Financial Services Authority
Our Reference GE-L01084**

I am writing to advise you that I have now completed my investigation into your complaint.

At this stage I think it would be worth explaining my role and powers. Under the Complaints Scheme (Complaints against the FSA-known as COAF) my role is as an independent reviewer of the FSA's handling of complaints. I have no power to enforce any decision or action upon the FSA. My power is limited to setting out my position on your complaint based on its merits and then if I deem it necessary I can make recommendations to the FSA. Such recommendations are not binding on the FSA and the FSA is at liberty not to accept them. Full details of Complaint Scheme can be found on the internet at the following website; <http://fsahandbook.info/FSA/html/handbook/COAF>.

Your Complaint

In the email you sent to my office on 1st December 2009 I understand that your complaint related to the following:

1. You believe that the FSA failed to take action to protect consumers by not ensuring Firm A clearly made potential investors aware, in its prospectus dated 18th June 2008, of its exposure to wholesale funding and that a considerable amount was due for repayment by 30th June 2009.
2. You are also unhappy that the FSA did not ensure Firm A clearly indicated the in the prospectus that, due to the state of the wholesale funding markets it was likely that Firm A was unlikely to be able to renew this funding and would therefore be technically insolvent.
3. You also feel the FSA failed to ensure that the prospectus was not misleading as in your opinion it did not have sufficient working capital for the next 12 months as it would have had to repay £155.9bn of wholesale funding by 30th June 2009, did not have sufficient reserves itself and in your view was unlikely to be able to renew or replace this funding.

My Position

As part of my investigation into your concerns I have obtained and reviewed the FSA's investigation file. I also have to have regard to the rules of the complaints scheme when considering what I can and cannot consider. I have also considered what enquiries the FSA made both internally and with the firm before authorising the rights issue. I have also obtained and reviewed the prospectus issued to existing shareholders in relation to the rights issue.

From my investigations I am satisfied that the FSA adequately considered the matter and that the requisite threshold conditions for authorising the rights issue were met. I am also satisfied that the FSA followed the standard and correct procedures in allowing the rights issue to take proceed. Likewise I am also satisfied that the prospectus clearly indicates that the purchase of (additional) shares carries a risk and that should financial conditions turn against Firm A then shareholders could potentially lose all or part of the value of their investment. This information is contained in Part II of the prospectus (pages 10 to 16). I have enclosed copies of the relevant pages from the prospectus as Appendix 1 at the end of this letter.

Although I accept that Firm A 'collapsed' within six months of the rights issue taking place, this does not in turn mean that the FSA was wrong in allowing Firm A to conduct the rights issue or that incorrect information was contained within the prospectus. As I have previously explained, the FSA considered a number of factors which could affect the long term future of the firm before it authorised the rights issue. Whilst, in this case, the FSA was unable to stop the 'collapse' of the bank, from the information provided to me there is nothing to indicate that the FSA was in possession of information at the time it approved the rights issue which showed that the bank would 'collapse' within the foreseeable future.

I appreciate that you feel the existing wholesale funding was not clearly explained in the prospectus, but I disagree with this view. Details of Firm A's wholesale funding position was included in Part XVI of the prospectus (Appendix 2) and a general summary is provided on page 132 of the prospectus and I have enclosed an extract below.

<i>Wholesale Funding – Residual Maturity</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
Less than one year	164.1	59.0	121.2	52.5
One to two years	21.6	7.8	19.3	8.4
Two to five years	46.3	16.7	46.5	20.1
More than five years	46.0	16.5	44.0	19.0
Total Wholesale Funding	278.0	100.0	231.0	100.0

Table taken from page 132 of Firm A' prospectus dated 18th June 2008.

From this I am sure you will agree this clearly indicates that, as at 31st December 2007, Firm A had obtained a total of £278.0bn of funding from the wholesale market and that £164.1bn (or 59% of its total wholesale funding) of this was to be repaid within 12 months of the date of the prospectus. Likewise, the risks associated with obtaining money from the wholesale market were clearly explained on pages 8 and 11 of the prospectus (contained within Appendix 1). On page 8 of the prospectus it states “[f]unding and liquidity risks are inherent in the Groups’ operations”. Likewise, on page 11 under the heading “[f]unding and liquidity risks are inherent in the Group’s operations” it states a “worsening of the current systemic market liquidity stress may further constrain (Firm A)’s ability to access sources of funding and liquidity”. In my opinion, this clearly indicates that Firm A relies on the wholesale market for funding and that it may not be able to obtain further funding in the future.

I accept that at the time of the prospectus was released the wholesale markets were not functioning as they had in the past or indeed as they should. However, in my opinion, it would have been inappropriate specifically to say that Firm A will be insolvent within 12 months as it was not possible predict whether wholesale funding (or any other types or methods of funding) would be available in 12 months time. As I have indicated above, the prospectus made potential investors aware that if wholesale funding continued to be restricted or not available to financial institutions then this would impact on Firm A' as a considerable amount of wholesale fund was due to be repaid/renewed within 12 months. In my opinion, the prospectus clearly indicated to potential investors that Firm A relied upon the wholesale markets for funding, had a considerable amount of funding that needed to be renewed/replaced (from the wholesale market) within the next 12 months and that should the wholesale markets continue to restrict lending then Firm A was likely to have difficulty replacing it.

I have also noted your comments that Firm A's statement that "taking into account the net proceeds of the Rights Issue, the working capital available to the Group is sufficient for the Group's present requirements, that is, for at least the twelve months from the date of this Prospectus" was incorrect. From my investigation it appears that, based upon the information provided to the FSA by Firm A and its financial advisers (who were two international financial institutions) there is insufficient, if any, evidence to indicate that Firm A was likely to have insufficient capital to meet its liabilities for the following 12 months.

Additionally, I would add that by your own admission Firm A's existing wholesale funding had to be replaced/renewed by 30th June 2009 and the prospectus was dated 18th June 2008. As such, at the time the prospectus was issued, it would appear to be technically correct as the funding did not have to be fully replaced until after 12 months from the date of the prospectus.

Conclusion

I am sorry, but from the papers presented to me I am unable to find any evidence to show that the FSA acted either incorrectly or unreasonably when considering Firm A's request to undertake a rights issue to existing shareholders. Likewise there is nothing to suggest that the FSA (or Firm A) either withheld or failed to release information about Firm A's financial position prior to the prospectus being authorised by the FSA or between the prospectus being issued and the rights issue taking place.

Yours sincerely,



Sir Anthony Holland
Complaints Commissioner

Appendix 1

PART II RISK FACTORS

All the information set out in this Prospectus should be carefully considered and, in particular, those risks described below. If any of the following risks actually materialise, HBOS's business, financial condition, prospects and share price could be materially and adversely affected to the detriment of HBOS and its Shareholders and you may lose all or part of your investment. All risks of which the Directors are aware at the date of this Prospectus and which they consider material are set out in this Part II; however, further risks which are not presently known to the Directors, or that the Directors currently deem immaterial, may also have a material effect on HBOS's business, financial condition and operating results. Investors and prospective investors should consider carefully whether an investment in the Company is suitable for them in light of the information in this Prospectus and the financial resources available to them.

1. Risks Relating to the Group and its Business

The Group's business is affected by general economic conditions in the markets in which it operates and in particular in the UK

The Group's business is affected by economic conditions in the UK, where the majority of the Group's earnings are generated, as well as in the other geographical areas in which it operates. Business and consumer confidence, employment trends, the state of the economy, including the state of the UK housing market, the commercial real estate sector, equity markets, inflation, the availability and cost of credit, the liquidity of the global financial markets and market interest rates at the time may impact the Group's earnings. In particular, significantly higher UK unemployment, reduced corporate profitability, increased corporate insolvency rates and/or increased interest rates may reduce borrowers' ability to repay loans and may cause prices of residential or commercial real estate or other asset prices to fall further, thereby reducing the collateral value on many of the Group's loans and increasing impairment losses. An economic downturn, lower transaction volumes in key markets, such as UK housing, or difficult market conditions may also reduce demand for and persistency of many of the Group's products, resulting in lower volumes and profitability. Results from the Group's investment and trading portfolios could also be adversely affected by a general economic downturn or market volatility leading to lower realisations or write-downs of investments. The profitability of the Group's insurance business could be affected by increased claims from factors such as increased unemployment or adverse weather conditions. The Group is also exposed to adverse economic conditions in other jurisdictions where it has material operations. The global and UK financial markets and credit conditions have been affected by financial dislocations which are impacting the wider economy. While the Group believes it has developed a diversified business model to operate in many different markets and cycles, adverse economic conditions in these markets could have a material adverse effect on the Group's business, financial condition and results of operations.

The financial performance of the Group is affected by borrower and counterparty credit quality in the markets in which it operates, in particular in the UK

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of HBOS's businesses. Adverse changes in the credit quality of HBOS's borrowers and counterparties or falls in collateral values could affect the recoverability and value of HBOS's assets and require an increase in HBOS's impairment provision for bad and doubtful debts and other provisions and in turn adversely affect the financial performance of the Group. In particular, higher UK unemployment, reduced corporate profitability and/or increased corporate insolvencies and/or increased interest rates may reduce borrowers' ability to repay loans.

HBOS provides secured and unsecured loans to borrowers, principally in the UK. UK house prices have declined in recent months, reflecting economic uncertainty, reduced affordability and lower availability of credit from lenders. Economic or other factors may lead to further contraction in the mortgage market and further falls in house prices. Many borrowers in the UK borrow on short-term fixed or discounted floating rates and when such rates expire the continued reduced supply of mortgages together with the potential for higher mortgage rates may lead to some borrowers facing significantly higher mortgage interest payments, which could result in higher delinquency rates. The Group provides mortgages to homeowners and also to buy-to-let investors where an excess supply of rental property or falls in rental demand could also impact the borrowers' income and ability to service the loans. These factors and more difficult economic conditions such as increased unemployment could lead to an increase in impairment losses.

HBOS has exposures to a range of corporate customers in different sectors, including investors in and developers of commercial real estate and residential property where exposures arise from loans, joint ventures and other investments. Commercial real estate prices have shown declines over the last year and developers of residential property are facing challenging market conditions including lower prices and volumes. Whilst the Group assesses counterparties principally on the strength of the underlying businesses rather than the value of collateral, a failure of these borrowers or ventures to operate through the economic cycle combined with falls in collateral values could adversely impact the Group's ability to recover on these loans or lead to write-downs of investments in this sector.

The Group uses a range of policies and techniques to mitigate credit risk, including credit scoring, behavioural scoring and affordability measures for retail portfolios, credit assessments for corporate portfolios and credit risk policies. The Group also imposes product, sector and country limits to avoid excessive concentrations of risk. However, these measures will only mitigate, and not avoid, credit risk and the assumptions on which they are based may prove inadequate or inaccurate in light of economic changes or otherwise, in which case credit risk could have a material adverse impact on the Group's financial condition and results of operations.

Changes in interest rates, foreign exchange rates and commodity and equity prices and other market risks affect the Group's business and financial results

Market risk is defined as the potential loss in value or earnings of the Group arising from changes in external market factors such as interest rates, foreign exchange rates, commodity and equity prices and the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Since August 2007, there has been a period of high and volatile interbank lending rates, which has exacerbated this issue. In order to remain competitive, or as a result of rates being fixed in existing loan commitments or facilities the Group may be unable to change the interest rates that it charges or pays to its customers in response to changes in interest rates that affect its wholesale borrowing or may have to increase the rates it pays to wholesale and retail customers.

Changes in currency rates affect the value of assets and liabilities denominated in foreign currencies and may affect earnings reported by HBOS. In the Group's international businesses, earnings and net assets are denominated in local currency which will fluctuate with exchange rates in Sterling terms.

Market risk within the insurance and investment businesses arises in a number of ways and depending upon the product: some risks are borne directly by the customer and some by the Group's insurance and investment businesses. The performance of the investment markets (equities, property and fixed income) has a direct impact on the Group's financial position and performance and can affect investor confidence resulting in lower sales or reduced persistency.

Market and other risks – principally interest rate, inflation, equity and mortality – also arise from the Group's defined benefit pensions obligations.

The Group's treasury trading portfolio also incurs market risk. Marketable assets held in trading and banking books, give rise to market risk as a result of movements in credit spreads. This risk, and its possible impact, is described under "HBOS's future earnings could be affected by declines in financial asset valuations resulting from deterioration in market conditions" below.

Whilst HBOS has implemented risk management methods, including hedging and portfolio diversification, to mitigate and control these and other market risks to which it is exposed, it is difficult to predict with accuracy changes in economic or market conditions, and such changes could have a material adverse effect on HBOS's business, financial position and results of operations.

Funding and liquidity risks are inherent in the Group's operations

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations when they fall due or will have to do so at excessive cost. This risk can arise from mismatches in the timing of cashflows relating to assets, liabilities and off-balance sheet instruments. In order to ensure that the Group continues to meet its funding obligations and to maintain or grow its business generally, it relies on customer savings and transmission balances, as well as ongoing access to the wholesale lending markets. The ability of the Group to access wholesale and retail funding sources on favourable economic terms is dependent on a variety of factors, including a number of factors outside of its control, such as general market conditions and confidence in the UK banking system. In wholesale markets, the Group typically looks to achieve a geographically diverse investor base and product set of an appropriate maturity profile to ensure it is not overly exposed to short-term market dislocation. In the current market conditions, global investor appetite in the medium and long term markets, including securitisations, remains greatly reduced and the cost of wholesale funds remains high by historical comparison. However, HBOS continues to fund effectively and holds a significant liquidity portfolio of assets that are available to generate funds through either outright sale or sale and repurchase arrangements with other market participants, depositories or central banks. In times of systemic market liquidity stress, or in the event of damage to market confidence in HBOS, the Group's ability to access sources of funding and liquidity could be constrained. A worsening of the current systemic market liquidity stress may further constrain HBOS's ability to access sources of funding and liquidity. No statement contained in this risk factor should be taken as qualifying the statements made as to sufficiency of working capital in paragraph 20 of Part XVIII ("Additional Information") of this document.

The Group's insurance businesses are subject to inherent risk involving claims

Insurance risk is the risk that claims arise (in both life assurance and general insurance contracts) from events outside HBOS's control over and above those which have been assumed in pricing and reserving.

Catastrophic weather conditions, particularly storms and flooding, and adverse changes in economic conditions, including increased unemployment, could lead to increased general insurance claims. While HBOS reinsures some of the risks it has assumed, especially in order to mitigate the impact of extreme weather events in the Household book, increased claims would adversely affect the profitability of current and future insurance products and services.

Demographic and medical developments, which give rise to changes in mortality and morbidity, could have an adverse impact on the value of the life assurance portfolio.

The Group's investment businesses are subject to inherent risks including investment returns and actuarial assumptions

Changes in the general economic climate, conditions of financial markets (equities, property or fixed interest assets) and competitor actions can impact the level of demand for HBOS's investment products, their persistency, the value of assets under management and the profit of the businesses.

Under IFRS, UK banks account for long term assurance contracts, being insurance contracts and investment contracts with discretionary participation features, on an Embedded Value ("EV") basis. Applying the EV basis results in the earlier recognition of profit on new business, but subsequently a lower contribution from existing business, when compared to the recognition of profits on investment contracts under IAS 39 (Financial Instruments: Recognition and Measurement). Differences between actual and expected experience on existing business may have a significant impact on an EV basis, as changes in experience can result in significant adjustments to modelled future cashflows. EV is calculated based on best estimate assumptions made by management, including value of investments under management, mortality experience and persistency. If these assumptions prove wrong, the EV of the insurance contracts could be materially reduced, which in turn could have a material adverse effect on the Group's business, financial position and results of operations.

The insurance and investment business includes the Clerical Medical With-Profits Fund, which comprises 18% of the Group's long term insurance and investment contract liabilities. The fund does take some investment risk with the aim of enhancing policyholder returns, but is managed with the intention that the fund is able to support its payouts from its own assets. However, in exceptional circumstances, and even after management action, this might not be possible which may adversely impact HBOS's financial position.

Operational and reputational risks are inherent in the Group's businesses

Operational risk is the risk of opportunities foregone, reputational damage or financial losses resulting from inadequacies or failures in internal processes, people or systems (including IT systems), or from external events. HBOS's businesses are dependent on the ability to process a very large number of transactions efficiently and accurately. Operational risk and losses can result from fraud (including inaccurate information being provided by counterparties or customers on which the Group relies), human error, failure to document transactions properly or to obtain proper internal authorisation, failure of third parties to comply with material agreements, failure to comply with legislative or regulatory requirements and conduct of business rules, equipment failures, information loss, natural disasters or the failure of external systems, for example, those of HBOS's suppliers or counterparties.

Damage to HBOS's reputation including to consumer confidence could have a significant adverse impact on the Group's business. Although HBOS has implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures and to staff training, there can be no assurance that such procedures will be effective in controlling each of the operational risks or that damage to HBOS's reputation will not arise, which could have a material adverse effect on the Group's business, financial position and results of operations.

This risk factor should not be taken as implying that either HBOS or any other member of the Group will be unable to comply with their obligations as companies with securities admitted to the Official List or as supervised firms regulated by the FSA.

HBOS's borrowing costs and its access to the capital markets depend significantly on its credit ratings

The long-term credit ratings for HBOS and Bank of Scotland are, respectively, AA- and AA with a stable outlook from S&P's rating service, Aa2 and Aa1 with a negative outlook from Moody's rating service, AA+ and AA+ with a negative outlook from Fitch Ratings and AA (high) with a negative outlook from DBRS. Reduction in the long-term credit ratings of HBOS or Bank of Scotland may increase its borrowing costs, limit its access to the capital markets and trigger additional collateral requirements in derivative contracts and other secured funding arrangements. Therefore, a reduction in credit ratings could adversely affect the Group's access to liquidity and competitive position and, hence, have a material adverse effect on the Group's business, financial position and results of operations.

HBOS is subject to capital requirements that could limit its operations

HBOS and certain other members of the Group are subject to capital adequacy guidelines adopted by the FSA for a bank or a bank holding company, which provide for a minimum ratio of total capital to risk-adjusted assets both on a consolidated basis and on a solo-consolidated basis expressed as a percentage.

The risk-adjusted capital guidelines (the "Basel Accord") promulgated by the Basel Committee on Banking Supervision (the "Basel Committee"), which form the basis for the FSA's capital adequacy guidelines, have been revised and implemented in the UK with effect from 1 January 2007 ("Basel II"). The principal changes effected by the revised guidelines include a range of options to determine risk-weighting. In this regard, HBOS has adopted the Advanced Internal Ratings Based Approach (for Credit Risk) and the Advanced Measurement Approach (for Operational Risk) with effect from 1 January 2008. This follows a year of parallel running of these approaches. Certain portfolios remain on the standardised approach with agreement with the FSA of a timetable for further roll out of credit risk models over the next two years. Under Basel II, capital requirements are inherently more volatile than under previous regimes and will increase if economic conditions or default trends worsen.

The Group's banking businesses outside the UK are subject to the capital adequacy regimes of those jurisdictions, some of which will implement Basel II on a longer time frame.

The Group's life assurance and general insurance businesses in the UK are also subject to the capital requirements prescribed by the FSA, and the Group's life and general insurance companies outside the UK are subject to local regulatory capital requirements. In July 2007, the European Commission published a draft proposal for primary legislation to define broad "framework" principles for Solvency II, a fundamental review of the capital adequacy regime for the European insurance industry. Solvency II aims to establish a revised set of EU-wide capital requirements where the required regulatory capital will be dependent upon the risk profile of the entities, together with risk management standards, that will replace the current Solvency I requirements. At this early stage of development, it is not possible to predict the ultimate impact of this proposed regime on the Group's capital. However, the final regime could significantly impact the capital the Group's life assurance and general insurance businesses are required to hold.

HBOS's failure to maintain adequate capital ratios may result in administrative actions or sanctions against it which may have a material adverse impact on HBOS's business, financial position and results of operations.

The values of certain securities held by the Group are recorded at fair value as determined by using financial models incorporating assumptions, judgements and estimates that are inherently uncertain and which may change over time

Under IFRS as adopted by the EU, HBOS recognises at fair value: (i) financial instruments classified as "held-for-trading" or "designated as at fair value through profit or loss", (ii) financial assets classified as "available-for-sale" and (iii) derivatives. The fair value of investment securities trading in active markets is based on market prices or broker/dealer valuations. Where quoted prices on instruments are not readily and regularly available from a recognised broker, dealer or pricing service, or available prices do not represent regular transactions in the market, the fair value is estimated. These estimates are referenced based on quoted market prices for securities with similar credit, maturity and yield characteristics or similar valuation models. In certain circumstances, the data for individual financial instruments or classes of financial instrument utilised by such valuation models may not be available or may become unavailable due to changes in market conditions, as has recently been the case. In such circumstances, HBOS's internal valuation models require it to make assumptions, judgements and estimates in order to establish fair value. In common with other financial institutions, these internal valuation models are complex, and the assumptions, judgements and estimates HBOS is required to make often relate to matters that are inherently uncertain. Such assumptions, judgements and estimates are updated to reflect changing trends and market conditions. Any change in the fair values of the financial instruments could have a material adverse effect on HBOS's business, financial position and results of operations.

HBOS's future earnings could be affected by declines in financial asset valuations resulting from deterioration in market conditions

Financial markets are sometimes subject to significant stress conditions where steep falls in perceived or actual asset values are accompanied by a severe reduction in market liquidity, as exemplified by recent events.

The Group's Treasury division holds a portfolio of debt securities. Included within this portfolio HBOS has credit exposure to monolines both through wrapped bonds and purchased credit default swap protection. At 31 December 2007 and subsequently, the Group made negative fair value adjustments relating primarily to its holdings of asset backed securities and floating rate notes in its trading books, and to its available for sale reserves in respect of its holding of debt securities in its banking book (although the banking book adjustments have no impact on reported profits or regulatory capital strength unless there is a credit impairment or assets are sold at below cost).

Whilst HBOS believes it has adopted a prudent basis for the valuation of its treasury assets, the fair value of these assets could fall further than currently estimated and therefore result in additional negative adjustments. In addition, default by a monoline insurer in respect of wrapped bonds or credit default swaps held by the Group could lead to further deterioration in asset values. Valuations in future periods, reflecting then-prevailing market conditions, may result in further negative changes in the fair values of the Group's treasury assets. In addition, the value ultimately realised by HBOS may be different from the

current or estimated fair value and changing economic circumstances may result in some credit impairment. Any of these factors could require HBOS to recognise further fair value adjustments or realise impairment charges, any of which may have a material adverse effect on its capital position, financial condition and results of operations.

Each of the Group's businesses is subject to substantial regulation and oversight. Any significant regulatory developments could have an effect on how the Group conducts its business and on its results of operations.

The Group is subject to laws, regulations, administrative actions and policies in each location in which it operates, all of which are subject to change. The FSA is the main regulator for HBOS, although the Group's international businesses in the United States, Australia and Ireland are subject to direct scrutiny from the Board of Governors of the Federal Reserve System and the Comptroller of the Currency, the Australian Prudential Regulation Authority and the Irish Financial Regulator respectively. Changes in supervision and regulation, in particular in the UK, could materially affect the Group's businesses, the products and services offered or the value of its assets. Although the Group works closely with its regulators and continually monitors developments, future changes in regulation, fiscal or other policies can be unpredictable and are beyond the control of the Group. Areas where changes could have an adverse impact include, but are not limited to:

- the monetary, interest rate and other policies of central banks and regulatory authorities;
- general changes in government or regulatory policy or changes in regulatory regimes that may significantly influence investor decisions in particular markets in which HBOS operates, may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;
- other general changes in the regulatory requirements, such as prudential rules relating to the capital adequacy or liquidity frameworks;
- changes to the arrangements for funding depositor or investor protection schemes and providing compensation in the event of a failure of another regulated firm;
- external bodies applying or interpreting standards or laws differently to those applied by the Group historically;
- changes in competition and pricing environments;
- further developments in the financial reporting environment;
- expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; and
- other unfavourable political, military or diplomatic developments producing social instability or legal uncertainty which, in turn, may affect demand for HBOS's products and services.

Further changes to the regulatory requirements applicable to the Group, in particular in the UK, whether resulting from recent events in the credit markets or otherwise, could have a material adverse effect on its business, the products and services it offers, its financial position and results of operations.

HBOS is subject to litigation and regulatory investigations which may impact its business

HBOS and its subsidiaries operate in a legal and regulatory environment that exposes them to potentially significant litigation and regulatory risks. As a result, the Group is and may in the future be involved in various disputes and legal proceedings in the UK and the other jurisdictions in which it operates, including litigation and regulatory investigations. Such cases are subject to many uncertainties, and their outcome is often difficult to predict, particularly in the earlier stages of a case or investigation. Currently, the Group is responding to regulatory inquiries and investigations and is involved in litigation arising from its operations. Regulatory intervention is an ongoing feature of UK retail banking and changes could affect the profitability of the Group's Retail business. For example, HBOS is one of eight banks involved in a test case to resolve legal uncertainties concerning the fairness and lawfulness of unarranged overdraft charges. In addition, the Competition Commission investigation of the payment protection insurance market may ultimately impact the profitability of HBOS and across the industry more generally. For details about certain litigation and regulatory investigations in which HBOS is involved, see paragraphs 18 and 19 of Part XVIII ("Additional Information").

Adverse regulatory action against the Group or adverse judgements in litigation to which the Group is a party could result in restrictions or limitations on the Group's operations or result in a material adverse effect on the Group's reputation, business and results of operations.

Future earnings growth and shareholder value creation depend on the Group's strategic decisions

Significant resources are devoted to the formulation and implementation of the Group's strategy. If elements of the strategy do not deliver as intended, either as a result of internal factors such as poor implementation associated with strategic change, or external factors, such as competitor actions, the Group's earnings may grow more slowly or decline.

The Group's financial performance is subject to substantial competitive pressures

There is substantial competition for the types of banking and other products and services that the Group provides in the regions in which it conducts its business. The intensity of this competition is affected by competitor behaviour, consumer demand, technological changes, the impact of consolidation, regulatory actions and other factors.

The Group's financial performance may be adversely impacted by competition, including declining lending margins or competition for savings driving up funding costs which cannot be recovered from borrowers. Customer attrition, as well as adverse persistency, in the Group's Investment business and General Insurance business is a risk to current and future earnings. The Group's growth plans are predicated on attracting customers from competitors and retaining and broadening existing customer relationships. If HBOS is not successful in attracting new customer relationships or retaining and broadening existing customer relationships, the Group will not be able to deliver the level of growth that it expects. The success of the Group's strategy will also be affected by the competitor reaction of both incumbent banks and new entrants to its markets.

If the Group is unable to provide attractive product and service offerings that are competitive and profitable, it may lose market share, incur losses on some or all of its activities or fail to attract new and retain existing deposits, which could have a material adverse effect on its business, financial position and results of operations.

HBOS may be adversely affected by changes in taxation legislation

HBOS's tax charge is based on current legislation in the countries in which the Group operates. Taxation legislation may be subject to future changes which could have a material adverse effect on HBOS's results of operation and financial condition.

HBOS could fail to attract or retain senior management or other key employees

HBOS's success depends on the ability and experience of its senior management. The loss of the services of certain key employees, particularly to competitors, could have a material adverse effect on the Group's revenue, profit and financial condition. In addition, as the Group's business develops, both in the UK and in other jurisdictions, the Group's future success will depend on its ability to attract and retain highly skilled and qualified personnel, which cannot be guaranteed. The failure to attract or retain a sufficient number of appropriate personnel could significantly impede HBOS's financial plans, growth and other objectives and have a material adverse effect on the Group's business, financial position and results of operations.

2. Risks Relating to the Rights Issue and the New Shares

HBOS's share price will fluctuate

The market price of the New Shares (including the Nil Paid Rights and the Fully Paid Rights) and/or the Shares could be subject to significant fluctuations due to a change in sentiment in the market regarding the New Shares (including the Nil Paid Rights and the Fully Paid Rights) and/or the Shares (or securities similar to them). Such fluctuations may depend on the market's perception of the likelihood of completion of the Rights Issue, and/or in response to various facts or events, including any regulatory changes affecting the Group's operations, variations in the Group's own operating results, business developments of the Group or those of its competitors or economic changes. Stock markets have, from time to time, experienced significant price and volume fluctuations that have affected the market prices for securities and which may be unrelated to the Group's operating performance or prospects. Furthermore, the Group's operating results and prospects from time to time may be below the expectations of market analysts and investors. Any of these events could result in a decline in the market price of the New Shares (including the Nil Paid Rights and the Fully Paid Rights) and/or the Shares.

An active trading market in the Nil Paid Rights may not develop

An active trading market in the Nil Paid Rights may not develop on the London Stock Exchange during the trading period. In addition, because the trading price of the Nil Paid Rights depends on the trading price of the Shares, the Nil Paid Rights price may be volatile and subject to the same risks as noted elsewhere herein. This may impact on investors' ability to sell Nil Paid Rights should they wish to do so.

HBOS's ability to continue to pay dividends will depend on the level of profits and cash flows generated by the Group

Under UK company law, a company can only pay cash dividends to the extent that it has distributable reserves and cash available for this purpose. As a holding company, HBOS's ability to pay dividends in the future is affected by a number of factors, principally its ability to receive sufficient dividends from subsidiaries. The payment of dividends to HBOS by its subsidiaries is, in turn, subject to restrictions, including certain regulatory requirements and the existence of sufficient distributable reserves and cash in HBOS's subsidiaries.

The ability of these subsidiaries to pay dividends and HBOS's ability to receive distributions from its investments in other entities are subject to applicable local laws and regulatory requirements and other restrictions, including, but not limited to, applicable tax laws and covenants in some of HBOS's debt

facilities. These laws and restrictions could limit the payment of dividends and distributions to HBOS by its subsidiaries, which could in future restrict HBOS's ability to fund other operations or to pay a dividend to holders of the Existing Shares or the New Shares.

Shareholders who do not subscribe in full for their entitlement to New Shares in the Rights Issue will experience dilution in their ownership of HBOS

If Shareholders do not subscribe in full for their entitlement to New Shares under the Rights Issue their proportionate ownership and voting interests in HBOS will be reduced and the percentage that their shares will represent of the total share capital of the Company will be reduced accordingly. Even if a Shareholder elects to sell his Nil Paid Rights, or such Nil Paid Rights are sold on his behalf, the consideration he receives may not be sufficient to compensate him fully for the dilution of his percentage ownership of the Company's share capital that may be caused as a result of the Rights Issue.

If the Company is unable to complete the Rights Issue, it may need to consider alternative methods of increasing its core Tier 1 and Tier 1 capital ratios

The purpose of the Rights Issue is to allow the Company to strengthen its capital position against the backdrop of current market volatility. If the Company is unable to complete the Rights Issue, the Board may need to consider alternative methods for achieving its stated target capital ratios, which could include a reduction in dividends, a reduction in the rate of growth of risk weighted assets, disposal of certain businesses or increased issuance of Tier 1 securities. If such measures were unsuccessful, there is a risk that HBOS would be unable to achieve satisfactory capital ratios and therefore the benefits of such capital ratios would not be obtained.

3. Additional risks for Overseas Shareholders

The ability of Overseas Shareholders to bring actions or enforce judgements against HBOS or the Directors may be limited

The ability of an Overseas Shareholder to bring an action against HBOS may be limited under law. HBOS is a public limited company incorporated in Scotland. The rights of holders of Shares are governed by Scots law and by HBOS's Memorandum and the Articles. These rights differ from the rights of shareholders in typical US corporations and some other non-UK corporations. In particular, both Scots law and English law significantly limit the circumstances under which shareholders of companies may bring derivative actions. Under both Scots and English law generally, only a company can be the proper pursuer or claimant in proceedings in respect of wrongful acts committed against it. In addition, it may be difficult for an Overseas Shareholder to prevail in a claim against HBOS under, or to enforce liabilities predicated upon, non-UK securities laws.

An Overseas Shareholder may not be able to enforce a judgement against some or all of the Directors and executive officers. The vast majority of the Directors and executive officers are residents of the UK and currently only one is a resident of the United States. Consequently, it may not be possible for an Overseas Shareholder to effect service of process upon the Directors and executive officers within the Overseas Shareholder's country of residence or to enforce against the Directors and executive officers judgements of courts of the Overseas Shareholder's country of residence based on civil liabilities under that country's securities laws. There can be no assurance that an Overseas Shareholder will be able to enforce any judgements in civil and commercial matters or any judgements under the securities laws of countries other than the UK against the Directors or executive officers who are residents of the UK or countries other than those in which judgement is made. In addition, English or other courts may not impose civil liability on the Directors or executive officers in any original action based solely on the foreign securities laws brought against HBOS or the Directors in a court of competent jurisdiction in England or other countries.

Appendix 2

PART XVI RISK MANAGEMENT

1. Introduction

Identification, measurement and management of risk are a strategic priority for the Group. The Board has established a comprehensive framework covering accountability, oversight, measurement and reporting to maintain high standards of risk management throughout the Group.

2. Key risks and uncertainties facing the Group

The key risks and uncertainties faced by the Group are set out in Part II ("Risk Factors").

3. Management and Controls

3.1 Governance

The Group's governance model comprises a robust committee structure that allows an efficient and mutually supportive control environment across the Group. The governance framework description set out in this Part XV is not intended to cover the business and control environments of St James's Place plc and Invista Real Estate Investment Holdings plc.

The Board is responsible for setting the Group's risk appetite and does so through an iterative process that aims to ensure that the Group's approved business plan is consistent with the Board's appetite for risk.

The strategy for managing risk is formulated by the HBOS Executive Committee (the "Executive Committee") and is informed through divisional and Group planning and key performance indicators, including monthly financial and business performance reporting of variances against plan.

The Board has overall responsibility for the Group's system of control and approval of principal risk policies and standards. The Board is also responsible for reviewing the effectiveness of the systems and controls. The system of controls described in this section accords with the Turnbull guidance on internal control and has also been reviewed by the Board. Within the Group, risk is managed in accordance with the following principles.

3.2 Risk Appetite

The Group uses risk appetite to describe:

- The level of acceptable risk given the Group's appetite for earnings volatility, external stakeholder expectations and any other defined objectives such as paying dividends; and
- The types of risk the Group is prepared to accept in line with its control environment and the market conditions in which it operates.

Key risks are identified and managed to achieve a balance between risk and reward which is acceptable to the Board. The Board carries out an annual strategic review of risk management, its appetite for risk and the Group's annual business plan. This focus on aligning the taking of risk with the achievement of business objectives means that the control system is designed to manage, rather than eliminate, risk. The Board also reviews the effectiveness of risk management through regular management information reporting.

Responsibility for risk is a key element of managers' competencies at all levels. Specialist Group and divisional risk teams have been established where appropriate to assist managers across the Group. Specialist risk managers research industry best practice and ensure that standards and policies within the Group evolve in line with recognised risk management practice.

Staff and systems resources are dedicated to ensuring that risk management information is accurate, timely and relevant to the business.

3.3 The Risk Management Framework

The Group allocates specific roles in the management of risk to executives and senior managers and to the Board and Executive Committees. This is undertaken within an overall framework and strategy established by the Board. The model is based on the concept of "three lines of defence", as shown in the table below.

1st Line of Defence	RISK MANAGEMENT	<ul style="list-style-type: none"> ● Divisional CEOs ● Divisional Risk Specialists ● Divisional Risk Committees 	<ul style="list-style-type: none"> ● Strategy ● Performance ● Risk control
2nd Line of Defence	RISK OVERSIGHT	<ul style="list-style-type: none"> ● Group Chief Executive ● Executive Committee ● Group Functions (incl. Group Risk and Group Finance) ● Executive Risk Committees 	<ul style="list-style-type: none"> ● Centralised policy management ● Independent oversight of risk
3rd Line of Defence	RISK ASSURANCE	<ul style="list-style-type: none"> ● Audit Committee ● Divisional Risk Control Committees ● Group Internal Audit 	<ul style="list-style-type: none"> ● Independent assurance

Divisional management has primary responsibility for identifying and evaluating significant risks to the business and for designing and operating suitable controls. Internal and external risks are assessed, including economic factors, control breakdowns, disruption of information systems, competition and regulatory requirements.

The four Group Executive Risk Committees – the Group Credit Risk Committee, the Group Market Risk Committee, the Group Insurance Risk Committee and the Group Operational Risk Committee develop the policies and parameters within which Divisions are required to manage risk. These Committees provide central oversight by reviewing and challenging the work of the Divisions and considering the application of appropriate risk management techniques.

The specialist Group Risk function, reporting to the Group Risk Director, supports these Group Executive Risk Committees. Its responsibilities are:

- to recommend Group policies, standards and limits;
- to monitor compliance with those policies, standards and limits;
- to provide leadership in the development and implementation of risk management techniques; and
- to aggregate risks arising in the Divisions and to monitor the overall Group position independently from the Divisions' own analysis.

Consideration of capital, liquidity and balance sheet management is undertaken on an integrated basis. All capital and funding related activities are the responsibility of the Group Capital Committee, supported by three sub-committees, which focus on the core aspects of overall Group requirements. The Group Capital Committee is chaired by the Group Finance Director and operates under delegated authority from the Board to oversee and manage the Group's balance sheet and capital in accordance with the Board approved Group business plan and within regulatory ratios.

In judging the effectiveness of the Group's controls, the Board reviews the reports of the Audit Committee and management. Certain responsibilities are delegated to the Audit Committee, including ensuring that there is an ongoing review of the adequacy and effectiveness of the internal control environment procedures. This role provides oversight on the financial internal control environment throughout the Group.

The Audit Committee, supported by Divisional Risk Control Committees, obtains assurance about the internal control and risk management environment through regular reports from Group Functions (including Group Risk and Group Finance) and Group Internal Audit. It also considers external auditors' reports.

4. Management of Key Risks

The Group is committed to developing its risk management techniques and methodologies, both to maintain high standards of risk management practice and to fulfil the requirements of UK and international regulators.

5. Credit Risk

Credit Risk is the risk of financial loss resulting from counterparty's failure to settle financial obligations as they fall due.

The Group Credit Risk Committee, one of the Group Executive Risk Committees, is chaired by the Group Risk Director and comprises senior executives from across the business Divisions and Group Risk and Group Finance functions. It meets monthly and reviews the Group's lending portfolio, approves material credit models and Group credit standards, limits and divisional credit risk policies. The Group Credit Risk Policy Statement is approved by the Board on an annual basis. The Group Credit Risk Committee also assists the Board in formulating the Group's credit risk appetite in respect of key products and sectors.

Group Credit, a specialist support function within Group Risk, provides centralised expertise in the area of credit risk measurement and management techniques. In addition to reporting on the performance of each divisional portfolio to the Group Credit Risk Committee, Group Credit exercises independent oversight over the effectiveness of credit risk management arrangements and adherence to approved policies, standards and limits.

Day to day management of credit risk is undertaken by specialist credit teams working within each Division in compliance with policies approved by the Board. Typically functions undertaken by these teams include credit sanctioning, portfolio management and management of high risk and defaulted accounts and credit risk model build and governance.

To mitigate credit risk, a wide range of policies and techniques are used across the Group:

- For retail portfolios use is made of credit scoring software for new applications. In addition, behavioural scoring is used to provide an assessment of the conduct of a customer's accounts in granting extensions to, and setting limits for, existing facilities. Affordability is a vitally important measure and is reviewed in combination with either application and/or behavioural scores. Small business customers may be rated using scorecards in a similar manner to retail customers.
- For corporate portfolios a full independent credit assessment of the financial strength of each potential transaction and/or customer is undertaken awarding an internal risk rating which is reviewed regularly. The same approach is also used for larger small to medium enterprise ("SME") customers.
- Within Treasury, which handles the Group's banking and sovereign related exposures, as well as the Group's structured credit bond portfolio held for liquidity and proprietary purposes, focused credit risk policies are established and reviewed by Group Wholesale Credit Committee ("GWCC"), a sub-committee of the Group Credit Risk Committee. Basel II Advanced IRB compliant models are used to rate banking and sovereign counterparties. Structured credit bonds are reviewed individually by an independent credit function prior to purchase and an internal rating is applied to all exposures. The rating assessment is commensurate with, and often more stringent than, those of the external credit rating agencies. Additional thresholds and limits are applied by rating and asset class and, as part of an ongoing portfolio review process, thorough surveillance is performed covering each bond holding, supplemented by stress analyses conducted on a periodic basis.

An additional measure within the credit risk framework is the establishment of product, industrial sector and country limits to avoid excessive concentrations of risk. Material portfolios, such as mortgages, have approved sub-sector limits to ensure that they remain within plan and tolerance for risk. All such limits are set and monitored by the Group Credit Risk Committee. Standards have been established across the Group for the management of credit risk. All Divisions are committed to continuously improving credit risk management. There continues to be investment in the development of credit risk rating tools, including enhancements to the portfolio risk measurement systems and in governance arrangements to support operations within the terms of the Basel II Accord. These include principles for development, validation and performance monitoring of credit risk models. The approval process for credit models is dependent upon materiality, with all models impacting the regulatory capital calculation requiring approval by the Group Credit Risk Committee and those deemed material to the Group being approved by the Group Capital Committee.

Internal reporting has developed further in response to the introduction of improved rating tools. Senior Management across the Group are now capable of assessing the risk profile in terms of Probability of Default and Expected Loss and will do so under the Basel II environment going forward.

5.1 Financial Instruments Subject to Credit Risk

The table below sets out the Group's exposure to credit risk relating to financial instruments before taking account of collateral and other security. Policyholder assets are excluded from the analysis in this table as the underlying credit risks are for the account of the policyholders and have no direct impact on the Group's results.

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	(£m)	
Loans and advances to customers	430,007	376,808
Financial assets held for trading	54,681	49,139
Debt securities	56,839	49,901
Other financial assets	24,215	22,290
	<u>565,742</u>	<u>498,138</u>
Contingent liabilities and commitments	106,718	90,944
Total	<u>672,460</u>	<u>589,082</u>

Loans and Advances to Customers

Loans and advances to customers are managed on a divisional basis.

Financial Assets Held for Trading

Management of credit risk within Treasury portfolios relies on obtaining detailed knowledge and understanding of the assets and issuers it deals with. As described above, full credit analysis is undertaken and, based upon that, an internal rating is derived which helps to establish a credit appetite for the issuer or asset intended to be acquired.

As Treasury manages the liquidity of the Group, its mandate is to maintain a high quality credit portfolio and, in addition to the credit process mentioned above, it also actively uses portfolio techniques to manage and monitor the quality of its portfolios, and to avoid concentration risk.

This includes the use of rating based thresholds, established portfolio level thresholds, asset class limits and sub-limits. There are also rules governing the types of assets that can be held within Treasury's Liquidity portfolios, Trading and Banking books and for individual Asset Backed Security ("ABS") tranche sizes. There are also limits controlling the maximum weighted average life of assets.

As at 31 December 2007, financial assets held for trading were almost exclusively investment grade investments with 99.6% (2006 99.5%) of inter-bank and structured investment portfolios rated A or above based on an internal credit ratings scale that is, in general, aligned with the ratings scales of the major credit ratings agencies (Moody's, S&P and Fitch).

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	%	
AAA	51.5	51.9
AA	34.4	30.6
A	13.7	17.0
Below A	0.4	0.5

Debt Securities

Debt securities are primarily held within the Treasury or Insurance & Investment Divisions and as at 31 December were almost exclusively invested in investment grade counterparties with 96.5% (2006 94.0%) of debt securities rated 'A' or above, again based on the Group's internal rating scale.

	<i>As at 31 December 2007</i>	<i>As at 31 December 2006</i>
	%	
AAA	57.8	67.6
AA	25.8	18.2
A	12.9	8.2
Below A	3.5	6.0

The AAA proportion of the portfolio fell during 2007 due to two factors: (i) a reduction in sovereign assets and (ii) an increase in the size of the portfolio comprising mainly AA and A assets, thereby reducing the AAA proportion.

Other Financial Assets

Other financial assets include cash and balances at central banks, items in the course of collection, derivative assets, loans and advances to banks and sundry financial assets.

6. Market Risk

Market risk is defined as the potential loss in value or earnings of the organisation arising from:

- changes in external market factors such as interest rates (interest rate risk), foreign exchange rates (foreign exchange risk), commodities and equities; and
- the potential for customers to act in a manner which is inconsistent with business, pricing and hedging assumptions.

The objectives of the Group's market risk framework are to ensure that:

- market risk is taken only in accordance with the Board's appetite for such risk;
- such risk is within the Group's financial capability, management understanding and staff competence;
- the Group complies with all regulatory requirements relating to the taking of market risk; and
- the quality of the Group's profits is appropriately managed and its reputation safeguarded.

Risk appetite is set by the Board which allocates responsibility for oversight and management of market risk to the Group Market Risk Committee, an Executive Risk Committee chaired by the Group Risk Director.

The Group devotes resources to ensuring that market risk is comprehensively captured, accurately modelled and reported, and effectively managed. Trading and non-trading portfolios are managed at various organisational levels, from the Group overall, down to specific business areas. Market risk measurement and management methods are designed to meet or exceed industry standards, and the tools used facilitate internal market risk management and reporting.

Market risk is controlled across the Group by setting limits using a range of measurement methodologies. The principal methodologies are Net Interest Income ("NII") sensitivity and Market Value ("MV") sensitivity for banking books and Value-at-Risk ("VaR") for trading books. All are supplemented by scenario analysis which is performed in order to estimate the potential economic loss that could arise from extreme, but plausible stress events.

Detailed market risk framework documents and limit structures have been developed for each division. These are tailored to the specific market risk characteristics and business objectives of each division. Each divisional policy requires appropriate divisional sanction, and is then forwarded to the Group Market Risk Committee for approval on at least an annual basis.

Market risk within the insurance and investment businesses arises in a number of ways and, depending upon the product; some risks are borne directly by the customer and some by the insurance and investment companies. Risk to customers is controlled by adherence to and regular monitoring of investment mandates and, if appropriate, unit pricing systems and controls. In the case of the risk to the companies, individual Boards approve overall risk appetites and policies against which exposure is monitored.

Market risk – principally interest rate, inflation and equity – also arises from the Group's defined benefit pensions obligations. These sensitivities are regularly measured and are reported to the Group Market Risk Committee every month.

6.1 Interest Rate Risk (Non-Trading)

A key market risk faced by the Group in its non-trading book is interest rate risk. This arises where the Group's financial assets and liabilities have interest rates set under different bases or reset at different times.

The principal Board limit for structural interest rate risk is expressed in terms of potential volatility of net interest income in adverse market conditions. Risk exposure is monitored using the following measures:

- Net Interest Income sensitivity – This methodology comprises an analysis of the Group's current interest rate risk position overlaid with behavioural assessment and re-pricing assumptions of planned future activity. The change to forecast NII is calculated with reference to a set of defined parallel interest rate shocks which measure how much current projections would alter over a 12 month period.
- Market Value sensitivity – This methodology considers all re-pricing mismatches in the current balance sheet including those beyond the time horizon of the NII measure. It is also calculated with reference to a set of defined parallel interest rate shocks.

The Board has delegated authority to the Group Market Risk Committee to allocate limits to divisions as appropriate within the overall risk appetite approved by the Board each year. In turn, the Group Market Risk Committee has granted limits which constitute the risk tolerance for each division.

Banking divisions are required to hedge all significant open interest rate mismatch positions with Treasury and are not permitted to take positions of a speculative nature. A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

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

Net Interest Income Sensitivity

The following table shows, split by major currencies, the Group's sensitivities as at 31 December 2007 to an immediate up and down 25 basis points change to all interest rates.

Impact of interest rate shift

	As at 31 December 2007	
	+ 25 bps	- 25 bps
	(£m)	
Currency	(21.2)	21.6
Sterling	(0.6)	0.5
US Dollar	(4.3)	4.3
Euro	0.1	(0.1)
AU Dollar	0.1	(0.1)
Other		
Total	(25.9)	26.2

Impact of interest rate shift

	As at 31 December 2006	
	+ 25 bps	- 25 bps
	(£m)	
Currency	(14.1)	16.0
Sterling	(1.2)	1.2
US Dollar	(4.4)	4.4
Euro	1.0	(1.2)
AU Dollar	(0.2)	0.2
Other		
Total	(18.9)	20.6

Base case projected NII is calculated on the basis of the Group's current balance sheet, forward rate paths implied by current market rates, and contractual re-pricing dates (adjusted according to behavioural assumptions for some products); it also incorporates business planning assumptions about future balance sheet volumes and the level of early redemption fees. The above sensitivities show how this projected NII would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

The principal driver of the risk is re-pricing mismatch but the methodology also recognises that behavioural re-pricing assumptions – for example, prepayment rates – are themselves a function of the level of interest rates.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount. Also, it does not incorporate the impact of management actions that, in the event of an adverse rate movement, could reduce the impact on NII.

Reserve Sensitivity

The following table shows the market value sensitivity, for a 25 basis point shift, of those items in respect of which a change in market value must be reflected in the equity of the Group – principally "available for sale" assets and cash flow hedges.

	As at 31 December 2007		As at 31 December 2006	
	+ 25 bps	- 25 bps	+ 25 bps	- 25 bps
	(£m)			
Available for sale reserve	(15.7)	15.7	(21.9)	21.9
Cash flow hedge reserve	101.5	(101.5)	76.4	(76.4)
Total	85.8	(85.8)	54.5	(54.5)

6.2 Foreign Exchange Risk (Non-Trading)

The Group Funding & Liquidity Committee ("GFLC") is responsible for the framework within which structural foreign currency risk is managed. The GFLC manages foreign currency exposures based on forecast currency information provided by the Divisions, and mandates Treasury to execute transactions and undertake currency programmes to manage structural currency risk. The actual risk position is monitored monthly by the Group Market Risk Committee.

Transaction exposures arise primarily from profits generated in the overseas operations, which will be remitted back to the UK and then converted into sterling.

Translation exposures arise due to earnings that are retained within the overseas operations and reinvested within their own balance sheet.

Structural currency exposures arise from the Group's investments in overseas subsidiaries, branches and other investments and are noted in the table below.

Functional currency of the operation	Net investments in overseas operations	Borrowing taken out to hedge net investments (£m)	As at
			31 December 2007 Remaining structural currency exposure
AU Dollar	2,023	2,023	
Euro	1,888	1,613	275
US Dollar	97	97	
Other	4		4
Total	4,012	3,733	279

Functional currency of the operation	Net investments in overseas operations	Borrowing taken out to hedge net investments (£m)	As at
			31 December 2006 Remaining structural currency exposure
AU Dollar	1,560	1,560	
Euro	1,464	1,224	240
US Dollar	106	99	7
Other	13		13
Total	3,143	2,883	260

As at 31 December 2007 and 31 December 2006, there were no material net currency exposures in the Group's non-trading book relating to transactional (or non-structural) positions that would give rise to net currency gains or losses.

6.3 Trading

The Group's market risk trading activities are conducted by Treasury. This Group activity is subject to a Trading Book Policy Statement, which is approved by the Board, and limits set by the Group Market Risk Committee.

Treasury trading primarily centres around two activities: proprietary trading and trading on the back of business flows. Both activities incur market risk, the majority being interest rate and foreign exchange rate exposure. In addition, a number of marketable assets held as part of the Group's liquidity risk management framework are also held in trading books. Such activity gives rise to market risk as a result of movements in credit spread.

The framework for managing the market risk in these activities requires detailed and tailored modelling techniques, which are the responsibility of the Treasury Market Risk team.

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 as part of the Group's management for trading activity, expresses market risk to 99% confidence using a one day holding period. The number provides an indication of the maximum mark to market loss which, to this level of confidence, might be incurred on a single day given the size of current trading positions. It is computed using a historical simulation approach and a one year history of price data.

The underlying assumption of VaR is that future price volatility and correlation will not differ significantly from that previously observed. It also implicitly assumes that all positions are sufficiently liquid to be realisable within the chosen one day holding period. Also, VaR gives no indication of the size of any loss that could occur from extreme adverse price changes (i.e. outside the chosen confidence level). For these reasons, stress testing is employed to simulate the effect of selected adverse market movements. Such measures are particularly relevant when market conditions are abnormal and daily price movements are difficult to source, as has been the case in a number of financial markets since August 2007.

The large increase in VaR, relative to 31 December 2006, is due principally to higher price volatility in wholesale markets – the size of underlying trading positions has not changed materially.

As at 31 December 2007, the regulatory capital charge for market risk trading exposures represents only 1.87% (2006 1.93%) of the Group's capital base.

For all significant exposures VaR is calculated on a daily basis and is used by senior management to manage market risk. On a more detailed desk and trader level, to increase transparency, interest rate risk relating to the trading book is principally managed using sensitivity methodology to measure exposure and set limits. This methodology calculates the present value impact of a one basis point movement in interest rates on the outstanding positions. Credit spread risk is managed using credit spread VaR and position limits based on credit spread sensitivity. Foreign exchange risk is principally managed by the use of position limits. Equity risk is managed through Equity Index VaR and position limits.

The Group's trading market risk exposure for the year ended 31 December 2007 is analysed below.

Exposure	As at 31 Dec. 2007	As at 31 Dec. 2006	Average		Highest		Lowest	
			2007	2006 (£m)	2007	2006	2007	2006
Total Value at Risk	13.2	4.5	7.6	4.2	13.9	6.4	4.0	2.9
Included in the above is the Value at Risk relating to:								
Interest rates	4.7	2.2	3.0	2.4	5.9	3.9	1.7	1.4
Credit spread	8.3	2.0	4.3	1.4	8.4	3.9	1.8	0.9
Foreign exchange	1.9	0.2	0.6	0.3	2.0	0.7	0.1	0.1
Equity risk factor	0.2	0.1	0.2	0.1	0.4	0.4		

6.4 Derivatives

In the normal course of 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, credit derivatives, forward foreign exchange contracts and futures. The Group uses derivatives 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 the Board and overseen by the relevant Group Risk Committees.

7. Liquidity Risk

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations when they are due or will have to do so at excessive cost.

Liquidity risk is governed by the Group Liquidity Policy Statement ("GLPS"), which is approved by the Board and defines the core principles for identifying, measuring, managing and monitoring liquidity risk across the Group. Detailed liquidity risk framework documents and limit structures are in place for the Group's operations, where liquidity is managed on a group basis, and for overseas banking units subject to specific regulatory requirements. The responsibility for oversight and management of Liquidity Risk is delegated to the Group Capital Committee ("GCC").

Policy is reviewed at least annually to ensure its continued relevance to the Group's current and planned operations. Operational liquidity management is delegated to Treasury. The authority to set specific limits and guidelines and responsibility for monitoring and controlling liquidity is delegated by the GCC to the GFLC (a sub-committee of the GCC).

The Group's banking operations in the UK comply with the FSA's Sterling Stock Liquidity approach for sterling liquidity management and regulatory reporting. A key element of the FSA's Sterling Stock Liquidity Policy is that a bank should hold a stock of high quality liquid assets that can be sold quickly and discretely in order to replace funding that has been withdrawn due to an actual or perceived problem with the bank. The objective is that this stock should enable the bank to continue business, while providing an opportunity to arrange more permanent funding solutions. Limits on the five day sterling net wholesale

outflow and the minimum level of stock liquidity have been agreed with the FSA. In addition, GFLC has set a requirement for the stock liquidity ratio of at least 105% (the FSA minimum level is 100%).

The Group also adheres to the requirements of other regulatory authorities, including the Australian Prudential Regulatory Authority and the Irish Financial Regulator, in whose jurisdictions the Group has branches or subsidiaries.

The internal approach to liquidity management, which has been in place for several years, goes beyond the regulatory requirements (in terms of the depth of analysis conducted and the amount of liquidity held). The approach looks at the Group's forecast cash flows across all currencies and at longer timeframes than the regulatory rules require. At 31 December 2007, the Group's liquidity portfolio of marketable assets was £60.0 billion (2006 £56.4 billion). The liquidity portfolio is recorded in Treasury and predominantly comprises Treasury debt securities, excluding Grampian and Landale. The assets in the liquidity portfolio are treated in two forms. Firstly, assets which the Group knows to be eligible under normal arrangements with the Bank of England, the European Central Bank and the FRB. Secondly, a substantial pool of high quality secondary liquidity assets that allow the Group to manage through periods of stress taking into account the likely behaviours of depositors and wholesale markets. These approaches are supported by a framework of limits to ensure that the Group is not subject to undue concentrations for either its assets or liabilities and by daily control processes to address both regulatory and internal requirements. In 2007, the primary method of realising the liquidity portfolio for cash has been via repo rather than outright sale.

This framework includes:

- Funding diversity criteria focusing on retail, other customer and wholesale sources;
- Sight to one week and sight to one month mismatch limits as a percentage of total wholesale funding for all major currencies and for all currencies in aggregate;
- Targets on the appropriate balance of short to medium term wholesale funding; and
- Criteria and limits on marketable assets, by asset class for Sterling, US Dollars, Euros, other currencies, and for all currencies in aggregate.

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements.

In addition to day-to-day prudential limits, the liquidity framework has two other important components.

Firstly, the Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis, with formal reporting at least monthly, in compliance with FSA regulations. The cash flow mismatch position considers on balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position.

Scenarios are based on varying degrees of stress and cover both the Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.

An example of a name specific scenario the Group models is a substantial fall in the Group credit rating. In such a scenario, the Group assesses the likely impact on customer deposits and assumes the wholesale markets would be closed to the Group. The Group approach is to hold substantial liquidity assets which would provide sufficient time for management to take appropriate mitigating actions. The Group also models the impact of systemic events across the banking sector. Typically the impact of these is less severe as wholesale markets normally continue to provide some funding and concerted central bank action would be expected to address such market dislocation.

The results of the stress testing are presented monthly to the GFLC. A formal strategic review is presented to the HBOS Board at least annually.

Secondly, the Group has a Liquidity Contingency Plan embedded within the Group Liquidity Policy Statement which has been designed to identify emerging liquidity concerns at an early stage, so that action can be taken to avoid a more serious crisis developing. This is achieved through the use of Early Warning Indicators ("EWIs").

Clear guidelines are set out for the management escalation process in the event of EWIs triggering and the actions to be taken (short and medium term) should such an event take place. Responsibilities for communication with various external parties and contact details of key personnel are also clearly stated.

In response to the market dislocation in the second half of 2007, the GCC has increased the frequency of its meetings and Treasury has introduced additional metrics which are monitored daily and tailored to prevailing market conditions.

Funding

Customer deposit growth and the supply of wholesale funding to the Group has remained strong during the dislocation in global financial markets in the latter part of 2007.

	<i>As at 31 Dec 2007</i>	<i>As at 31 Dec 2006</i>
	<i>(£bn, except %)</i>	
Loans and advances to customers	430.0	376.8
Customer accounts	243.2	211.9
Customer lending less customer accounts	186.8	164.9
Customer accounts as a % of loans and advances to customers	<u>56.6%</u>	<u>56.2%</u>

The wholesale funding capacity of the Group is dependent upon factors such as the strength of the balance sheet, earnings, asset quality, ratings and market position. GFLC assesses the Group funding mix to ensure that adequate diversity is maintained. It is Group policy to manage its balance sheet profile to ensure customer deposits sourced outside Treasury represent a significant component of overall funding, and GFLC directs and coordinates the activities of the Divisions in raising liabilities from a range of sources.

In order to strengthen the Group's funding position, the Group has over the last few years diversified its funding sources and lengthened its maturity profile of market sensitive funding. This has been achieved through:

- Widening the wholesale investor base and product set;
- Building and maintaining a large securitisation programme;
- Accessing the covered bond market;
- Utilising the geographic diversity of New York and Sydney as funding hubs for the Group; and
- Extending the Group's Medium Term Note programmes.

During 2007 the Group's wholesale funding sources were well diversified by instrument, currency and by maturity as shown in the tables below. Tables are prepared on the basis that "retail" is defined using the current statutory definition, *i.e.* administered rate products. Wholesale funding, when issued in a foreign currency but swapped into sterling, is included at the swap exchanged amount. Wholesale funding is shown excluding any repo activity and the funding raised in the names of the conduits.

<i>Retail and Wholesale Funding Sources</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
<i>Instrument</i>				
Bank Deposits	32.9	6.7	27.9	6.6
Deposits from Customers	27.8	5.6	17.1	4.0
Certificates of Deposit	63.1	12.8	42.5	10.0
MTNs issued	42.8	8.7	41.5	9.7
Covered Bonds	23.7	4.8	17.2	4.0
Commercial Paper	16.9	3.4	17.3	4.1
Securitisation	45.9	9.3	47.2	11.1
Subordinated Debt	20.0	4.1	15.4	3.6
Other	4.9	0.9	4.9	1.1
Total Wholesale	<u>278.0</u>	<u>56.3</u>	<u>231.0</u>	<u>54.2</u>
Retail	<u>215.4</u>	<u>43.7</u>	<u>194.8</u>	<u>45.8</u>
Total Group Funding	<u><u>493.4</u></u>	<u><u>100</u></u>	<u><u>425.8</u></u>	<u><u>100.0</u></u>

<i>Wholesale Funding – Currency</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
US dollar	104.5	37.6	87.2	37.7
Euro	79.0	28.4	65.3	28.3
Sterling	69.7	25.1	60.7	26.3
Other	24.8	8.9	17.8	7.7
Total Wholesale Funding	<u>278.0</u>	<u>100</u>	<u>231.0</u>	<u>100.0</u>

<i>Wholesale Funding – Residual Maturity</i>	<i>As at 31 December 2007</i>		<i>As at 31 December 2006</i>	
	<i>£bn</i>	<i>%</i>	<i>£bn</i>	<i>%</i>
Less than one year	164.1	59.0	121.2	52.5
One to two years	21.6	7.8	19.3	8.4
Two to five years	46.3	16.7	46.5	20.1
More than five years	46.0	16.5	44.0	19.0
Total Wholesale Funding	278.0	100.0	231.0	100.0

During the second half of 2007, with the increased cost of term funding, the Group chose to reduce its term issuance and utilise its significant available capacity in the money markets.

However, covered bonds and securitisation issues continue to be important funding sources for the Group with outstandings as at the end of December 2007 of £69.6 billion, an increase of £5.2 billion during 2007 (as compared to 2006). In addition, issuance of Certificates of Deposit (“CDs”) rose to £63.1 billion (2006 £42.5 billion). As at the end of December 2007, £113.9 billion of wholesale funding had a maturity over one year, compared with £109.8 billion at the end of 2006.

Conduits

HBOS sponsors two conduits, Grampian and Landale, which are special purpose vehicles that have invested in highly rated assets and fund via the Asset Backed Commercial Paper (“ABCP”) market. At 31 December 2007, investments held by Grampian totalled £18.6 billion. Grampian is, and always has been, fully consolidated into the Group’s balance sheet. The Group also consolidated £0.6 billion of assets held by Landale. Grampian is a long established, high grade credit investment vehicle that invests in diversified Asset Backed Securities of which, as at 31 December 2007, 99.9% were rated AAA by S&P and Aaa by Moody’s. Grampian has a liquidity line in place with HBOS which covers all of the assets and programme wide credit enhancement is also provided by HBOS. Landale holds both assets originated from the Group’s own balance sheet and third party transactions. Landale has liquidity lines from HBOS and from third-party banks, and therefore the former, but not the latter, are consolidated into the Group’s balance sheet.

In the latter half of 2007, due to the disruption in the ABCP market, there have been occasions when Grampian and Landale (in respect of assets backed by HBOS liquidity lines) have declined to issue ABCP given the unattractiveness of the spreads and maturities available. At these times the Group funded the conduits, on a temporary basis, through the available liquidity lines rather than through the ABCP market.

8. General Insurance & Long Term Assurance Business Risks

The general insurance and long term assurance business contracts underwritten by the Group expose HBOS to both investment and insurance risk.

Insurance risk is the potential for loss, arising out of adverse claims from both life and general insurance contracts.

Investment risk is the potential for financial loss arising from the risks associated with the investment management activities of the Group. Investment risk includes market, credit and liquidity risks. The loss can be as a result of:

- Direct risks relating to changes in the value of Group assets in support of the general insurance and long term insurance contracts;
- Indirect risks arising from policyholder funds where the assets and policyholder liabilities are matched; and
- Indirect risks associated with the management of assets held on behalf of third parties.

The Group Insurance Risk Committee, one of the Executive Risk Committees considers regular reports on specified aggregate insurance risks across all of the Group’s insurance and investment businesses. It oversees the development, implementation and maintenance of the overall insurance risk management framework, covering insurance risk in each business individually, as well as in aggregate.

As part of the overall Group risk management framework, the Group Insurance & Investment Risk Team provides regular support to the Group Market Risk Committee and to the Group Credit Risk Committee on the inter-relationship between insurance risk and investment risks (market, credit and liquidity risks respectively) arising within these businesses, and the development of appropriate policies and standards for the management of those risks.

The majority of the Group’s long term insurance and investment contract liabilities are managed within the HBOS Insurance and Investment Division and Insight Investment with approximately 3% (2006: 3%) operated by the life businesses outside the UK. Day-to-day management of insurance and investment risk is undertaken by management supported by specialist risk functions. Use is made of the statutory actuarial roles, both to help ensure regulatory compliance in respect of the authorised insurance companies in the Group and to help meet Group risk management standards.

8.1 Long Term Assurance

The insurance and investment business that is transacted by the life insurance companies within the Group comprises unit linked business, fixed benefit business (also known as non-profit business) and with-profits business (described as insurance contracts and investment contracts with discretionary participating features ("DPF") written within the with-profits fund).

Several companies within the insurance and investment business transact either unit linked and/or other non profit business, but all with-profits business is underwritten by Clerical Medical Investment Group Limited ("Clerical Medical"), a subsidiary of HBOS Financial Services Limited.

The key characteristics of long term assurance that give rise to insurance and investment risk are its long term nature, the guarantees provided to policyholders, the dependency on the performance of investment markets and the extent to which assets backing the contractual liabilities are matched.

The quality, mix and volume of business have a significant influence on the extent of insurance and investment risk assumed by the Group and resulting profits. The quality of business written is influenced by variations in product terms as well as the average premium size, age and term profile within the particular products. Accordingly, the mix in products written may impact on profits, depending on the nature, extent and profitability of new business in addition to existing business. This risk is managed through the application of clear pricing policies that require full financial assessment for each new product, incorporating consideration of expected hurdle rates of return.

Additionally, variations in administration and development costs may impact the available profit margin within the product charges. To manage this risk, there is a regular process of expense budgeting and reporting with appropriate targets set for new insurance and investment products that are developed.

The risks associated with particular sections of the long term assurance business are set out below.

8.2 Unit Linked Funds

For unit linked funds, including consolidated collective investment schemes, which comprise 77% (2006 74%) of the Group's long term insurance and investment contract liabilities, investors bear the investment risk, with changes in the underlying investments being matched by changes in the underlying contract liabilities. Similarly, the Group manages a number of collective investment schemes where the investors bear the investment risks. The investor selects from a range of investment opportunities available from the Group in accordance with their personal risk appetite and circumstances.

On a day-to-day basis, cash outflows which are necessitated by investors withdrawing their funds are generally met by cash inflows from new investors. In circumstances where funds are contracting, or to meet unusually high levels of withdrawals, the Group sells assets in the fund in order to meet the cash demands with any dealing costs charged to the underlying unit linked fund and consequently the policyholders. The underlying assets in the unit linked funds are subject to credit and market risks in the form of interest rate, equity prices, foreign exchange and other market risks depending on the fund, including movement in property values. These changes are matched by changes in the unit linked liabilities. Accordingly, the Group is not directly exposed to significant liquidity, credit or market risks, although the investors' benefits will vary as a consequence. Decreases in the capital value of unit linked funds (as a result of falls in market values of equities, property or fixed interest assets) will however reduce the future annual investment management charges that will be earned from unit linked business. The Group estimates that if the capital value of the unit linked funds, excluding consolidated collective investment schemes, classified as investment contracts had been reduced, on average by 10% for the year, the profit before tax for the year would have decreased by £22 million (2006 £25 million).

Unit linked products provide some discretion for variation in annual administration charges, and therefore management of variations in expenses may be achieved through variation in charges.

An additional risk the Group faces in respect of unit linked business is the risk that increases to surrender rates for both insurance and investment contracts reduce the value of future investment management charges. Actions to control and monitor this risk include charges applicable on some products where the investor surrenders early, regular experience monitoring, consideration of the sensitivity of product profitability to levels of lapse rates at the product development stage; and initiatives within the relevant businesses to encourage customer retention.

8.3 Non-Profit Business

The Group has a diversified portfolio of life insurance and annuity policies within its portfolio of non-profit insurance contracts, which includes the insurance risk component of unit linked policies classified as insurance contracts. The principal investment risk in respect of the non-profit business is interest rate risk which arises because assets and liabilities may exhibit differing changes in value as a result of changes in interest rates. This may potentially impact on the results and the capital position. The investment risk also includes the risk of increases in corporate bond yield spreads over

government risk free yields or the ratings downgrade of certain securities, both of which reduce the capital value of the bonds. These risks are controlled by processes carried out to help ensure an appropriate level of matching is maintained in the funds so that changes in fixed interest assets backing the non-profit business are substantially mitigated by offsetting changes in liabilities (as the discount rate used in valuing the liabilities is linked to that of the matching assets). These processes include the use of and monitoring against fund mandates.

The ultimate amounts payable under these policies are sensitive to general trends in mortality rates. For annuitants comprising 3% (2006 3%) of the Group's long term insurance and investment contract liabilities, there is a risk that increases to life expectancy through medical advances will prove greater than that anticipated. For protection business, the risk is that an unforeseen event such as a natural disaster will cause a material increase in death rates.

8.4 With-Profits Fund

The insurance and investment business includes the Clerical Medical With-Profits Fund which comprises 17% (2006 20%) of the Group's long term insurance and investment contract liabilities (the "With-Profits Fund"). The With-Profits Fund takes some investment risks with the aim of enhancing policyholder returns but aims to limit payouts to policyholders to that supportable by the With-Profits Fund's assets.

For "unitised" with-profits contracts the Group receives an annual management charge. For "traditional" with-profits contracts, which form the minority of the with-profits fund business, the Group receives one ninth of bonuses declared to policyholders as long as there is a distributable surplus within the fund.

Ordinarily, variations in the capital value of the fund's assets would result in variations in the level of benefits available to the with-profits contract holders and accordingly a variation in the insurance and investment contracts with DPF liabilities. Included in the With-Profits Fund are certain contracts with minimum payment guarantees at certain policy durations and on death. Of these with-profits contracts issued between 1997 and 2001, a significant proportion have guaranteed benefits which are in the money at the balance sheet date. The costs of meeting these guarantees, up to a certain level, are met by charges to the benefits for all with-profits contract policyholders. The amount of these guaranteed benefits, net of charges to be levied on policyholder funds, was less than 1% (2006 1%) of the Group's long term insurance and investment contract liabilities at the balance sheet date. Above this level the costs are met by the free assets of the fund (the assets maintained in the fund which are not held to meet contractual liabilities). There remains a risk that Clerical Medical may suffer an additional charge in exceptional circumstances where even after management action, the fund is unable to meet the costs of guarantees within the fund.

As well as pooling of risks, the other important measures in controlling the investment risk within the With-Profits Fund include having agreed management actions to adjust the nature and extent of investment exposure in response to certain investment conditions; by recognising and holding appropriate levels of risk capital; by restricting holdings to assets which meet admissibility criteria; and by using derivative strategies to reduce downside risk.

Accordingly, other than the secondary impact of the Group's annual management charges and bonuses declared, the insurance and other investment risks (credit, liquidity and market risks) within the With-Profits Fund are generally expected to be borne by the with-profits insurance and investment contracts with DPF policyholders except in the extreme scenarios.

8.5 General Insurance

For general insurance household contracts the most significant risks to claims experience arise from weather events. For repayment insurance contracts the most significant risks arise from changes in economic conditions.

The Group manages its exposure to insurance risk through a strategy which includes limitation of the nature of the risks underwritten and allowance within the price charged for the underlying risks. This allowance for risks is based on both external information and the Group's own experience data. For all classes of insurance there are pricing models that are regularly adjusted for actual claims experience. For household insurance the Group limits its exposure to large weather events through the use of reinsurance.

The majority of claims are reported and settled within 12 months and generally there is limited reserving uncertainty for events before the balance sheet date.

For some renewable contracts (household, travel and some repayment insurance), the longer term exposure to risk is managed in conjunction with the ability to re-price contracts to take account of changes in the level of risk within those contracts.

9. Operational Risk

Operational risk exists in the normal conduct of business. Examples of potential sources of operational risk include fraud, system reliability, human error, failure of key suppliers, IT security, business continuity, change management, operational outsourcing and failure to comply with legislation or regulation.

The Board has approved an Operational Risk Policy that establishes the framework for managing operational risk (the "Operational Risk Policy"). The main components of the Operational Risk Framework include risk and control assessment, internal loss reporting, capture of risk event information, key risk indicator monitoring and evaluation of external events.

The Group Operational Risk Committee is one of the four Executive Risk Committees chaired by the Group Risk Director. It is attended by senior executives from the divisions and group specialist areas. The Group Operational Risk Committee considers the management of issues and exposures, recommends the appropriate capital requirement, approves policies and standards and provides oversight of the operational risk communities.

A key enhancement to the Group's infrastructure has been to focus on the explicit risk management of specialist areas that underpin the Operational Risk Policy. All specialist functions have clear roles defined to help lead the identification, management and measurement of risks relevant to their areas across the Group. The Group Operational Risk Function co-ordinates the specialist areas, designs and maintains Group-wide risk systems and undertakes the detailed modelling required to assess risk exposure.

10. Regulatory Risk

The FSA is the main regulator for HBOS, although the Group's international businesses in the USA, Australia and Ireland are subject to direct scrutiny from the FRB, the Australian Prudential Regulation Authority and The Financial Regulator, respectively.

The Group understands that consumers have an ever-increasing choice of suppliers and products and are more demanding of financial services providers. Consumer lobby groups have also become more active on their behalf. The Group's Customer Contract, which was approved by the Board in November 2005, sets out principles for doing business and is HBOS's flagship response to the FSA's Treating Customers Fairly initiative, supported by ongoing development of procedures across the Group. The objective is to meet the requirements of the HBOS shareholders through meeting the needs of the Group's customers.

The Group is alert to the wider, cumulative picture of regulatory change and utilises centralised expertise in the area of regulatory and legal compliance, specifically to:

- Identify and assess the impact of, respond to and where possible influence the direction of regulatory developments on behalf of the Group;
- Lead the development and monitoring of the application of specific Group-wide policies and standards; and
- Oversee the management, support and co-ordination of the liaison and interaction with Group regulatory stakeholders across all its international businesses.

The impact of regulatory change is reported across all Executive Risk Committees with specific reference to the discipline affected and at Group level to Audit Committee and the Board.

11. Capital Management

It is the Group's policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times.

The Group recognises the impact on shareholder returns of the level of equity capital employed and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on equity possible with greater leverage.

The Group's capital is managed via the Board through the Group Business Plan, with the objective of maintaining both the optimal amount of capital and the most appropriate mix between the different components of capital. The day-to-day management of the Group's capital is delegated to the Group Capital Committee.

The Group's policy is to issue capital in a range of different forms and also from diverse sources to spread the investor base. HBOS raises the non-equity Tier 1 capital and subordinated debt for all the Group's businesses, with the exception of Clerical Medical which is permitted to raise capital separately as part of the overall Group capital plan to spread the investor base for subordinated debt.

The principal forms of capital are included in the following balances on the consolidated balance sheet: called up share capital, share premium account, other reserves, retained earnings and other borrowed funds. Capital also includes collective impairment allowances held in respect of loans and advances for capital assessed under the Basel I Accord.

11.1 Capital Requirements

The FSA supervises HBOS on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the Group as a whole. Individual banking and insurance subsidiaries are directly regulated by either the FSA or their local supervisors, who set their capital adequacy requirements.

Up to 31 December 2007, HBOS was regulated under the EU's Banking Consolidation Directive ("Basel I"). In implementing Basel I, the FSA requires each bank and banking group to maintain an individually prescribed ratio of total capital to risk-weighted assets, taking into account both balance sheet assets and off-balance sheet transactions.

The Group must at all times monitor and demonstrate compliance with the relevant regulatory capital requirements of the FSA. The Group has in place processes and controls to monitor the Group's capital adequacy and no breaches were reported to the FSA during the year. HBOS's capital is divided into two tiers:

- Tier 1 capital comprises shareholders' funds, innovative Tier 1 securities and minority interests, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at Tier 1 capital.
- Tier 2 capital comprises qualifying subordinated loan capital, and unrealised gains arising on the fair valuation of equities held as available for sale. Under Basel I, collective impairment allowances may be included within capital.

Various limits are applied to elements of the capital base. The amount of innovative Tier 1 securities cannot exceed 15% of overall Tier 1 capital, qualifying Tier 2 capital cannot exceed Tier 1 capital, and qualifying dated subordinated loan capital may not exceed 50% of Tier 1 capital. There are also limitations on the amount of collective impairment allowances which may be included as part of Tier 2 capital. From the total of Tier 1 and Tier 2 capital the carrying amounts of unconsolidated investments (e.g. insurance company investments), investments in the capital of banks, and certain regulatory items are deducted.

Risk weighted assets are categorised as either trading book or banking book and risk weighted assets are determined accordingly. Banking book risk weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. Banking book off-balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned weights appropriate to the category of the counterparty, taking into account any eligible collateral or guarantees. Trading book risk weighted assets are determined by taking into account market-related risks such as foreign exchange, interest rate and equity position risks and counterparty risk.

11.2 Basel II

The FSA general prudential sourcebook ("GENPRU") and the FSA prudential sourcebook for banks, building societies and investment firms ("BIPRU") rules were adopted into the Prudential Sourcebook for Banks, Building Societies and Investment Firms with effect from 1 January 2007. This legislative process converted the European Capital Requirements Directive and, therefore, the Basel II Capital Accord, into UK regulation that applies to HBOS.

HBOS elected to adopt transitional arrangements in 2007 and remain on the Basel I rules to determine minimum regulatory capital requirements.

The primary goal of the Group's Basel II programme has always been to optimise the way the Group conducts business through an improved risk management capability. This is integral to the Group's strategy of targeted growth within the Group's overarching objectives of delivering sustainable income streams and generating added shareholder value.

Basel II is structured around three "pillars": minimum capital requirements, supervisory review process and market discipline. The supervisory objectives that form Basel II are to promote safety and soundness in the financial system and maintain at least the overall level of capital within the system; enhance competitive equality; and constitute a more comprehensive approach to addressing risks; and focus on internationally active banks.

Pillar One determines the minimum capital requirements and for HBOS this is divided into two approaches to determining credit risk regulatory capital requirement, with increasing complexity and sophistication.

- *Standardised approach.* This requires banks to use external credit ratings to determine risk weightings for rated counterparties and groups other counterparties into broad categories and applies standardised risk weightings to these categories.
- *Advanced Internal Ratings approach.* Banks use their own internal assessment of both the probability of default and the exposure at default and loss given default.

Basel II also introduces capital requirements for operational risk comprising three levels of increasing sophistication. One level calculates a capital charge based on gross revenues, a second uses three defined percentages based on gross revenues in eight business lines and finally an Advanced Measurement Approach based on the bank's own analysis of potential loss based on operational risk data.

HBOS has FSA approval to use the Advanced Internal Ratings Based Approach (Credit Risk) and Advanced Measurement Approach (Operational Risk) for capital determination purposes with effect from 1 January 2008.

Pillar Two is the supervisory review of a bank's internal assessment of the appropriate level of regulatory capital to hold, consistent with its risk profile and strategy. The FSA has conducted its supervisory review and evaluation process and issued under Pillar Two Individual Capital Guidance to HBOS.

Pillar Three is the appropriate disclosure of risk exposures and risk assessment processes of each firm. Pillar Three recognises that market discipline has the potential to reinforce capital regulation and other supervisory efforts to promote safety and soundness in banks and financial systems. It is the Group's intention to publish full disclosures under Pillar Three as required by BIPRU rules as at 31 December 2008. This is in line with emerging UK and EU consensus that the first disclosures for banks adopting advanced approaches from 1 January 2008 will be published based on year end 2008 data.

The Group continues to promote a prudent and responsible approach to the management of capital. Management and the Board's view of future requirements will continue to be the main determinant of total capital holdings.